Market practice for settlement of third-party trading via T2S and VP (application of the derogation rule) after 29 October 2018

Contents

1. Background

As of 29 October 2018, securities trading in DKK and EUR[1] must as a general rule, if the securities are issued or registered with VP Securities A/S ("VP"), be settled via the pan-European securities settlement platform Target2Securities ("T2S"), which is a platform that provides Euro delivery-versus-payment ("DVP") settlement in central bank money, i.e. if the purchaser and the seller use two different cash providers (third-party trading[2]). However, T2S settlement is only possible if the trading concerns T2S eligible securities[3].

Free-of-payment ("FOP") settlement of securities and DVP settlement of trading between two parties using the same cash provider will also be available via VP's settlement platform after 29 October 2018.

As an exception to the above, in its T2S participation agreement, VP has been allowed to execute up to 5 per cent of all DVP settlements taking place via VP (i.e. either on VP's own or T2S's platform) as DVP settlements in central bank money via VP. In this memorandum, this exception is referred to as the "derogation rule".

The purpose of this memorandum is to describe the market practice for settlement of third-party trading via T2S after 29 October 2018.

In addition, the memorandum describes the market practice for when to settle third-party trading under the exception (the derogation rule) via VP after 29 October 2018. The market practice thus describes the standard which – unless otherwise agreed by the settling banks – must be observed in order to ensure a match. The market practice has been designed to avoid that the 5 per cent threshold is exceeded.

The market practice has thus been prepared to assist the settling banks with ensuring that both of them issue instructions against the same custody accounts – thus ensuring that the settlement instructions match.

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1) And any currencies that will also be available for T2S settlement after 29 October 2018.
2) This memorandum uses the term "third-party trading" to describe the situation where a customer holds a custody account with one bank (Bank Y), but engages in trading with another bank (Bank Z). The customer holds an account with Bank Y or a third bank (Bank X), and either Bank Y or Bank X thus acts as the customer's cash provider. Bank Z is its own cash provider. The customer and Bank Z (the parties to the transaction) thus use two different cash providers (regardless of whether the bank acting as cash provider for the customer is Bank Y or Bank X).
3) Reference is made to VP's Securities Register.

The market practice has been prepared by a task force under Finance Denmark and the Danish Securities Dealers Association consisting of member representatives. VP has provided assistance during the process and participated in a number of the task force meetings.

In case of any questions about the market practice for settlement of third-party trading via T2S and VP (compliance with the derogation rule), please contact Finance Denmark or the Danish Securities Dealers Association.

The market practice document will be updated on a regular basis and available on the associations' website http://financedenmark.dk/the-danish-securities-dealers-association/about-the-danish-securities-dealers-association/standards-and-reccomendations/

2. Market practice for settlement of third-party trading

As already mentioned, all trades using DVP settlement in central bank money (i.e. where the purchaser and the seller use two different cash providers) must as a general rule be settled via T2S after 29 October 2018.

As an exception to the above, however, in its T2S participation agreement, VP has been allowed to execute up to 5 per cent of all DVP settlements taking place via VP (i.e. either on VP's own or T2S's platform) as DVP settlements in central bank money via VP (the derogation rule).

The derogation rule is based on the following formula:

$$\frac{\text{Number of DVP settlements in central bank money via VP}}{\text{Total number of DVP settlements via VP and T2S}} < 5\%$$

In order to avoid that the 5 per cent threshold is exceeded, the industry has prepared the following market practice for which transactions are to be settled on a DVP basis in central bank money via T2S and VP, respectively:

2.1. Market practice for settlement of third-party trading via T2S

After 29 October 2018, the following scenarios are envisaged with regard to settlement of third-party securities trading via T2S:

1. **The 1:1 model**
   The account manager may on its own behalf or on behalf of its customers open a segregated T2S custody account, if relevant in addition to an existing VP custody account. **Example:** The customer has opened a segregated T2S custody account. The T2S custody account and related account have been opened with Bank Y. The customer engages in trading with Bank Z. Settlement is effected in T2S between the customer's segregated T2S custody account and Bank Z's T2S custody account. The pre-advice from Bank Y is generated on the basis of release/instructions, see Figure 1 in Appendix 4.

2. **The omnibus model**
   The account manager may open one or more T2S custody accounts in the form of omnibus custody accounts and have groups of VP custody accounts (such group to be defined by the account manager itself)

"point upwards to" one of these T2S custody accounts. If the account manager wishes to introduce the option of a pledge, it must do so via a VP omnibus custody account.[4] **Example:** The customer has opened a segregated VP custody account that "points upwards to" a VP custody account (omnibus custody account), which again "points upwards to" a T2S custody account (omnibus custody account). The customer's segregated VP custody account and related account are with Bank Y, but the customer decides to engage in trading with Bank Z or Bank Z's customer. Settlement is effected in T2S between Bank Y's T2S custody account (omnibus on behalf of customers) and Bank Z's T2S custody account, see Figure 2 and Figure 3 in Appendix 4.

The concept of "T2S professional", which has been used in the transitional solution (12 September 2016 - 29 October 2018) will be phased out after 29 October 2018. After that date, there will no longer be any distinction between a "retail customer" and a "T2S professional". The above scenarios for settlement of third-party securities trading in DKK and EUR thus apply to all third-party trading.

2.2. Market practice for settlement of third-party trading via VP

Model a
The market practice is applicable where the trading does not involve T2S eligible securities (e.g. SKAGEN Fondene) or if the cash provider and the custodian bank are not identical. This could be transactions where one of the parties uses one account manager (Bank Y) as its custodian bank and another account manager (Bank X) as its cash provider, and where trading with a third account manager (Bank Z) is to be settled via VP, although settlement is effected on a DVP basis in central bank money. The pre-advice is generated on the basis of release/instructions, see Figure 4 in Appendix 4.

Model b
Transactions between two parties where one of the parties (Bank Z) has been granted VP authority to the other party's custody account (which is with Bank Y) are to be settled via VP although settlement is effected on a DVP basis in central bank money. The pre-advice is generated on the basis of release/instructions, see Figure 5 in Appendix 4.

Model c
Transactions where one of the parties (the customer) has a custody account and trades with Bank Z – and has a regular account with Bank Y – must be settled via

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4 See also Appendix 2.

VP although settlement is effected on a DVP basis in central bank money. The pre-advice is generated on the basis of release/instructions, see Figure 6 in Appendix 4.

The market practice has been designed with the aim of staying below the 5 per cent threshold. Observance of the derogation rule depends on the settlement effected by the individual market participant.

Settlement via VP takes place via VP custody accounts, including the custody accounts which have already been opened with VP and which, after 29 October 2018, will only be available for settlement via VP.

For more information about match criteria and information required for settlement of third-party trading via VP using the derogation rule, **see Part 3**.

3. Match criteria and required information

3.1. Match criteria for settlement via VP (using the derogation rule)

When Bank Z generates a pre-advice, the customer in Party 1 must be identified using Bank Y's account manager/BIC + the customer's BIC – if the customer does not have a BIC of its own, the customer's VP custody account with Bank Y must be stated. The pre-advice is FH-PR. Bank Y must match this pre-advice.

See also the instructions **enclosed** in **Appendix 1** for an exemplification of VP matching.

3.2. Match criteria for settlement via T2S

The 1:1 model

When Bank Z generates a pre-advice, the customer in Party 1 must be identified using Bank Y's account manage/BIC + the customer's BIC – if the customer does not have a BIC of its own, the customer's T2S custody account with Bank Y must be stated. The pre-advice is FH-PR. Bank Y must match this pre-advice.

The omnibus model

When Bank Z generates a pre-advice, instructions against Bank Y's account manager/BIC must be stated in Party 1. In the Party 2 field (receiving)/ SUB-IDENT-NUMBER, either the customer's (i) BIC or (ii) account manager and VP custody account number (in order of priority) must be stated.

Bank Y must match this pre-advice (by filling in the PART. SUB ID NO. field). In addition, Bank Y must either:

1. generate a transfer between the Omnibus T2S custody account and the Omnibus VP custody account, as well as generate a settlement transaction against the customer with VP (DVP or FOP). Here, any agreement for registration in the holder's name must also be added (as this will no longer come from Bank Z's instructions);

2. or generate a transfer between the Omnibus T2S custody account and the customer's custody account with VP. Here, any agreement for registration in the holder's name must also be added (as this will no longer come from Bank Z's instructions).

See also the instructions **enclosed** in **Appendix 1** for an exemplification of T2S matching.

Appendices

Appendix 1: Instructions for VP and T2S

Instructions in proprietary format

The format of COUNTERPARTY-SUB-IDENT concerning instructions envisaged to go via the "commission model" – Third-party trading

1. 1. The third party is identified in Bank Z with its VP account number

SUB-IDENT-BIC	PIC X(11)	Spaces	N/A
SUB-IDENT-NUMBER	PIC X(35)	T2S: Account manager/XXXXXDEP/YYYYYYYYYYYYYYY	"T2S" – In order to be able to tell that this involves the "commission model". XXXXX = Account manager-ident YYYYYYYYYYYYYYYYY = The customer's VP account no.
Issuer CSD	PIC X(4)	VPDK	

2. The third party is identified in Bank Z with its BIC address

SUB-IDENT-BIC	PIC X(11)		N/A
SUB-IDENT-NUMBER	PIC X(35)	T2S:BIC/ZZZZZZZZZZZ	"T2S" – In order to be able to tell that this involves the "commission model". ZZZZZZZZZZZ = The customer's BIC
Issuer CSD	PIC X(4)	VPDK	

Instructions in ISO format

1. The third party is identified in Bank Z with its VP account number

```
<Pty2>
<Id>
<PrtryId>
 <Id>T2S: Account manager/XXXXXDEP/ YYYYYYYYYYYYYYYYYY </Id>
 <Issr>VPDK</Issr>
 </PrtryId>
 </Id>
 </Pty2>
```

2. The third party is identified in Bank Z with its BIC address

```
<Pty2>
<Id>
<PrtryId>
<Id>T2S:BIC/ ZZZZZZZZZZZ </Id>
 <Issr>VPDK</Issr>
 </PrtryId>
 </Id>
 </Pty2>
```

Appendix 2: VP custody account structure after 29 October 2018

After 29 October 2018, a VP-marked custody account can only be used in VP, and T2S-marked custody accounts can only be used in T2S. Therefore, each account manager must inform VP of any requests that they may have to the custody account structure.

- The account manager may create, on its own behalf or on behalf of its customers, a segregated T2S custody account, if relevant in addition to an existing VP custody account (**1:1 custody account structure**); or
- The account manager may create one or more T2S custody accounts as omnibus accounts and have groups of VP custody accounts (such group to be defined by the account manager itself)"point upwards to" one of those T2S omnibus custody accounts – if the account manager wishes to introduce the option of a pledge, it must do so via a VP omnibus custody account (**omnibus custody account structure**)[5].

For each customer – and in relation to the custody of their own holdings – the account manager may choose which custody account structure it would like to establish. Some customers may thus opt for a 1:1 custody account structure – while the custody accounts of other customers form part of an omnibus custody account structure. Thus, for those customers who are not expected to engage in trading for settlement via T2S, one or more VP custody accounts may thus be maintained without being linked to an omnibus or other T2S custody account.

When using the 1:1 custody account structure, the account manager must ensure that the custody accounts for settlement via VP and T2S, respectively, are registered to the same name (i.e. either the name of the account manager or a customer).

When using the omnibus custody account structure, VP custody accounts which have been opened as segregated custody accounts "point upwards to" a T2S custody account (omnibus custody account) that has been opened by the account manager on customers' behalf[6].

For technical reasons, the pledge cannot be registered over securities in connection with DVP settlement via T2S. Therefore, the omnibus custody account structure has been expanded by an additional omnibus custody account which

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5 See Figure 5 - Figure 8 in Appendix 4 for an illustration of the omnibus structure.
6 This relation must be managed in own systems.

is available for settlement in VP. This way, the account manager may create the pledge over the securities in question in connection with a DVP settlement (transfer) from the omnibus custody account (available for settlement in VP) to the customer's segregated custody account[7].

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7 See Figure 5 - Figure 8 in Appendix 4 for an illustration of the omnibus structure.

Appendix 3: Definitions

In this document, the following definitions apply:

"**Transaction**" means a securities trade between two parties.

"**Settlement**" means mutual consideration in compliance with the parties' obligations, see section 50(2) of the Danish Securities Trading Act (*værdipapirhandelsloven*).

"**Release**" means the generation of a pre-advice which is generated by the custody account holder's account manager (Bank Y) based on a pre-advice from the counterparty (Bank Z) prior to settlement of a transaction which has been entered into by a custody account holder with Bank Y and Bank Z.

Thus, release is when the custody account holder with Bank Y engages in a transaction with Bank Z, and both of Bank Y and Bank Z must send a pre-advice to VP. Until notified by the customer, Bank Y is not aware of the transaction, and many banks have therefore introduced systems which "copy" the pre-advice from Bank Z when it is received. Bank Y will check that the information submitted by the customer tallies with the instructions issued by Bank Z, and will okay the pre-completed pre-advice = will release, if this is the case.

If the customer has **purchased** securities from Bank Z, Bank Y will release the funds, and if the customer has **sold** securities, Bank Y will release the securities.

Transactions are settled in the VP system.

The difference between **release** (example 1) and **instruction** (example 2) may be illustrated as follows:

Example 1.
  A. A retail customer engages in trading with a party (Danske Bank) other than the custodian bank (Nordea).
  B. Danske Bank issues a pre-advice to VP.
  C. The customer contacts the relevant Nordea branch to inform them of the transaction.
  D. The transaction is released and a pre-advice is generated.
  E. The transaction is then settled in VP.

Example 2.

    A.   A foreign customer engages in trading with a party (Danske Bank) other than the custodian bank (Nordea).

    B.   Danske Bank issues instructions (pre-advice) to VP.

    C.   The customer issues instructions to Nordea, requesting settlement of the transaction (via SWIFT).

    D.   Nordea submits instructions (a pre-advice) to VP.
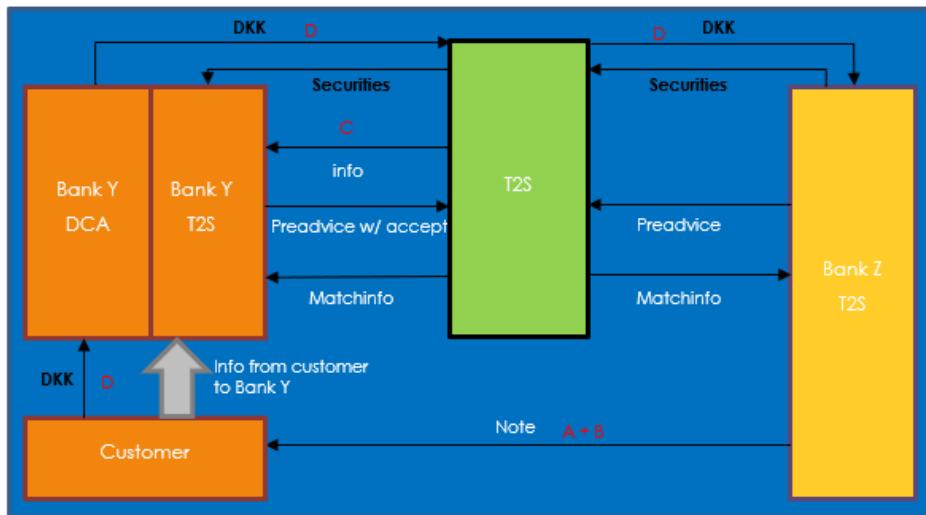
    E.   The transaction is settled in VP.

Appendix 4: Illustrations

Figure 1: Bank Y's customer purchases from Bank Z (1:1 model)

Scenario: The customer is a customer with Bank Y, but engages in trading with Bank Z. (NB: This type of trading is currently settled via VP)
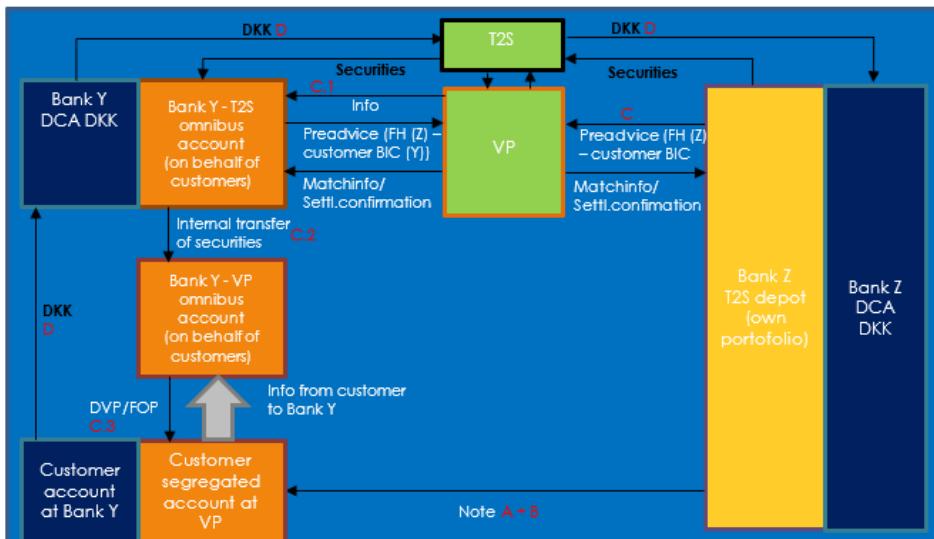
A. Bank Z draws up a contract note, reports the relevant information to the Danish tax authorities, the Danish FSA and Nasdaq (all information concerning the transaction)

B. The contract note states the customer's custody account and related account with Bank Y

C. Bank Y matches bank Z

D. On the settlement day: The funds are drawn via Bank Y's DCA account from the customer's account with Bank Y and deposited into Bank Z's DCA account. The securities are drawn from Bank Z's T2S custody account and deposited into the customer's T2S custody account.

Figure 2: Bank Y's customer purchases from Bank Z (omnibus model)

Scenario: The customer is a customer with Bank Y, but engages in trading with Bank Z.

A. Bank Z draws up a contract note, reports the relevant information to the Danish tax authorities, the Danish FSA and Nasdaq (all information concerning the transaction)

B. The contract note states the customer's custody account and related account with Bank Y

C. Bank Z issues instructions against Bank Y[8].

    Bank Y generates 2 or 3 instructions:[9]

    1. Instructions against Bank Z

    2. Transfer (FOP) between T2S (omnibus on behalf of customers) and VP (omnibus on behalf of customers) (to be linked to item C.1. in accordance with established T2S procedure)

    3. DVP settlement/FOP transfer between VP (omnibus on behalf of the customer) and the customer's segregated custody account with VP.

D. On the settlement day: The funds are drawn via Bank Y's DCA account from the customer's account with Bank Y and deposited into Bank Z's DCA account. The securities are drawn from Bank Z's T2S custody account and deposited into Bank Y's T2S omnibus custody account. Then, proceed to items C.2 and C.3.

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8) At the meeting of the task force set up by Finance Denmark concerning market procedure for the application of the commission model on 17 January, VP stated that it was not necessary for customers – in order to use the option of settlement via T2S (via an omnibus custody account) – to have their own BIC/LEI code. This is because the instructions concerning settlement of a security which belongs to the account manager's customer and is held in an omnibus custody account must state the account manager's BIC/LEI code.
9) If Bank Y uses a VP omnibus custody account.

Figure 3: Bank Y's customer sells to Bank Z (omnibus model)
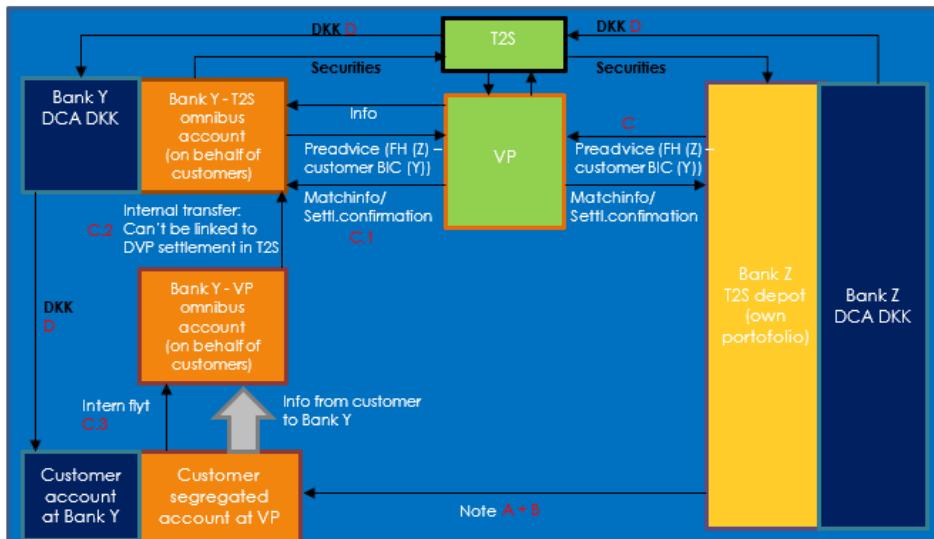
Scenario: The customer is a customer with Bank Y, but engages in trading with Bank Z.

A. Bank Z draws up a contract note, reports the relevant information to the Danish tax authorities, the Danish FSA and Nasdaq (all information concerning the transaction)

B. The contract note states the customer's custody account and related account with Bank Y

C. Bank Z issues instructions against Bank Y[10].

    Bank Y generates 2 or 3 instructions:[11]

    1. Instructions against Bank Z

    2. Transfer (FOP) between VP (omnibus on behalf of customers) and T2S (omnibus on behalf of customers) (to be linked to item C.1. in accordance with established T2S procedure)

    3. DVP settlement /FOP transfer between the customer's segregated custody account with VP and VP (omnibus on behalf of the customer)

D. On the settlement day: The funds are drawn from Bank Z's DCA account and deposited into Bank Y's DCA account and directed to the customer's account with Bank Y. Items C.3 and C.2 are executed and the securities are drawn from Bank Y's omnibus T2S custody account and deposited into Bank Z's T2S custody account.

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10) At the meeting of the task force set up by Finance Denmark concerning market procedure for the application of the commission model on 17 January, VP stated that it was not necessary for customers – in order to use the option of settlement via T2S (via an omnibus custody account) – to have their own BIC/LEI code. This is because the instructions concerning settlement of a security which belongs to the account manager's customer and is held in an omnibus custody account must state the account manager's BIC/LEI code.
11) If Bank Y uses a VP omnibus custody account.

Figure 4: Bank Y's customer sells to Bank Z (the customer's funds and securities are held in two different places)
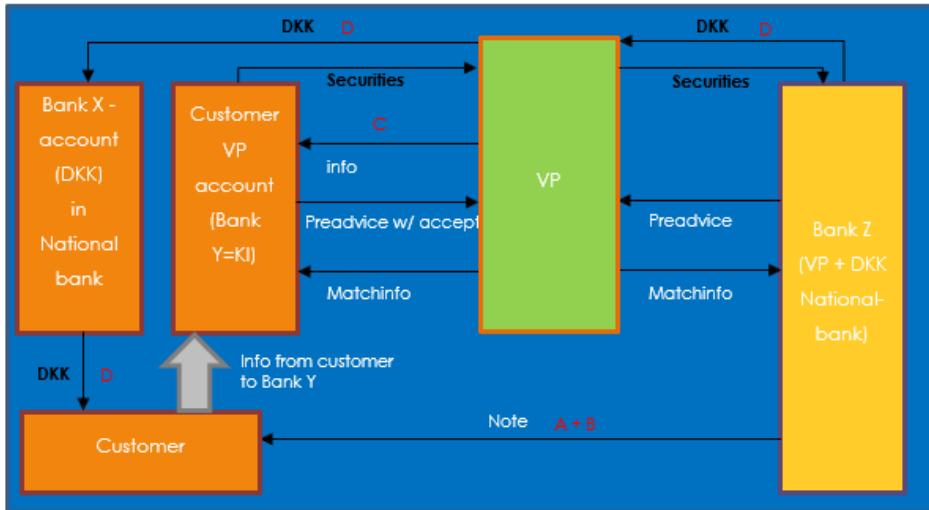
Scenario: The customer is a custody account holder with Bank Y, but is provided with liquidity from Bank X and engages in trading with Bank Z.
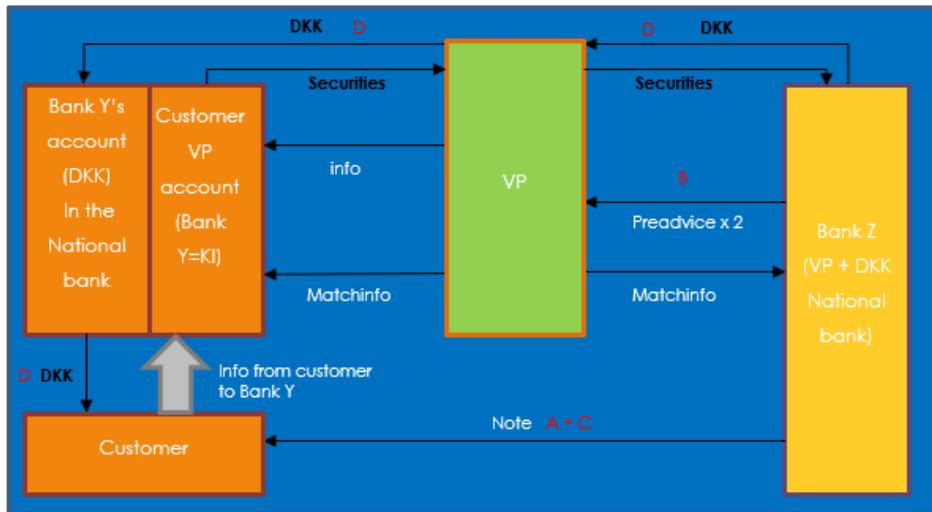
A. Bank Z draws up a contract note, reports the relevant information to the Danish tax authorities, the Danish FSA and Nasdaq (all information concerning the transaction)

B. The contract note states the customer's custody account with Bank Y and account with Bank X

C. Bank Y releases the securities for settlement

D. On the settlement day: Settlement is effected by drawing the securities from the customer's VP custody account and transferring them to Bank Z's custody account in which the bank's own portfolio is held and, at the same time, transferring the funds from Bank Z's account with the Central Bank to Bank X's account with the Central Bank (i.e. DVP settlement) and then registering the funds to the customer's account with Bank X.

Figure 5: Bank Y's customer sells to Bank Z (Z has been granted VP authority)

Scenario: The customer is a customer with Bank Y, but engages in trading with Bank Z, and Bank Z has been granted VP authority.

A. Bank Z draws up a contract note, reports the relevant information to the Danish tax authorities, the Danish FSA and Nasdaq (all information concerning the transaction)

B. Bank Z generates 2 x pre-advice (i.e. both legs), which are submitted to VP

C. The contract note states the customer's custody account and related account with Bank Y

D. On the settlement day: Settlement is effected by drawing the funds from Bank Z's account with the Central Bank and depositing them into Bank Y's account with the Central Bank and, at the same time, transferring the securities from the customer's custody account with Bank Y to Bank Z's custody account in which the bank's own portfolio is held (i.e. DVP settlement) and then registering the funds to the customer's account with Bank Y.

Figure 6: Bank Z's customer has a custody account with Bank Z and sells to Bank Z – and has a regular account with Bank Y
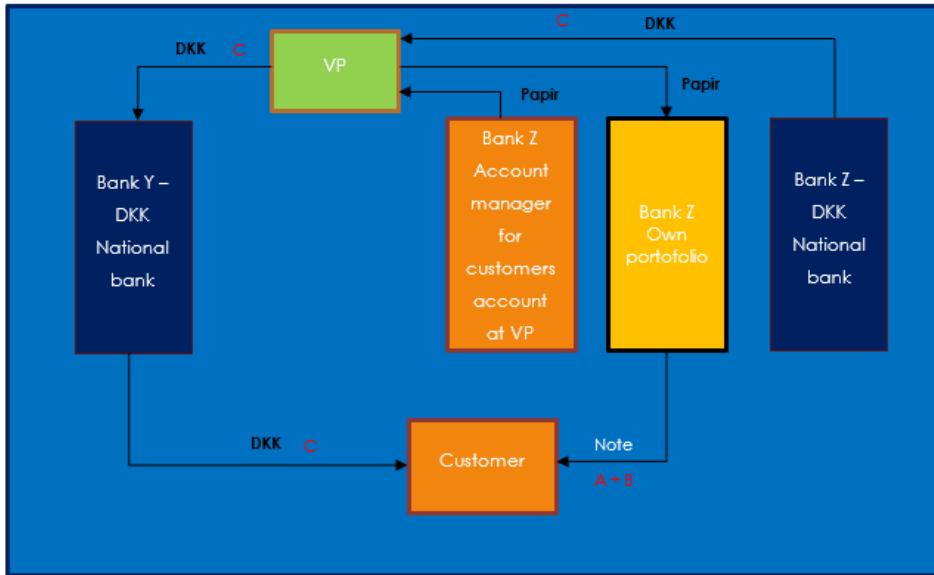
Memorandum

10 September2018
Doc. no. MARKEDSPRAKSIS FOR
TREDJEMANDSHANDLER_FINAL-v1

Scenario: The customer is a custody account customer with Bank Z, and engages in trading with Bank Z, but is provided with liquidity from Bank Y.

A. Bank Z draws up a contract note, reports the relevant information to the Danish tax authorities, the Danish FSA and Nasdaq (all information concerning the transaction)

B. The contract note states the customer's custody account with Bank Z and account with Bank Y

C. On the settlement day: Settlement is effected by drawing the securities from the customer's custody account and transferring them to Bank Z's custody account in which the bank's own portfolio is held and, at the same time, transferring the funds from Bank Z's account with the Central Bank to Bank Y's account with the Central Bank (i.e. DVP settlement) and then registering the funds to the customer's account with Bank Y.

Note: If the customer had purchased securities, Bank Y would have to release the funds to Bank Z for settlement.