The Formation of the Custodian and Settlement Infrastructure of the Russian Financial Market

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The functioning of institutions of the financial markets and their interaction with a view to implementation of the main objectives of the market is provided by one of the constituent elements of the market, namely, the infrastructure of the securities market. The Russian securities market is going through a crucial point and provides a central post-trading infrastructure. In this paper, the author defines the notion of custodian and settlement infrastructure of the financial market, analyzes the modern state of this sub-sector of the financial market, and formulates problems of development of the custodian and settlement institutions of the Russian financial market, in particular in connection with the entry into force of the federal law “On the Central Depositary”. The author defines the place and role of the Central Depositary and its impact on the level of development of the market in general and the formation of the machine in Russia, at the same time, it shows the world experience in building custodian and settlement systems and the integration of the Russian custodian and settlement infrastructure and global stock architecture.

Keywords: custodian, securities market, the Central Depositary, registrars, the National Settlement Depositary, PARTAD (Professional Association of Registrars, Transfer Agents, and Depositaries)

The modern financial market is a complex and multi-faceted system, which sometimes develops rapidly, as at the expense of internal resources as of and for the account of the generated external conditions and incentives. The Russian financial market is an extremely growing and developing market. This paper is devoted to research of custodian and registrar infrastructure as the backbone of financial architecture in developed and developing markets. So we will understand the main definitions, underline the current status, the main problems, the place, and role of the Central Depositary, research the integration processes and the main stream of integration of the Russian custodian and settlement infrastructure and global stock architecture.

The Concept (the Definition) of the Custodian and Settlement Infrastructure of the Financial Market

The backbone of any economic system is its infrastructure, which allows you smoothly operate and develop. Thus, the operation of the financial market connected with the conduct by its participants of the various kinds of professional activity in the market, in particular, the activities of asset management, brokerage activities, and depositary activity. The functioning of institutions of the financial markets and their interaction...
with a view to implementation of the main targets of the market is provided by one of the constituent elements of the market, namely, the infrastructure of the securities market.

At that, the infrastructure of the securities market can be defined as a number of specialized organizations, supporting the activity of the professional participants in the financial markets, and providing the latest necessary services. The infrastructure of the securities market includes the system of market regulation, Depositary and Registrar and settlement and clearing systems, exchange and OTC (Over-The-Counter) Market trading systems, information and personnel systems and agencies. In a wider sense, here also you can enable auditing infrastructure, information infrastructure (rating and information agencies), and developers of specialized information products.

The Depositary-Registrar system is a financial “sub”, which keeps records of the rights on securities as a kind of property and the rights of creditors to debtors, secured by the securities market in all their complexity. The Depositary-Registrar system in the securities market is the totality of the institutions: organizations pursuing depositary activities and organizations carrying out the activity on management of registry of holders of securities (1, The Regulations, 1997).

The main task of the Depositary-Registrar system of the securities market is to act as a “witness”, confirming the presence and nature of the legal relations, which are the subjects of civil turnover in the securities market (we are talking about the relations, connected with the rights confirmed by securities, and the rights to securities as kind of property).

This task is expressed in the following two main (“characteristic”) functions of the Depositary-Registrar system of the securities market:

1. Confirmation of the rights of creditors, expressed in the securities;
2. Confirmation of the property rights (and any other proprietary rights) of the securities as a kind of property.

From this point of view, any person who performs these functions, carries out depositary activities and the referred to as the “Depositary”.

Are only registrars and depositaries involved in the Depositary-Registrar system of the securities market? And is it properly to separate the clearing infrastructure from the Depositary-Registrar system of the securities market?

This is a discussion question.

Settlements on each deal concluded in the financial market consist of two parts: the settlement of securities and settlement of funds. In the author’s opinion, it is impossible to separate accounting and clearing infrastructure, as well as it is impossible to divide into two components of settlements for transactions in the financial market.

In this connection, it is expedient to speak about such a sub-sector of the financial market, as the “custodian and settlement infrastructure” of the financial market, which in fact, is not only a set of accounting institutions (depositaries and registrars), but also the totality of clearing organizations.

Current Status of the Custodian and Settlement Infrastructure of the Russian Financial Market

Modern custodian and settlement infrastructure of the Russian market is at a historic turn. Legally recorded the highest number of efforts to transform the current unsustainable segment of the financial market.
The formation of the custodian and settlement infrastructure corresponds to all world standards of developed markets. Next is the market itself that will stimulate the development of technologies.

From 2010 to 2011, there have been adopted landmark laws:

Firstly, there is the federal law from 07.12.2011 No. 414-FZ “On the Central Depositary” (hereinafter, the Law on the Central Depositary);

Secondly, there is the federal law from 07.02.2011 No. 7-FZ “On Clearing Operations”;

Thirdly, it is the federal law from 21.11.2011 No. 325-FZ “On Organized Trading”.

The initial reaction to the Law on the Central Depositary was ambiguous. Many experts are talking about a split of the market. This is especially felt in the ranks of the professional participants-members of PARTAD (Professional Association of Registrars, Transfer Agents, and Depositaries).

The law introduced a monopoly on the maintenance of exchange settlements and interaction with the registrars as a nominal holder. And indignation of many registrars and depositaries, losing thus identified or for many substantial part of the business, are connected with the restriction of competition in the provision of their professional services. FAS (Federal Anti-monopolystic Service) is not denied, but the state agency would prefer to take a wait and see attitude and monitor the results of the implementation of this law.

With all of this, you cannot deny the significant plus of the law—it simplifies the entry of foreign investors to the Russian stock market and improves the exchange infrastructure.

Adoption of the Law on the Central Depositary has entailed a further detailed work of the Ministry of Finance on the procedure of conferring the status of the Central Depositary. In June 2012, the mentioned document entered into force (2, Order, 2012).

At the moment of receiving the status of a Central Depositary, the applicant not later than December 1 should present the working plan for next year and bring its activities in compliance with the Law on the Central Depositary.

The conditions of suspension and cancellation of the status of the Central Depositary are expected to be introduced at the legislative level.

The following document in the rule-making process followed the adoption of the Law on the Central Depositary, and became the Order of the Federal Service for Financial Markets (FSFM) of Russia from 15.03.2012 No. 12-13/pz-n “On approval of the additional requirements to the order of formation of the committee of users of services of the Central Depositary and Requirements. The regulations on the committee of the users of the services of the Central Depositary” (3, Order of the FSFM, 2012). The committee users of the services of the Central Depositary are the institution through which clients-depositors of the Central Depositary will be able to influence the adoption of such documents, as the terms and conditions of depository activity, tariffs for the services, etc.

For the elapsed time from the moment of occurrence of the first depository in the Russian market, prior to the adoption of the Law on the Central Depositary in the Russian market, formed the only institution that without adoption of the law was seen by the participants of the market as a Central Depositary. The institute became Closed Joint-Stock (CJSC) “The National Settlement Depositary”, the depository, which grew out of depository unit Moscow Interbank Currency Exchange (MICEX), originally created for the service of the accounts of the professional participants-members of the stock exchange MICEX, which kept records of government securities.

The market expects the development of the situation.

Problems of Development of the Custodian and Settlement Institutions of the Financial Market

If the author now tries to identify and formulate the basic problems of development of the custodian and settlement institutions, then clearly we refer exclusively to those of them, which are connected with the entry into force of the new legislation in the period from 2010 to the end of 2012.

The first and probably, the main problem associated with the activities of registrars.

Again, the same question of the conflict of interests of the two kinds of institutions—depositaries and registrars—which is not just that, but largely bare in connection with the introduction of the Central Depositary, for which introduced monopoly on the opening of accounts of the nominal holder in the registers on a large number of securities. In connection with reduction of the range of clients, as well as in connection with the introduction of certain procedures of interaction between the Registrar and the Central Depositary, registrars have to expand the spectrum of provided services, to revise the conception of running your own business and its positioning in the market, actually reasserting oneself its place in the Depositary-Registrar system of the financial market.

By the government of the concept of an international financial centre in Russia, it implies the creation of a centralized Depositary-Registrar system. And any centralized system—not necessarily financial—has some of the kernel. And that is the core of the system of accounting and settlements which will become the Central Depositary.

What will allow registrars to remain in the market?

Such an infrastructure unit, as the registrar, the need of the market, otherwise the chain of interaction “the issuer-the registrar-a Central Depositary-custodian-broker-investor” may be broken, as a consequence, lead to violations, failures, and even in the blocking of the work of the whole infrastructure.

In spite of the fact that in the law, there are certain norms, which may be freely interpreted by the market participants, as priority issues that require attention from the current perspective can be identified such as:

(1) Unification of operational standards for all market participants;
(2) Formation of clear instructions regarding the technical implementation of operations;
(3) Approval of control procedures;
(4) Provision of operational interaction in carrying out of corporate actions.

Not sufficiently clear point is issuer’s access to information from the registry. Why the issuer, responsible for its shareholders, dealing with corporate issues, does not have the right to receive the information about all its shareholders at any time?

If these problems will not be solved, the Central Depositary will become the second service organization for the issuer. Question: Whether is it necessary to the market? This will lead to the concentration of all operations on a single party and the concentration of all risks.

As part of the development of electronic document circulation between the registrar and the issuer has been prepared, and discusses by the professionals of the market of the bill on amendments to the law “On joint stock companies” (5, Federal Law, 2012), which provides the opportunity to conduct a series of procedures,
connected with the preparation and holding of the general meeting of shareholders, in electronic form.

Still one of the current problems is the problem of correlation of the standards of depositary activity of the national Central Depositary of the Russian market to the international depositary systems.

One of the last and the main issues is the question of competition, which also makes the boiling market participants.

The Federal Antimonopoly Service of Russia has expressed their comments during the discussion of the draft of the Law on the Central Depositary. However, they remained without attention and FAS took a wait-and-see policy. After the adoption of the law, the FAS will oversee its implementation. In case there are risks associated with the restriction of competition, then the FAS will make a decision about further actions.

It should be noted that for the past period of development of the Russian financial market from the beginning of the 90s of the last century to the current historical moment of creation of Institute of the Central Depositary, we have made a huge breakthrough that developed economies have done for centuries. In comparison with the problems behind the decision of the current issues, it looks a lot easier.

**Place and Role of the Central Depository and Its Impact on the Level of Development of the Market in General and the Formation of the International Financial Center in Russia**

Perfect model of infrastructure, which is good for all participants of the market, there is no and it is a fact. Each market develops systems that have been formed in accordance with country-specific historical factors, etc. And any of them have own “pros” and “cons”. But the process of integration of the capital market dictates its own conditions. For efficient cooperation in the international financial market, it requires a certain set of correspondences to local markets. The development of these correspondences, as well as the definition of approaches and recommendations for market participants engaged in various international organizations, associations, and unions. Among them, there are Group of 30, European Central Securities Depositories Association (ECSDA), International Organization of Securities Commissions (IOSCO), International Social Securities Association (ISSA), The Giovannini Group, Bank for International Settlements (BIS), Committee for Payments and Settlement System (CPSS), European Central Bank (ECB), etc.

If you try to define the place and role of the Central Depositary in the infrastructure of the financial market, according to the recommendations of the international professional associations and groups of specialists [in particular, a Group of 30 (6, Group of 30, 2012)], we are talking about a financial institution with a certain functionality.

The main kinds of activities of the Central Depositary from the point of view of the world experience can be classified as follows:

1. Storage of documentary securities as in their own storage facilities and in other Central Depositaries, custodian banks, and the transfer agents;
2. The maintenance and management of a computerized system for accounting of securities and cash;
3. Keeping the cash accounts of customers and implementation of multi-currency transfers in the relevant national currency;
4. Delivery or transfer of securities against simultaneous payment in accordance with the instructions of the client;
5. Collection and distribution of dividends, interest income and the amounts of redemption of securities on behalf of its customers on their accounts;
(6) Performance of functions of a nominee for clients on registered securities, adopted for the accounting of the Central Depositary;

(7) Maintain relations/relations with the Central Depositary of securities in other markets to conduct international operations participants.

The centralized system is needed, but the mechanisms of its formation can be absolutely different.

The law marked a new stage of development of the custodian and settlement infrastructure of the securities market—stage of simplifying the calculations, increasing of efficiency of accounting, and reducing the risks and costs of all its participants.

It defined the legal status of the Central Depositary, requirements, and its activities, functions, and the basis of the interaction with other participants of the securities market.

The basic articles of the new regulation:
1. The emergence of the Central Depositary in the securities market.

The legislator has given the Central Depositary of a number of exclusive features designed to ensure the stability and openness of the Russian stock market, such as:

(1) Perform the functions of the Settlement Depositary;

(2) Exercise the functions of the nominal holder in the registers of holders of securities of issuers who are obligated in accordance with Art. 30 of the federal law “In securities market” to disclose information in the form of material facts;

(3) Carrying out the functions of the nominal holder in the register of owners of investment units or mortgage certificates, if the rules of trust management provide the possibility of their public circulation;

(4) Opening of the deposit accounts of the foreign nominal holder for foreign organizations, which are international centralized systems of accounting of rights on securities and (or) settlements on securities or the Central Depositary, carrying out securities settlements by results of trades in foreign exchange, other regulated markets or clearing;

(5) Storage of bonds of the bearer bonds with mandatory centralized custody to be admitted to public circulation.

2. Changes in the order of implementation of activities of professional participants of the securities market.

3. Ensuring the confidentiality of information.

4. Disclosure of information on the final beneficiaries of ADR/GDR issued on shares of Russian issuers.

Thus, Moscow seven-league strides to become an international financial centre.

Integration Processes and Tendencies of Development of the Custodian and Settlement Institutions

The basic integration processes that have taken place in recent years in the Russian market concerned the basic operators of the trading and custodian and settlement infrastructure currently being completed. These two processes took place publicly and each specialist of the market knows about them.

The first process is the integration of stock exchanges of Russian Trading System (RTS) and MICEX.

The second process is the integration of post-trading systems of the two above mentioned groups.

The end of 2012 will mark the completion of these integration processes.

The second process involves the integration of the three major professional participants of the market
CJSC “NSD” (hereinafter—the NSD), CJSC “DCC (Depositary-Clearing Company)” (hereinafter—the DCC), and the Non-banking Credit Organization (NCO), “RTS Settlement Chamber” (CJSC) (hereinafter—SP RTS). The process of integration takes place in accordance with the strategic initiatives of groups of MICEX and RTS on the creation of the united stock exchange.

The aim of integration is the increase of efficiency and competitiveness of the Russian post-trading infrastructure, creation on the basis of the merged companies of the Central Depository of Russia, and the leading settlement depositary institute in the Russian stock market.

The combined company—NSD, in the course of the integration of NSD, it first will be the second settlement depositary markets of the ex-RTS, then the only settlement depositary and settlement bank of the united stock exchange, and after that will fully serve its own customers and clients of DCC at the same time.

Corporate governance of the combined company will be carried out on the basis of the principles set forth in the stockholders’ agreement in respect of the NSD, concluded by June 30, 2011 (7, NSD, 2011).

The principles of integration:
(1) Ensuring business continuity;
(2) Maximum full consideration of the interests of clients of the integrated companies;
(3) Joint work of the companies;
(4) Transparency of the process of integration;
(5) Collegiality of decision-making.

Integration stages:
It is supposed at first, there will be operational integration, which can be divided into four main stages:
(1) Launching the mechanism of integration;
(2) Translation of settlement business DCC in NSD;
(3) The beginning of the operation in the mode of the combined company;
(4) Development of the united company in accordance with the approved strategy.

At the end of the year, it is planned to finally solve the question of the legal status of DCC.

The main advantages of integration for the participants of the market:
(1) The creation of a single product line;
(2) Increase of efficiency of activity and the reduction of costs of market participants.

Terms of the integration of NSD and DCC:
The integration process involves a number of key milestones and dates:
(1) II quarter of 2012—the beginning of performance of functions of a settlement depositary on the part of NSD on the market standard, the preservation of the depositary functions of a settlement depositary on the market standard (T + 4) in parallel DCC with the NSD, as well as the function of an authorized depositary for trading on the main market of MICEX (T + 0);
(2) September 3, 2012—termination by the DCC fee schedule the execution of functions of a settlement depositary for the standard market, the preservation of the depositary functions of the authorized depositary for trade in the markets of standard and core, as well as stops acceptance of securities as collateral assets transactions. NSD becomes the only settlement depositary of the joint exchange for these markets;
(3) October 1, 2012—the beginning of the provision of NSD services for settlements on the conditions of DVP (please add the full name) in a currency (the launch of services similar to that available in DCC). Parallel maintenance of the two payment schemes DVP-NSD and DVP-DCC bridge;
(4) December 1, 2012—termination by the DCC rendering services of DVP-DCC bridge.

With the account of requirements of the Law on the Central Depositary to the candidate for the status of the Central Depositary, at the present time, the only bidder is an NSD, it meets all requirements to the candidate for the status of the Central Depositary.

The third integration process about which the market spoke in the autumn—creation of a mega-regulator—unification of the Federal Service for Financial Markets and the Bank of Russia.

The Place and Role of the Custodian and Settlement Institutions in the Global Stock Architecture

What is the global stock architecture?

The global stock architecture is a huge reservoir of the global financial market, on which depends the viability and the continuous development of the market, financial institutions, financial instruments, and which consists of two main elements: the network of stock exchanges (trading systems) and the international custodian and settlement system (post-trading systems). At the present time in the world economy formed the structure of the capital markets, within which there are two types of trading systems: global and regional. Each type has its own market niche and economic specialization.

What is the role of the custodian and settlement institutions in the global stock architecture? The quality of the custodian and settlement system in any developed or developing market determines the amount of the transaction costs and competitiveness of trading systems.

The functions of the accounting and settlement systems in the global stock architecture:
(1) Confirmation of rights of investors on financial assets;
(2) Accounting of financial assets;
(3) Settlements on transactions with financial assets;
(4) Clearing of financial liabilities arising from transactions with financial assets;
(5) Netting of financial obligations;
(6) Payments related to market transactions with financial assets.

Modern Models of the Custodian and Settlement Systems

Analyzing the developed financial markets and systems of these markets, we can distinguish several types of organization and construction of the custodian and settlement systems.

European German model completes the vertical integration of trading and post-trading operations in the context of commercial companies. Such a structure is characteristic for the markets of Italy, Germany, and Spain. Exchange controls all stages of the business process (clearing, settlement, and custody), owning the controlling package of shares in commercial organizations. In the year 2000, the German Stock Exchange acquires International Depositary Cedel and combines it with the German Central Depositary (in which it already owned a controlling package of shares) in the international Central Depositary Clearstream. She also owns the clearing organization Eurex Clearing. The German Stock Exchange is a company with a broad shareholder base. In Italy and Spain, the national stock exchange is managed by a syndicate of national banks.

European English model is horizontal integration of commercial companies. The most striking example is the clearing organization CREST, which is the Central Depository for the British and Irish markets and is controlled by the participants-users. In 2001-2002, Euroclear Bank teamed up with Sicovam (France), Negicef
Formed the holding company of a Euroclear ED in the national and international CSD is composed as subsidiaries. In 2003, the English LCH has teamed up with the French Clearnet and the Dutch clearing organization into a single company LCH.Clearnet. Now Euroclear Group includes a number of companies, providing settlement and custody services in the United Kingdom, France, the Netherlands, Belgium, and other countries. The merger of LCH and Clearnet is seen as an important step toward the creation of a pan-European clearing organization. In the past, the big work was conducted on the formation of the unified system platform. Also, the consolidation of the settlement systems of Belgium, France, the UK, and Ireland was maintained. This successfully completed project will serve as a stimulus for the merging of the Central securities depositories on a wide scale, which would significantly reduce the costs of international transactions. The developed standards could become the basis for a large European project. Works on the creation of a common platform of the Central Depositary for the exchange of all countries of the Euroclear operator were completed in 2011 (8, Euroclear, 2012).

The American model is a vertical integration of post-trading services in the framework of the non-profit organization. It is characteristic for the USA, where Brussels (the Depository trust and clearing Corporation, formed in 1999) at the same time controls the Central Clearing Counterparty (NSCC) and the Central Depositary (CSD) for all trading systems (shares) of the country. These three legal persons have the same group of managers and a single board of directors, as well as the united corporate services (legal, financial, and audit). The existence of one of the clearing organization was challenged in court on the basis of the antitrust laws of the United States. However, the court decided that the competition is of a secondary importance in comparison with the efficiency and stability of settlement and clearing infrastructure. Today, the structure of the stock markets in the United States is characterized by competition exchanges and trading platforms in a Central Clearing Counterparty and the national Central Depositary.

To what model does the Russian financial market come?

The conditions of the world financial center of the Russian market and its accounting and settlement infrastructure, in the author’s opinion, will be able to demonstrate the most efficient in the conditions of formation of horizontally integrated system.

The current stage of development of our infrastructure is based on integration processes and the centralization of the accounting system, the most consistent with this model.

The Integration of the Russian Custodian and Settlement Infrastructure and Global Stock Architecture

The Russian stock market is largely integrated into the global financial system. According to experts, a few years ago up to 80% of all deals on the shares of Russian companies was performed on foreign exchanges in London, Frankfurt, and New York. Recently, thanks to the vigorous efforts of the FSFM of this figure fell to less than 50%. The share of “foreign” money in the Russian stock market remains in the range of 70%-75%. As in Russia is absent the Central Depositary, and existing settlement depository does not have direct links with the Central Depositaries of developed countries, the de facto integration of the Russian stock market in this system so far has been through and under the control of the transnational banks and global custodians. As the reform of settlement and clearing systems, as well as the creation of a Central Depositary, they will increase the competitiveness of the Russian financial market. With the advent and development of Institute of the Central Depositary and the formation of relations with the Central Depositaries of other countries will have an
additional channel for implementation of cross-border transactions and integration into the world system of the Russian market, undoubtedly, that will have a positive impact on the development of all sectors of the Russian economy.

It is with this purpose of Part 4 of Article 25 of the Law on the Central Depositary condition stipulated on the opening of the July 1, 2012 accounts of the foreign nominal holder of foreign organizations included in the list approved by the FSFM and the relevant following requirements:

(1) Is an international, centralized system of accounting of rights on securities and (or) settlements on securities;

(2) Are in accordance with the personal law of the Central Depositary of securities and (or) perform calculations in securities on the results of trading on foreign stock exchanges or other regulated markets or carry out clearing of the results of such trades.

The discussion of the issue of access to the Russian market of Western institutions began in the second quarter of the current year.

The largest representatives of these systems are Euroclear Bank SA/NV (Belgium) and Clearstream International SA (Luxembourg).

In August, the Federal Service for Financial Markets of July 27, 2012, No. 12-65/PZ-n “On approval of the list of foreign organizations, which the Central Depositary shall open a depo account of a foreign nominee”, was registered by the Ministry of Justice of the Russian Federation. This order lists 67 foreign organizations.

Conclusions

So, now the Russian market is living with the Central Depository CJSC “NSD” for two years already. And a new era, not be afraid of this word, the development of the Russian market will show us the readiness to the formation of an international financial centre on the basis of laid the foundations of the custodian and settlement institutions.

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