EUROPEAN CENTRAL BANK

OPINION OF THE EUROPEAN CENTRAL BANK

of 22 February 2006

at the request of the Cypriot Ministry of Finance
on a draft law amending the Cyprus Securities and Stock Exchange (Central Depository and Central Securities Registry) Laws of 1996 to 2005

(CON/2006/9)

Introduction and legal basis

On 7 February 2006 the European Central Bank (ECB) received a request from the Cypriot Ministry of Finance for an opinion on a draft law amending the Cyprus Securities and Stock Exchange (Central Depository and Central Securities Registry) Laws of 1996 to 2005 (hereinafter the 'draft law').

The ECB's competence to deliver an opinion is based on Article 105(4) of the Treaty establishing the European Community and on the fifth and sixth indents of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[1], as the draft law relates to payment and settlement systems and to rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1 Purpose of the draft law and general observations

1.1 The ECB understands that the objective of the draft law is to enable the Central Depository and Central Registry (CDCR) for securities listed and traded on the Cyprus Stock Exchange (CSE) to operate more flexibly. This would be achieved by delegating to the Council of the CSE (hereinafter the 'CSE Council') the power to regulate certain technical issues relevant to the management of the CDCR's business by means of 'Regulatory Decisions'. Until now, such issues have been dealt with by means of either CSE 'Council Regulations', which are subject to the endorsement of the Cypriot Council of Ministers and the approval of the House of Representatives[2] or CSE 'Council Decisions', which are subject to the approval of the Cyprus Securities and Exchange Commission. In this context, the ECB understands that the intention underlying the draft law is that the CSE

1 OJ L 189, 3.7.1998, p. 42.

2 See section 192 of the Cyprus Securities and Stock Exchange Laws of 1993 to 2005.

Council should have the power in future to regulate technical matters only, while other issues will continue to be regulated by law.

1.2 The ECB notes that the CSE Council is responsible for managing and operating: (i) the CSE, a public law-regulated market that operates subject to the supervision of the Cypriot Minister for Finance[3]; and (ii) the CDCR[4], which operates as a division of the CSE rather than as an independent legal entity. Members of the CSE Council are designated by the Minister for Finance and appointed by the Council of Ministers[5].

2. Corporate governance considerations

2.1 The changes that the draft law introduces to the decision-making process within both the CSE and the CDCR have important implications for the latter's governance and supervision, which the draft law does not directly address. As the CDCR is the central securities depository (CSD) for all Cypriot book-entry securities, its governance arrangements are of a significance that goes beyond corporate law. The ECB therefore makes a few observations relevant to the supervision of payment and securities clearing and settlement systems. These observations are also in the spirit of the future implementation of Directive 2004/39/EC on markets in financial instruments[6] (MiFID), and in particular of Articles 36 to 47 thereof. The ECB emphasises these observations are offered as policy recommendations only, not as a statement of legal requirements.

2.2 As CSDs combine the provision of final settlement with the recording of changes in legal title resulting from transactions in securities, they should identify, monitor and assess sources of risk.

2.3 Regardless of a CSD's status under national company law or of the national corporate governance requirements applicable to it, a CSD should adopt the highest corporate governance standards or best practices recommended for listed companies and ensure that they are effectively implemented. These may include traditional corporate governance mechanisms, (e.g. the appointment of non-executive directors and the use of specialised board committees, such as an audit committee), or mechanisms specifically developed for securities settlement systems, (e.g. the use of board advisory committees or public consultation documents). It is noted that a CSD should disclose adequately its corporate governance arrangements to enable its participants and the competent public authorities to assess how to prevent, resolve or mitigate conflicts of interest among owners, the CSE Council and CSD participants, and how to safeguard the public interest. Finally, corporate

3 *Ibid*, sections 3(1) and (2), read in conjunction with section 7(1). State supervision is exercised through the Cyprus Securities and Exchange Commission.

4 *Ibid*, section 9, read in conjunction with section 3 of the Cyprus Securities and Stock Exchange (Central Depository and Central Securities Registry) Laws of 1996 to 2005 (hereinafter the 'CDCSR Laws'). Accordingly, the CSE Council supervises their operation, manages their resources and is responsible for implementing their business strategy.

5 *Ibid*, section 11(1).

6 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ L 145, 30.4.2004, p. 1).

governance arrangements for CSDs should be subject to adequate regulation and oversight. Regulators, central banks and competition authorities should institute policies the combined operation of which ensures that services are provided at a fair price to participants under equitable conditions of access.

3 Powers delegated to the CSE Council under the draft law

3.1 Section 2 of the draft law amends section 2 of the CDCSR Laws entitled 'Interpretation' to provide that '"Regulatory Decision" means the decision of the [CSE] Council containing regulatory content, issued in accordance with the provisions of this Law and which is published in the Official Gazette of the Republic'. It follows from the definition of the term 'Regulatory Decision' that the powers which the draft law confers on the CSE Council are conceived as being regulatory powers of general applicability and that rights and obligations imposed under Regulatory Decisions issued by the CSE Council would bind all regulated market participants[7], not contractually, but as a matter of law.

3.2 The ECB would remind the consulting authority that, in view of the obligation incumbent on Member States to consult the ECB on any draft legislative provision within its field of competence pursuant to Decision (EC) No 98/415, and taking into consideration the vague nature of the delegation to the CSE Council, it will be necessary to submit to the ECB for consultation all significant secondary legislation[8], including Regulatory Decisions, issued by the CSE Council on the basis of the powers delegated to it under the draft law before such legislation is adopted.

4 Scope of delegation under the draft law

4.1 The ECB notes that, while the contents of the Regulatory Decisions to be issued by the CSE Council under the powers delegated to it pursuant to the draft law cannot be anticipated, several of the provisions of the draft law – in particular sections 13, 15, 19 and 22 – confer broad decision-making powers on the CSE Council in connection with matters not directly related to the management and operation of the CDCR[9]. These powers, *inter alia*, affect: (i) the property rights of owners of securities registered with the CDCR; (ii) the finality of the settlement of transactions entered into in respect of securities listed and traded on the CSE; and (iii) financial stability[10]. The

7 This refers to CSE Members (brokerage firms), issuers of securities listed and traded on the CSE and investors.

8 The ECB draws attention to its 'Guide to consultation of the European Central Bank by national authorities regarding draft legislative provisions' which states on page 14 that '[T]he duty of consultation is not limited to draft legislative provisions which are destined to be adopted by a parliament. Decision 98/415/EC covers all types of legally binding provisions, including secondary legislation, as well as binding acts of general applicability of [national central banks] or supervisory authorities (where these bodies have regulatory powers)'.

9 The ECB notes that section 3 of the CDCSR Laws, apparently limits the CSE Council's powers to the 'creation, management and administration of [the CDCSR]'.

10 Section 19 of the draft law which, *inter alia*, confers on the CSE Council the power to establish and operate a 'fund' and to determine the contributions to be made by CSE members and/or depositories and the giving of guarantees or security by the CSE Members and/or the depositories, to ensure the clearing and settlement of stock exchange transactions.

ECB notes that, as Cyprus has implemented the Settlement Finality Directive (SFD)[11], the draft law could further clarify that settlement finality issues are governed by the national law implementing the SFD[12], and that it is only on technical issues (including deadlines, transfer of funds issues, etc.) that the CSE Council will enjoy decision-making powers. The same principle should apply to issues affecting the property rights of CSE Members and their clients, which are already governed by national law. Overall, the ECB recommends that the scope of delegation to the CSE Council should be restricted to technical issues only.

4.2 The ECB considers that section 20 of the draft law, which empowers the CSE Council to stipulate, by means of Regulatory Decisions, the conditions for provision of the services of a custodian ('depository'), is *prima facie* inconsistent with the freedom to provide services and the 'home country control' principle enshrined in the Investment Services Directive (ISD)[13].

4.3 Regarding the exercise, under the draft law, of broad decision-making powers by the CSE Council, the ECB would also draw attention to the provisions of Articles 34, 36, 46 and 48 of the MiFID on regulated markets and competent authorities[14]. In view of the future implementation of the MiFID in Cyprus, certain amendments to the draft law may need to be considered.

5. Assessment of the CDCR against the Eurosystem user standards

5.1 Because Cyprus has not yet adopted the euro and the CDCR is not used for Eurosystem operations**,** the Eurosystem has not assessed the CDCR against the Standards for the use of EU securities settlement systems in ESCB credit operations (known as the 'Eurosystem user standards')[15].

5.2 The ECB considers that sections 3, 5 (on the limitation of the CSE's responsibility) and 9 of the draft law are *prima facie* inconsistent with the Eurosystem user standards.

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11 Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (OJ L 166, 11.6.1998, p. 45).

12 Law 8(I)/2003 on settlement finality in payment and securities settlement systems (Official Gazette of the Republic, No 3679, 31.1.2003). See ECB Opinion CON/2005/28 of 10 August 2005 at the request of the Central Bank of Cyprus on a draft law amending the Settlement Finality in Payment Systems and Securities Settlement Systems Law of 2003.

13 See Titles V and VI of Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field (OJ L 141, 11.6.1993, p. 27). Directive as last amended by Directive 2004/39/EC (OJ L 145, 30.4.2004, p. 1). Pursuant to the ISD, the competent home Member State authorities are responsible for the prudential supervision of investment services firms. However, responsibility for implementing the rules of conduct and for monitoring compliance with these rules remains within the competence of the host Member State, which, when applying them, has to respect the principle of the public interest.

14 The MiFID was originally intended to be transposed into national legislation after the standard period of two years from adoption (April 2006). In June 2005, the Commission presented a proposal to extend the transposition deadline for Member States and the compliance date for regulated firms to October 2006 and April 2007, respectively.

15 Published in 1998, the Eurosystem user standards have been regarded as de facto common standards for EU securities settlement systems. Nevertheless, they are not intended to be a comprehensive set of standards for the oversight or supervision of securities settlement systems. The standards are available on the ECB's website at http://www.ecb.int/home/html/index.en.html.

6. Additional comments

6.1 Section 19 of the draft law amends section 24 of the CDCSR Laws entitled 'Certain issues defined by a decision of the Council' to, *inter alia*, provide that '(f) … the currency in which stock exchange transactions are conducted in and any other related matters regarding currency exchange rates' will be determined by means of Regulatory Decisions issued by the CSE Council. The ECB invites the legislator to clarify in the draft law whether the purpose of this amendment is to enable the CSE Council to designate the euro as a reference unit for transactions in the context of the planned common trading platform between the CSE and the Athens Stock Exchange, or to institute the euro as the settlement currency for such transactions. Whilst the use of the euro as a trading unit of account in a common platform raises no concern, its use as a settlement currency would need to take into account that, before Cyprus adopts the euro, it qualifies in Cyprus as a foreign currency, and thus is subject to liquidity and credit risks. This may have implications for the smooth settlement of securities transactions.

6.2 Whatever the purpose of the designation of the euro, the ECB would remind the consulting authority that the CSE Council's power under section 19 of the draft law to define 'matters regarding currency exchange rates' by means of Regulatory Decisions will become redundant (as far as the euro is concerned) once Cyprus has adopted the euro, and draws attention to the fact that the ECB publishes the euro foreign exchange reference rates on its website based on the daily concertation procedure between central banks within and outside the European System of Central Banks.

6.3 Given the urgency of the present consultation, this opinion raises general issues only. The ECB reserves the right to raise further issues on a future occasion.

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 22 February 2006.

[signed]

The President of the ECB

Jean-Claude TRICHET