THE
INVESTMENT
ASSOCIATION

European Commission targeted consultation document - Review of regulation on improving securities settlement in the European Union and on central securities depositories

Investment Association final response

6. Scope

Question 31. Do you consider that certain requirements in CSDR would benefit from targeted measures in order to provide further legal certainty on their scope of application?

- Yes
~~- No~~
~~- Don't know / no opinion~~

Question 31.1: If you answered "yes" to Question 31, please specify what clarifications/targeted measures could provide further legal certainty.

There are three areas in particular where a lack of definition or inconsistency between the Level 1 (CSDR) and Level 2 (RTS on settlement discipline) legislation causes confusion and debate regarding the scope:

1. <u>Parties involved</u>

Article 7 of CSDR itself, refers to the rights, obligations and liabilities of receiving and failing participants, "participant" being defined specifically in Article 2(1)(19) as the participant to a securities settlement system. This is widely understood as reference to those institutions that hold accounts directly with a CSD, but they are merely settlement agents and have no control over the trading that leads to a fail.

The term "trading party" is introduced by the RTS, while referring to the receiving and failing participant only for certain aspects. This application of the Level 2 requirements should be consistent with the Level 1 obligations.

2. <u>What constitutes a transaction for the purposes of the buy-in regime</u>

There has been considerable discussion among industry participants with regard to types of transactions that might be included or excluded from the buy-in regime, noting that the term is not defined anywhere in CSDR or the RTS. The term "trade" is also used, which many consider implies a narrower scope. The legislation should be consistent in its descriptions of the obligations in order to provide clarity as to their scope.

3. <u>SME growth market transactions</u>

The phrasing used when referring to SME growth markets is ambiguous as to whether the relevant provisions relate to transactions that are executed on SME growth markets or in instruments that are traded on SME growth markets. That ESMA has published a Q&A on

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this topic in relation to penalties is testament to this, but the intention this suggests - that the reduced penalty rate would apply only to trades that have been executed on an SME growth market - arguably is inconsistent with the text of the Level 1 legislation.

Question 31.2: If you answered "yes" to Question 31, please specify which provisions could benefit from such clarification and provide concrete examples.

1. Parties involved

We believe references to the receiving and failing "participant", particularly in Articles 7(3) - 7(9) should be amended to "trading party", who is responsible for the trade that is failing (whereas the participant is merely an agent they instruct to arrange the delivery and receipt of the securities per the trade. The definition currently in Article 1(f) of the RTS might be suitable for this purpose.

Reference should be made to "participants" only in their capacity as holders of the accounts at CSDs through which settlement instructions and information are passed and as conduits for the payment and redistribution of penalties among the ultimate principals for whom they maintain those accounts.

2. What constitutes a transaction for the purposes of the buy-in regime

Although a broader term may be appropriate when considering the scope of transactions that would be subject to penalties, there are many types of "transaction" for which buy-ins would not be an appropriate remedy.

These include margin transfers, which aim to mitigate risks associated with other transactions that represent the "original agreements" the enforcement of which is what we believe Recital 15 to CSDR aims to describe. The terms of those contracts will already include remedies for the non-settlement of collateral.

Another would be where the holder of a portfolio changes their safe custody arrangements and transfers the instruments between their own accounts.

We recommend therefore that the terminology in Articles 7(3) - 7(9) of CSDR be amended so that it is limited to where there is an agreement for the outright disposal and acquisition of the instruments between the trading parties. To this end, there may be benefit in adopting an approach similar to that set out in Article 2 of Commission Delegated Regulation (EU) 2017/590, which defines "transaction" for the purposes of the transaction reporting obligations under MiFIR, with appropriate modifications.

3. SME growth market transactions

As noted in our response to Question 31.1, we are concerned with the apparent interpretation of the second paragraph of Article 7(3):

> *"Where the transaction relates to a financial instrument traded on an SME growth market…"*

We believe this should be read as referring to a feature of the instrument, not to where the transaction is executed - otherwise, why does it not speak simply of transactions that are executed on SME growth markets, as ESMA suggests in the Q&A on penalties. Although the Q&A pertains to the penalty rates as set out in the Commission Delegated Regulation (EU) 2017/389 on that subject, Recital 11 to that makes reference to the above provision in the Level 1.

We recommend that the intention with regard to SME growth market instruments be made clear and is applied consistently throughout CSDR.

In doing so, we would urge that consideration be given to the asymmetry that is created along a transaction chain by the current interpretation as inferred from the ESMA Q&A. Where a broker fills an order from its client on an SME growth market, the SME growth market derogation and penalty rate applies to the market-side leg but not to the client-side leg, which is executed off-market. We therefore believe that any provision that is specific to SME growth markets should be determined by reference to the instrument, not to the place of execution.

As some instruments may be traded on markets that are both SME growth and non-SME growth, and for other reasons noted later in this response, we believe ESMA should be required to maintain a list of instruments that are in scope for the settlement discipline regime and their SME growth status.

Question 32: Do you consider that the scope of certain requirements, even where it is clear, could lead to unintended consequences on the efficiency of market operations?

- Yes
~~- No~~
~~- Don't know / no opinion~~

Question 32.1: If you answered "yes" to Question 32, please specify what targeted measures could be implemented to avoid those unintended consequences while achieving the general objective of improving the efficiency of securities settlement in the Union?

1. <u>Shares vs. non-shares</u>

Article 7 is disapplied in the case of *shares* for which the principal venue of trading is outside the EU. While it may appear convenient to tie this to the definition in the Short Selling Regulation (SSR), the distinction this established between different types of security creates inefficiency for the industry and confusion as to what constitutes a "share" for this purpose.

For example, in separating the transparency regimes for equity/equity-like and non-equity under MiFIR, reference is made to "shares, depositary receipts, ETFs, certificates and other similar financial instruments", which introduces a distinction between shares and instruments such as ETFs. However, the list published by ESMA pursuant to Article 16 of the SSR includes ETFs.

We believe the apparent distinction between shares and other securities instruments for settlement discipline purposes is unnecessary and unhelpful and should be removed.

2. <u>Instruments that are issued outside the EU</u>

We believe challenges will arise where a failing settlement chain extends beyond the EU, due to conflict with the local settlement regime in the relevant jurisdiction. This frequently will be the case where the instrument concerned is issued in a third country, including where the chain involves an account held by an EU CSD/ICSD in the CSD of that country.

In order to avoid such complications, transactions in such instruments should be excluded from the EU settlement discipline regime.

3. <u>Securities financing transactions</u>

There is a clear exclusion under the current legislation for securities financing transactions, but only to the extent that the return leg is within 30 days of the initial transfer. We

believe it is unnecessary to include any transactions where the agreement is for the temporary transfer of an instrument, and unhelpful to impose buy-in obligations that overlap and may compete with the agreed contractual remedies in the event of a settlement fail in either direction.

4. Issuance and redemption

There is no explicit exclusion of transactions involved in the issuance or redemption of instruments between an investor and the issuer. including in the case of ETFs and other open-ended collective investments that might otherwise fall within the scope of the buy-in regime.

In the case of issuance, we do not believe a problem exists with settlement, either from the issuer to the CSD or between their designated agents and those to whom the instruments have been allotted. In the case of redemption, there would be no knock-on impact in the market should the holder be unable to deliver - they will simply not receive the proceeds.

We also believe such transactions, should be out of scope for the penalties regime.

5. Corporate actions

Corporate actions may or may not involve the issuance and/or redemption of the instrument(s) concerned, but the buyer protection mechanism that exists already offers suitable protection in the event that instruments are not delivered as expected.

Question 32.2: If you answered "yes" to Question 32, please specify which provisions are concerned.

1. Shares vs. non-shares
2. Article 7 is disapplied Instruments that are issued outside the EU

In order to address the concerns raised under these points in our response to Question 32.2, we recommend that Article 7(13) be amended to cover all instruments that are issued outside the EU.

In association with this and the proposal in point 3 of our response to Question 31.2 we recommend that ESMA be mandated to maintain a list of those instruments to which the buy-in regime does apply, including their status with regard to trading on an SME growth market.

3. Securities financing transactions
4. Issuance and redemption
5. Corporate actions

To address the proposal under point 3 of our response to Question 32.2, Article 4(b) and Article 22 of the RTS might be revised so all transactions that involve the temporary transfer of instruments be excluded from the buy-in regime. However, as noted in point 2 of our response to Question 31.2, adoption of a definition of transactions to which the buy-in regime would apply that is similar to the one used for MiFIR transaction reporting offers a potential approach to address all of these three points.

For the purposes of CSDR, we would propose certain modifications to the definition of transaction in Article 2 of Commission Delegated Regulation (EU) 2017/590, as follows:

- removal of references to derivative contracts;
- expansion of paragraph 5(n) to include all securities (as opposed to just bonds and securitised debt);

- removal of the exclusions listed at the end of paragraph 5, concerning securities financing transactions with ESCB members and new issuance.

7. Settlement discipline

Question 33: Do you consider that a revision of the settlement discipline regime of CSDR is necessary?

-Yes
~~-No~~
~~-Don't know / no opinion~~

Question 33.1: If you answered yes to Question 33, please indicate which elements of the settlement discipline regime should be reviewed:
(you may choose more than one options)

- Rules relating to the buy-in
- Rules on penalties
~~- Rules on the reporting of settlement fails~~
- Other

Question 33.2: If you answered "Other" to Question 33.1, please specify to which elements you are referring.

We believe aspects regarding the measures concerning professional clients, per Article 2 of Commission Delegated Regulation (EU) 2018/1229 should be modified. Currently these stipulate various deadlines to be met by the professional client without acknowledging the dependency they have in certain respects on the investment firm.

We have recommended changes to the current framework to address this in our response to Question 36.

Question 34: The Commission has received input from various stakeholders concerning the settlement discipline framework. Please indicate whether you agree (rating from 1 to 5) with the statements below:

	1 (disagree)	**2 (rather disagree)**	**3 (neutral)**	**4 (rather agree)**	**5 (fully agree)**	**No opinion**
Buy-ins should be mandatory	1					
Buy-ins should be voluntary					5	
Rules on buy-ins should be differentiated, taking into account different markets, instruments and transaction types					5	

A pass on mechanism should be introduced					5	
The rules on the use of buy-in agents should be amended					5	
The scope of the buy-in regime and the exemptions applicable should be clarified					5	
The asymmetry in the reimbursement for changes in market prices should be eliminated					5	
The CSDR penalties framework can have procyclical effects			3			
The penalty rates should be revised					5	
The penalty regime should not apply to certain types of transactions (e.g. market claims in cash)					5	

Question 34.1: Please explain your answers to question 34, providing where possible quantitative evidence and concrete examples.

1. Mandatory vs. optional buy-ins

A key concern with buy-ins, we believe, is that a mandatory regime is likely to have an adverse impact on liquidity, especially for instruments that are already illiquid. We believe the receiving party should be able to determine the course of action according to their risk management policy, which will take into consideration the type of instrument and its liquidity.

Although a decision would be expected at some point if a trade were to fail over an extended period with little prospect of settlement, we believe the timing of any decision to initiate a buy-in or "close out" the transaction with the counterparty (see our response to Question 36) should be left entirely to the discretion of the receiving party and, as such exercise of any right in this respect would be voluntary.

2. Pass-on mechanism

We do believe that provision should be made for a pass-on mechanism, otherwise multiple parties along a settlement chain will chase the same liquidity, which may already be of

limited availability. This will give a false appearance of increased demand for the instrument, which will drive the price up artificially and to the extent that the various parties are able to complete the buy-in, they will be left with unwanted instruments.

We recommend that the legislation should go only so far as to permit such a mechanism to exist, so that the detail can be developed and/or agreed with the industry separately.

3. Buy-in agents

The current legislation has so far produced only one confirmed service offering, the provider of which is therefore free to determine its operating model and pricing entirely without competition, and as such has a de facto monopoly. We believe there is limited interest from others to enter this market, which raises the concern that at best we may still be faced with an oligopoly among buy-in agents. Moreover, both the operating and pricing models appear wholly inappropriate for buy-side firms, who act entirely for their clients who are the actual trading parties and more often than not on the receiving party side of a fail.

We understand that the model in question includes service fees for maintaining the accounts required to initiate a buy-in and ex-post charges that would be highly inefficient to recover from the failing party. Receiving parties will therefore suffer as a result of being forced to adopt the only model that may be available, despite not being at fault. The mechanism will also require processes and interfaces that, for the buy-side at least, are bespoke for this purpose, which would be highly inefficient.

We therefore believe strongly that the specific concept of "buy-in agent" should be dropped and that receiving parties should be allowed freedom to find alternative sources of liquidity with an obligation to provide best execution to the failing party.

4. Scope of the buy-in regime

We have made detailed comments in this regard in our responses to Questions 31 and 32.

5. Asymmetry

We believe the object of a buy-in or "close-out" (see our response to Question 36) should be to place the receiving party in as near an economic position as possible to the one that would have resulted had the original transaction settled on time, regardless of the direction in which the price of the instrument may have moved.

On the one hand the buyer should be protected against a rising price. On the other hand, if sellers have no protection from the risk of markets falling after they have agreed to fill a client order through a short sale, that mechanism to provide liquidity, which is important to the efficient functioning or markets will become more limited and/or more expensive when that risk is factored into their quotes more generally.

6. Penalties

Although penalties may have some adverse impacts, including potentially a widening of spreads by market makers to mitigate penalties they may or may not suffer ultimately, the extent to which these would be procyclical is not immediately clear. Moreover, we believe that a properly calibrated penalties regime can offer a greater incentive for settlement efficiency than buy-ins, which we believe are more likely to have a procyclical impact given their potential to soak up much-needed market liquidity.

We believe penalties should be not applicable to the issuance of instruments to investors by the issuer or their agents, as these are not dependent on their inventory or market activity and where any delay in creation or delivery to the end investor invariably is due to the investor's own failure to deliver cash or instruments in exchange. This would include,

for example, the delivery of units/shares in an ETF of other collective investment scheme by the fund itself or its transfer agent.

Question 35: Would the application of the settlement discipline regime during the market turmoil provoked by COVID-19 in March and April 2020 have had a significant impact on the market?

- Yes
~~- No~~
~~- Don't know / no opinion~~

Question 35.1: Please explain your answer to Question 35, describing all the potential impacts (e.g. liquidity, financial stability, etc.) and providing quantitative evidence and/ or examples where possible.

As open-ended funds responded to sizeable outflows during the early weeks of the COVID-19 crisis, other portfolios such as those that support pension schemes needed to be rebalanced to hedge against the consequent market turmoil, which placed a huge strain on the liquidity of fixed income markets. Had the mandatory buy-in regime been in place at that time with its objective to make settlement fails economically unattractive to the seller, market making activity would have been severely limited. This would have made the already difficult task of protecting pension investors in times of market stress impossible, with potentially catastrophic consequences for those investors in retirement.

The absence of a mandatory buy-in regime allowed greater tolerance of settlement fails during that period than otherwise would have been possible, which enabled market makers to provide much-needed liquidity for investment managers to protect those investors to a much greater extent.

Question 36: Which suggestions do you have for the improvement of the settlement discipline framework in CSDR? Where possible, for each suggestion indicate which costs and benefits you and other market participants would incur.

1. *The penalties regime should be leveraged as a tool to drive settlement efficiency*.

   We recommend that ESMA be empowered to set targets for settlement fails and given a mandate to adjust the various penalties rates periodically where the targets for particular instruments are being missed consistently.

   ESMA should be required to undertake proper analysis of the fails data provided by CSDs in order to determine the target ceiling for fail rates, and the associated penalties, which would also consider the type of instrument and its MiFID liquidity assessment. The mandate should also require ESMA to assess both the likely impact of the rates it determines on reducing fail rates and the increase they may bring in everyday costs for the market as a whole.

   A particular factor to consider, we believe, is that the penalty rates should be higher than the financing cost to obtain the instruments through securities borrowing or the repo market - if the penalty rate is lower, there would be little incentive for a failing party to source the instruments by securities financing in preference to suffering the penalties.

2. *The buy-in regime should focus entirely on the principal party to the failing transaction*.

   Regardless of whether a trade is executed over the counter or on a trading venue, the obligations should fall to the principals to the transaction. This should be

notwithstanding the fact that transactions may be executed on their behalf and under their authority by others (eg. investment managers) who may also then undertake the actions that may be required under the regime, again on their behalf.

3. *In the event that a counterparty is unable to deliver the instrument, the receiving party should have a right to choose between executing a buy-in or closing out the trade at the prevailing market price*.

   These options should be subject to an appropriate period of notice, during which the receiving party may still agree to accept delivery against the original trade.

   We recommend certain key features of these options as indicated below.

   <u>Buy-in</u>

   (a) We recommend that buy-in transactions be executed by the receiving party with <u>any</u> investment firm (or equivalent) that has the regulatory permission necessary to execute client orders.

   (b) In conducting the buy-in, the receiving party should be subject to an obligation to provide best execution to the failing party and to avoid any conflicts of interest.

   (c) As noted in our response to Question 34.1, we believe a successful buy-in should deliver the same economic outcome to the receiving party as the failing trade. To this end:

   - if the settlement amount (ie. total consideration) of the buy-in is higher than it would have been for the original trade, the failing party should be required to pay the difference to the receiving party, plus compensation for any entitlements (income, corporate actions etc.) that may have been missed;
   - if the settlement amount of the buy-in is lower than it would have been for the original trade, the receiving party should be required to pay the difference to the failing party, after deducting compensation for any entitlements (income, corporate actions etc.) that may have been missed;
   - in the event of a capital reconstruction occurring between the original transaction and the buy-in, it may be necessary to buy-in the different instruments resulting from that reconstruction.

   (d) Having received prior notice of the buy-in, the failing party should be able to deliver the instruments subsequently only with the express agreement of the receiving party.

   (e) In addition to the option from the outset of a fail, in the event that buy-in is not possible the receiving party should be able to close out the original failing transaction.

   (f) As noted in our response to Question 34.1, we believe the regime should provide specifically for a pass-on mechanism in order to minimise the number of buy-ins along a settlement chain. To this end the regime should include that the failing party is able to pass on a notice of buy-in and the associated economic consequences (price difference etc.) to the party(ies) from whom they sourced liquidity to fill the buyer's order and whose own inability to deliver has led to the buy-in.

<u>Close out option</u>

(a) As an optional alternative to a buy-in, we recommend that the receiving party should have a right to sell the instruments back to the failing party at the prevailing market price.

(b) We believe that where no market price exists for the instruments concerned, the regime should provide for the application of suitable market methodology to determine their fair value.

(c) As noted in our response to Question 34.1, we believe this mechanism should deliver the same return to the receiving party as they would have received over the period since the original trade had it settled normally. To this end the value of any entitlements that may have been missed by the receiving party and are not reflected in the prevailing market price should be addressed though the payment of cash compensation paid to them by the failing party.

(d) Having received prior notice of the close-out, the failing party should be able to deliver the instruments subsequently only with the express agreement of the receiving party.

4. *The obligations concerning trade allocation and confirmation should recognise the dependencies that each party has on the other.*

We recommend that the Level 2 provisions be revised to include the features:

(a) The investment firm should be required to provide their settlement details to the professional client at the latest by close of business on the day of execution.

(b) The investment firm should be required to provide a report of the execution, including the execution price, by close of business on the day of execution.

(c) The professional client should be required to send allocation details and confirmation:

- by close of business on the day of execution, where the execution report is received from the investment firm by 4pm CET and time difference is 2 hours or less;
- otherwise by 10am on the next business day.

(d) The investment firm should be required to provide confirmation of allocation-level settlement details:

- by 10am on T+1 where the allocation details are received from the professional client on the day of execution;
- otherwise by noon on the next business day.

The aim of the above would be to ensure that the professional client is informed of the terms of the trade with sufficient time to confirm its acceptance and for the final settlement details to be matched by noon on T+1, before the settlement instructions may be issued.

In addition, the current legislation provides only that the investment firm must allow its professional clients the option of sending them the allocation and confirmation electronically - it should also provide that the investment firm must be willing to send its own communications electronically.

We believe the above is already facilitated by central trade matching utilities that exist today, which allow each party to submit the relevant details when available and view the matching status versus the details entered by the other.

9. Other areas to be potentially considered in the CSDR Review

Question 43: What other topics not covered by the questions above do you consider should be addressed in the CSDR review (e.g. are there other substantive barriers to competition in relation to CSD services which are not referred to in the above sections? Is there a need for further measures to limit the impact on taxpayers of the failure of CSDs)?

MiFIR reporting obligations

The purpose of a buy-in is ultimately to secure settlement of the original transaction according to its original economic terms. As such, we believe clarification should be provided, perhaps from ESMA through the relevant Level 3 Q&A, that the buy-in represents "a contract arising exclusively for clearing or settlement purposes", as described in Article 2(5)(b) of Commission Delegated Regulation (EU) 2017/590, and therefore excluded from the scope of "transaction" as defined for the purposes of MiFIR Article 26.

In the event that a failing trade is closed out, the transaction is merely notional for restoration and record-keeping purposes and to determine the price difference to be paid by one party to the other. We therefore believe this should not be considered as an acquisition or disposal for the purposes of the definition of "transaction" under Article 2 of Commission Delegated Regulation (EU) 2017/590, to which end we recommend that a further exclusion be added to paragraph 2(5) of that Article regarding transactions that are for the purposes of closing out a failing transaction in accordance with the settlement discipline regime under CSDR.

In the event of either a buy-in or a close-out, the original transaction remains, so neither eventuality should cause any revision to the report submitted in relation to that transaction.

CSDR Article 5(2) settlement timeline

CSDR Article 5(2) provides that transactions that are executed on trading venues must be settled by no later than the second business day following the date of the trade (T+2).

We believe such a strict determination is inappropriate for less liquid instruments and recommend that counterparties should be free to agree longer settlement cycles when negotiating transactions in such instruments, for example on an RFQ trading platform.

Implementation

As noted in our response to Question 34.1, we believe a properly calibrated penalties regime can make an effective contribution to improving settlement. We do not believe the changes we have proposed would have a material impact on the implementation of the regime by market participants and therefore suggest that this might still commence in February 2022 or as soon afterwards as the appropriate calibrations can be agreed.

We are, however, very concerned that with entry into force of the current regime scheduled for 1 February 2022, this will leave insufficient time for any amending legislation to be confirmed in law and implemented in practice.

We would urge that the Commission provides clarity as early as possible regarding what will need to be implemented and from when, bearing in mind that firms will need *at least* 12 months to develop, test and implement any new changes to their systems and interfaces, once they have certainty of the requirements. This will only be when the final legislation is published in the Official Journal of the European Union. We would also note the interdependencies that exist among market participants, for example in the repapering of relationships to take account of obligations under CSDR; and reliance on the CSDs and custodians to finalise their operation of the penalties regime, on which we believe work has largely been suspended pending the outcome of this consultation.

We therefore ask that industry be provided with a clear understanding as soon as possible of what will remain to be implemented in February 2022 and the mechanism(s) by which other aspects will be deferred in order to allow time for the new legislation to enter into force with an appropriate period for implementation.