Response to European Commission Consultation on CSDR

0. Overview

Section	Q	AFME Response
1/ CSD Authorisation	1	Yes
	2	No
	3	No
	4	No
	5	No
	6	Yes
	7	Yes
2/ Cross Border	8	No
	9	No
	10	No
	11	No
	12	No
	13	Yes
	14	Yes
3/ Internalised Settlement	15	Yes
	16	Yes
4/ Technology	17	Yes
	18	Yes
	19	Yes
	20	Yes
5/ Ancillary Services	21	No
	22	No
	23	No
	24	No
	25	No
	26	No
	27	No
	28	No
	29	No
	30	Yes
6/ Scope	31	Yes
	32	Yes
7/ Settlement Discipline	33	Yes
	34	Yes
	35	Yes
	36	Yes
8/ Third Country CSDs	37	No
	38	No
	39	No
	40	No
	41	No
	42	No
9/ Other Areas	...	No

1. CSD AUTHORISATION & REVIEW AND EVALUATION PROCESSES

CSDs are subject to authorisation and supervision by the competent authorities of their home Member Sate which examine how CSDs operate on a daily basis, carry out regular reviews and take appropriate action when necessary.
Under Articles 16 and 54 of CSDR, CSDs should obtain an authorisation to provide core CSD services as well as non-banking and banking-type ancillary services. Article 69(4) however allows CSDs authorised under national law prior to the adoption of CSDR to continue operating under such national law until they have been authorised under the new CSDR rules.
As of August 2020, 22 out of 30 existing EU[1] CSDs[7] are authorised under Articles 16 and/or 54 CSDR. ESMA's register of EU CSDs shows that the time to complete the authorisation process varies significantly and that 7 existing EU CSDs[2] have not yet been authorised under CSDR, while one CSD has been authorised under Article 16 of CSDR, but not yet under Article 54 of CSDR (i.e., for banking-type ancillary services). The size and complexity of CSDs and the different services they offer, as well as their initial level of compliance with primary and secondary legislation at the time of its adoption, may explain, at least partially, such differences. Furthermore, there is also anecdotal evidence from some stakeholders that the administrative burden of the authorisation process under CSDR, or as applied by some NCAs, can act as a barrier to new market entrants, thereby limiting competition. Similar feedback suggests that the authorisation process might lack proportionality in circumstances where not all requirements are relevant to the activity envisaged by the applicant.
Once a CSD has been authorised, CSDR requires national competent authorities (NCAs) to review CSD's compliance with rules emerging from the Regulation and to evaluate risks to which a CSD is or might be exposed, as well as risks it might create. This review and evaluation must be done at least on an annual basis. Its depth and frequency is to be established by NCAs taking into consideration the size, nature and systemic importance of the CSD under supervision. The detail of the information to be provided on an annual basis by CSDs to NCAs is set forth in [Commission Delegated Regulation (EU) 2017/392](#).
Looking forward, the lessons learnt from the way the authorisation procedures have run should also be useful for the CSDs' annual review and evaluation by their competent authorities. It has been argued that annual reviews should be integrated in NCAs' supervisory activities in such a way that they bring added value, suit their risk-based supervisory approach and ensure supervisory convergence at Union level.

Question 1
Given the length of time it has taken, and is still taking in some instances, to authorise CSDs under CSDR, do you consider that the application process would benefit from some refinement and/or clarification in the Regulation or the relevant delegated acts?

- Yes, some aspects of CSDR or the relevant delegated acts would merit clarification, although no legislative or regulatory amendment would be required.
- Yes, the CSDs authorisation process should be amended to be made more efficient.
- No, the length and complexity of the authorisation process reflects the complexity of CSDs' businesses.
- No, most of the CSDs in the Union have already been authorised under CSDR, there is no case for amending the authorisation process.
- **Other**

Question 1.1
Please explain your answer to question 1, providing where possible quantitative evidence and/or examples.

As acknowledged by the Commission, the process could have been better and there has been significant variation in the length of the approval process. However, AFME and its members do not have sufficient insight into the approval process and believe that CSDs are best place to opine on this topic.

[1] This should be read as 'EEA' given that CSDR has been incorporated into the EEA Agreement as of 1 January 2020. [7] Excluding CSDs managed by Central Banks (and other Member States' national bodies performing similar functions or other public bodies charged with or intervening in the management of public debt in the Union) which are exempted from the authorisation requirements under Article 1(4) of CSDR.

[2] CSDR applies in the EEA EFTA States since 1 January 2020 following the incorporation of CSDR into the EEA Agreement. (a CSD from an EEA EFTA State has not been authorised under CSDR either)

Question 2.
Should an end date be introduced to the grandfathering clause of CSDR?
- Yes
- No
- Don't know / **no opinion**

Question 2.1.
Please explain your answer to Question 2, providing where possible examples.

If you answered "yes", please also indicate what the end date for the grandfathering clause should be.

Question 3.
Concerning the annual review process, should its frequency be amended?
- Yes
- No
- Don't know / **no opinion**

Question 3.1
If you responded yes to question 3, what should be the frequency of such reviews?
- Once every two years
- Once every three years
- At the discretion of NCAs

Question 3.1.
Please explain your answer to Question 3, providing where possible quantitative evidence and/or examples.

Articles 41 and 42 of Commission Delegated Regulation (EU) 2017/392 prescribe the information and the statistical data that CSDs should provide to NCAs on an annual basis.

Question 4.1
Do you consider this information and statistical data to be relevant for the review and evaluation process described in Article 22 of CSDR?
- Yes, all information and statistical data are relevant.
- No, not all information and statistical data should be required to be provided on an annual basis.
- Don't know / **no opinion**

Question 4.2
Do you consider these requirements to be proportionate?
- Yes, all information and statistical data must be provided on an annual basis.
- No, not all information and statistical data should be required to be provided on an annual basis.
- Don't know / **no opinion**

Question 4.3.
Please explain your answers to Questions 4.1 and 4.2, providing where possible quantitative evidence and/or examples. If you answered "no" to any of them or to both, please also specify which information and/or statistical data are not relevant or could be provided on a less frequent basis.

Question 5.
Are there specific aspects of the review and evaluation process, other than its frequency and the content of the information and statistical data to be provided by CSDs, that should be examined in the CSDR review?

Question 6.
Do you think that the cooperation among all authorities (NCAs and Relevant Authorities) involved in the authorisation, review and evaluation of CSDs could be enhanced (e.g. through colleges)?

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

Question 6.1
Please explain your answer to Question 6 providing, where possible, quantitative evidence and/or examples.

AFME supports the recommendation of the CMU High-Level Forum to strengthen supervisory convergence among NCAs. As noted in their Final Report, the differing application of CSD rules directly impacts the cross-border provision of services.

The objective of pan-EU harmonisation and competition between CSDs without barriers has not been achieved.

We note that for authorisation of EU-based CCPs, a college of supervisors is established. As noted in ESMA's annual peer reviews, the overall assessment of the functioning of these colleges is generally positive. AFME members anecdotally report that the EMIR CCP authorisation process appears relatively efficient and well-functioning. The impact to cross border provision of services should not be underestimated. Current CSD passporting arrangements require approval from the relevant home state NCAs into which the CSD will provide services. A college of supervisors would provide an even-handed approach which may accelerate such approvals.

Question 7
How do you think ESMA's role could be enhanced in order to ensure supervisory convergence in the supervision of CSDs (for example with possible further empowerments for regulatory technical standards and/or guidelines, or an enhanced role in supervisory colleges, or direct supervisory responsibilities)?

We would refer to the CMU HLF Report which stated that "ESMA's work within the current scope of its mandate in terms of convergence should be continued and strengthened. The aim should be to ensure convergence in supervisory approaches across the Member States to reduce administrative burdens on CSDs and to generate the value added for the EU financial markets in terms of the CSDR objectives."

2. CROSS-BORDER PROVISION OF SERVICES IN THE EU

A core objective of CSDR is the creation of a single market for CSDs. CSDR provides important opportunities for cross-border activities by CSDs within the Union as it grants CSDs authorised in one Member State with a "passport" to provide their services in the EU without the need for further authorisation. This means also that CSD groups should be able to consolidate certain aspects of their operations in a much more efficient way. When a CSD provides its services in a Member State other than where it is established, the competent authority of the home Member State is responsible for the supervision of that CSD.
The procedure through which a CSD authorised in an EU Member State can provide notary and central maintenance services in relation to financial instruments constituted under the law of another EU Member State or to set up a branch in another Member State is set out in Article 23(3) to 23(7) of CSDR and is based on the cooperation of the CSD's home Member State competent authority with the host Member State competent authority. In that case, the home Member State competent authority bears the primary responsibility to determine the adequacy of the administrative structure and the financial situation of the CSD wishing to provide its services in the host Member State.

Despite the fact that most of the applying CSDs have been able to obtain a "passport" to offer notary and central maintenance services in one or several other Member States, anecdotal information from stakeholders has indicated that this process has been significantly more burdensome than previously thought. This, in turn, could potentially lead to a reduction in the level of cross-border activity, limiting potential efficiency gains and, potentially, competition. This may be due to differing interpretations of CSDR's requirements related to the provision of services in another Member State, but could also arise from the requirements themselves. Challenges mentioned include, but are not necessarily limited to, the role of the host NCA in granting the passport and supervision cooperation among NCAs, the determination of the law applicable to the issuance and the assessment of the measures the CSD intends to take to allow its users to comply with the national law under which the securities are constituted.

Question 8.

Question for issuers - One of the main objectives of CSDR is to improve competition between CSDs so as to enable market participants a choice of provider and reduce reliance on any one infrastructure provider. In your view, has competition in the provision of CSD services increased or improved in your country of establishment in recent years?
- Yes
- No
- Don't know / no opinion

Question 8.1

Please explain your answer to Question 8, providing where possible quantitative evidence and/or concrete examples.
Please indicate where possible the impact of CSDR on:
(a) the number of CSDs active in the market;
(b) the quality of the services provided;
(c) the cost of the services provided.

Question 9.

Question for issuers/CSDs – are there aspects of CSDR that would merit clarification in order to improve the provision of notary/issuance, central maintenance and settlement services across the borders within the Union?
- Yes
- No
- Don't know / no opinion

Question 9.1

Please explain your answer to Question 9, providing where possible quantitative evidence and/or concrete examples.

Question 10.

Question for CSDs – have you encountered any particular difficulty in the process of obtaining the CSDR "passport" in one or several Member States different to the one of your place of establishment?

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

Question 10.1

If you answered "yes" to Question 10, please explain your answer, providing where possible quantitative evidence and/or concrete examples.

Question 11

Question for CSDs – in how many Member States do you currently serve issuers by making use of your CSDR "passport"?

Question 12

Question for CSDs – are there any obstacles in the provision of services to issuers in a Member State for which you have obtained the CSDR "passport" that actually prevent you from providing such services?

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

Question 12.1

Please explain your answer to Question 12, providing where possible quantitative evidence and/or concrete examples.

Question 13

Do you think that the cooperation amongst NCAs would be improved if colleges were established for [or cooperative arrangements were always involved in] the Article 23 process?

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

Question 13.1

Please explain your answer to Question 13, providing where possible quantitative evidence and/or concrete examples.

Question 14:

How do you think ESMA's role could be enhanced in order to ensure supervisory convergence in the supervision of CSDs that provide their services on a cross-border basis within the EU?

We believe that, in addition to matters relating to supervisory convergence, there are several barriers to the provision of cross border issuer services. The effective ability of CSDs to provide these services on a cross-border basis is critical. Without such an effective ability, the merger of CSDs, and effective competition between CSDs, are impossible. Key reasons why CSDs find it difficult to provide these services include:

a) the complexity and cost of the CSDR process for the authorisation of cross-border services, as set out in Articles 23 and 49 of CSDR. This specific CSDR process is much more burdensome than the standard "passporting" process under most European legislation.

b) Diversity of national issuance processes and requirements, of national corporate law requirements, and of national processes for the attribution of corporate action entitlements. (On this last point, we note that many national processes for the attribution of corporate action entitlement are – prima facie – inconsistent with Article 3 of CSDR).

Major improvements will require, inter alia, that the proposals of the Commission's Action Plan on CMU are put into effect. Key areas are Action 12 (regarding an EU definition of 'shareholder' and further clarification and harmonisation of corporate action processing) and Action 10 (a standardised system for withholding tax relief at source)

Legislative change will also need to be complemented by the creation of, and effective compliance with, pan-European market practices. We see the work that will take place in the context of the European Central Bank groups, including the T2S Debt Issuance Market Practice Group and Corporate Events Group, as being very important.

3. INTERNALISED SETTLEMENT

Article 9 of CSDR provides for internalised settlement reporting, whereby a settlement "internaliser" must report to the competent authority of its place of establishment, on a quarterly basis, the aggregated volume and value of all securities transactions that it settles outside a securities settlement system (SSS). The information which is required to be included in the quarterly internalised settlement reports is specified in Commission Delegated Regulation EU 2017/391,[3] while the format of reports is outlined in Commission Implementing Regulation EU 2017/393.[4]

The first internalised settlement reports were due to the competent authorities by 12 July 2019 and contained details of transactions settled internally from 1 April 2019 to 30 June 2019.

The objective of internalised settlement reporting is to enable NCAs to monitor and identify the risks (e.g. operational, legal) associated with internalised settlement. The identification of such risks or of any trends seems to have been limited to date. Nevertheless, the reported figures show very high volumes and values, high concentration, as well as high settlement fail rates. This proves the importance of monitoring the internalised settlement activity. Data quality issues (e.g. clarification of the exact scope of the requirement, development and implementation of IT tools and systems, correct implementation of reporting formats, etc.) and the relatively short timeframe since the start of this reporting regime (Q2 2019) may have limited any such analysis of risks and/or trends.

As part of its fitness check on supervisory reporting requirements, the Commission has committed to assessing whether the reporting objectives are set correctly (relevance), whether the requirements meet the objectives (effectiveness, EU added value), whether they are consistent across the different legislative acts (coherence), and whether the costs and burden of supervisory reporting are reasonable and proportionate (efficiency). Furthermore, the Commission is aware that changes to reporting requirements may imply costs and as such the overall benefits of any amendment to an established reporting requirement should exceed its costs.

Question 15.

Article 2 of Commission Delegated Regulation (EU) 2017/391 establishes the data which internalised settlement reports should contain. Do you consider this data meets the objectives of relevance, effectiveness, EU added value, coherence and efficiency?

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

Question 15.1

Please explain your answer to Question 15, providing where possible quantitative evidence and/or concrete examples.

We agree with ESMA's report on internalised settlement of 5th November 2020 "that data covering a longer period of time would be needed in order to have a clearer picture regarding internalised settlement trends."

AFME members view settlement internalisation as an important tool for reducing counterparty risk and driving operational efficiencies. It is an inevitable result of the existence of omnibus accounts, which many market participants choose to use, as detailed in Article 38 of CSDR.

[3] Commission Delegated Regulation (EU) 2017/391 of 11 November 2016 further specifying the content of the reporting on internalised settlements, OJ L 65, 10.3.2017, p. 44–47.

[4] Commission Implementing Regulation (EU) 2017/393 of 11 November 2016 laying down implementing technical standards with regard to the templates and procedures for the reporting and transmission of information on internalised settlements in accordance with Regulation (EU) 909/2014 of the European Parliament and of the Council, OJ L 65, 10.3.2017, p. 116–144.

The implementation of settlement internalisation reporting required a significant technology build and firms have refined the reporting as the requirements may differ between NCAs. The process is efficient, and our view is that the reporting methods should not be changed.

According to the ESMA report, the levels of settlement internalisation are deemed as high. We would like to take the opportunity of this consultation to present below some reasons why this may be the case.

- Tri-party Collateral – Tri-party collateral managers provide an efficient means of moving collateral between counterparties, whereby both collateral provider and receiver hold accounts on the Tri-party agents' books. The Collateral provider delivers assets into the Tri-party program (an external movement from the provider's custodian), after which the Tri-party agent (acting upon client instruction) will ensure that securities are allocated, substituted and reused as necessary to ensure all parties are fully collateralised for their underlying transactions. All resulting collateral movements are reportable transactions and the volume is very high. The Tri-party model is an efficient and effective risk mitigation program that adds substantial value to securities financing. However, the overall fails rate is low.
- Fund managers may move assets between different funds which they manage. Where both funds are linked to an omnibus account, this will generally result in an internalised settlement. The volume is relatively low, but for custodians who primarily service buy-side clients it will comprise a significant portion of their reported volume.
- Pair-offs –a mechanism by which two counterparties have offsetting buy/sell instructions which are matched at a CSD, but which are unable to settle as neither party has the full quantity available to deliver. The parties agree to cancel the original trades and settle the difference at the CSD preventing transactions from continuing to fail at CSD. The netted portion of the trade is reported.
- The methodology of assessing failed internalised settlement instructions may give the impression of overstating the number and value of failed trades. A single trade which fails for three business days will be reported three times and multiply the value accordingly. We trust this is well understood by NCAs and ESMA alike and does not lead to a reduction in the quality of the reporting or the conclusions which may be drawn.

We welcome ESMA's initial report and would like to remain involved in future detailed analysis, since the underlying explanation of these transactions may not be immediately apparent to ESMA and the NCAs, but available through data analysis at the internaliser level.

Question 15.2

If you are an entity falling under the definition of "settlement internaliser", what have been the costs you have incurred to comply with the internalised settlement reporting regime? Where possible, please compare those costs to the volumes of your average annual activity of internalised settlement.

Question 16.

Do you think that a threshold for a minimum level of settlement internalisation activity should be set for entities to be subject to the obligation to report internalised settlement?

- Yes, based on the volume of internalised settlement
- Yes, based on the value of internalised settlement
- Yes, based on other criterion
- **No**
- Don't know / no opinion

Question 16.1

Please explain your answer to Question 16, providing where possible quantitative evidence and/or examples. Please indicate:

- whether you consider that the introduction of such a threshold could endanger the capacity of NCAs to exercise their supervisory powers efficiently;

- the cost implications of complying or monitoring compliance with such a threshold

If you answered "yes" to Question 16, please also consider whether such a threshold should be set at national level or at Union level.

The introduction of such a threshold would i) make more burdensome for NCAs to perform their supervisory activities and ii) generate additional operational complexities insofar as it would imply the need to periodically verify whether the threshold is exceeded and, as consequence, to establish whether to generate the relevant report or not. This would require significant internal technical and operational support.

Should the Commission decide to implement a threshold, settlement internalisers should be permitted to continue reporting even when their reporting activity falls below the threshold should they decide to.

4. CSDR AND TECHNOLOGICAL INNOVATION

CSDs and providers of ancillary services increasingly explore new technologies in relation to 'traditional' assets in digital form and crypto-assets that qualify as financial instruments. Two aspects can be distinguished: on the one hand the use of new technologies to service traditional assets (in digital form) and on the other hand, services provided for crypto-assets.

While CSDR is meant to be technology-neutral, the Commission services have received feedback from various stakeholders (including following the public consultation on an EU framework for markets in crypto-assets that ended in March 2020) who argue that some of its rules create obstacles to the use of distributed ledger technology (DLT[5]) and the tokenisation of securities. However, feedback received so far by the Commission in this respect has not allowed for the full specification of those obstacles and potential solutions or proposals to address them in the framework of CSDR in order to ensure the full potential of these technological innovations with regard to the settlement of securities.

Furthermore, some of the feedback received suggests that certain definitions contained in the CSDR would require specific clarification to contextualise them in an environment where DLT is used and securities are tokenised. Some of these definitions are for example "securities account", "dematerialised form" or "settlement".

On 24 September 2020, as part of the Digital Finance Package, a Commission Proposal for a Regulation on a pilot regime on market infrastructures based on distributed ledger technology has been published.[6] Under this proposal, a CSD operating a DLT SSS would be able to benefit from certain exemptions from CSDR rules that may be difficult to apply in a DLT context (e.g. exemptions from the application of the notion of transfer of orders, securities account or cash settlement). This should help stakeholders test in practice potential solutions.

Question 17.

Do you consider that certain changes to the rules are necessary to facilitate the use of new technologies, such as DLT, in the framework of CSDR, while increasing the safety and improving settlement efficiency?

- Yes
- No
- The pilot regime is sufficient at this stage
- Don't know / no opinion

Question 18.

Would you see any particular issue (legal, operational, technical) with applying the following requirements of the CSDR in a DLT environment? Please rate each proposal from 1 to 5.

Definition of 'central securities depository' and whether platforms can be authorised as a CSD operating a SSS which is designated under Directive 98/26/EC (Settlement Finality Directive (SFD))	3
Definition of 'securities settlement system' and whether a blockchain/DLT platform can be qualified as a SSS under the SFD	3
Whether and under which conditions records on a DLT platform can fulfil the functions of securities accounts and what can be qualified as credits and debits to such an account;	3
Whether records on a DLT platform can be qualified as securities account in a CSD as required for securities traded on a venue within the meaning of Directive 2014/65/EU (MiFID II)	3
Definition of 'book entry form' and 'dematerialised form'	2

[5] According to point (1) of Article 3(1) of the Commission proposal for a Regulation on Markets in Crypto-assets, and amending Directive (EU) 2019/1937 (COM/2020/593 final) 'distributed ledger technology' or 'DLT' means a type of technology that support the distributed recording of encrypted data.

[6] Proposal for a Regulation of the European Parliament and of the Council on a pilot regime for market infrastructures based on distributed ledger technology, COM/2020/594 final.

Definition of "settlement" which according to the CSDR means the completion of a securities transaction where it is concluded with the aim of discharging the obligations of the parties to that transaction through the transfer of cash or securities, or both; clarification of what could qualify as such a transfer of cash or securities on a DLT network/ clarification what constitutes an obligation and what would qualify as a discharge of the obligation in a DLT environment	2
What could constitute delivery versus payment (DVP) in a DLT network, considering that the cash leg is not processed in the network/ what could constitute delivery versus delivery (DVD) or payment versus payment (PVP) in case one of the legs of the transaction is processed in another system (e.g. a traditional system or another DLT network)	3
What entity could qualify as a settlement internaliser, that executes transfer orders other than through an SSS	2

Question 18.1
Please explain your answers to question 18 (if needed), including how the relevant rules should be modified.

i. Definition of a central securities depository

Broadly, the current definition of a CSD is appropriate for DLT based securities. However, we have some concern with:

• **The concept of 'initial recording of securities'** - an issuer seeking to issue securities tokens on a DLT network would need to appoint a CSD for the issuance. That CSD will, in combination with the issuer, police the establishment and control of the DLT-based register. The issuer's act of dematerialisation is the placing of securities on the DLT-based register. Provided the CSD agrees to carry out its establishment and control functions, it seems that the CSD's role would broadly equate to the initial recording of securities in a book-entry system. Clearly, the language of CSDR does not cater for DLT issuance, however, it is not outside the conceptual meaning of this provision. Whilst AFME does not see this as an inherent challenge, further clarity would be helpful in the form of regulatory guidance or amendments to CSDR.

• **The concept of 'top tier level' maintenance** - It is essential that there is a control function performed by a responsible entity to ensure that the 'top tier' level holdings reflected in the securities accounts ("wallets") are correct. The process may vary depending on the network and protocol and may require the ability for a CSD to have a master node or similar control.

• **The use of 'central' in the definition** - we welcome clarification that a central view of accounts can be maintained by a decentralised database, e.g. a CSD could make use of DLT infrastructure.

ii. Whether records on a DLT platform can be qualified as securities accounts and what can be qualified as credits and debits to such an account?

While CSDR defines a securities account, it does not explicitly state whether there is a legal difference between accounts, records and ledgers. We assume that the notion of 'wallets' is similar to that of accounts. Clarity is welcomed. In a DLT context, we assume that a CSD should, through technological means, be able to control any attempts to transfer title and to record and clearly reflect at any point current ownership. AFME's view is that there is significant value in a single entity performing this role.

iii. Definition of 'book-entry form' and 'dematerialised form'

We see no inherent challenge with these definitions although AFME's view is that the concept of book-entry form ought to be clarified/broadened to include entries on a DLT ledger.

iv. What could constitute delivery versus payment in a DLT network, considering that the cash leg is not processed in the network?

The most significant source of credit risk in securities settlement, and, therefore, the most likely source of systemic risk is the principal risk that may arise on the settlement date. Such principal risk can be eliminated if the securities settlement system adheres to the principle of, as required by Article 39.7 of CSDR. Delivery versus Payment (DvP) is achieved today in systems such as T2S, where the Eurosystem operates the cash and securities entries on behalf of all parties in Central Bank money, or it can be realised via a licensed commercial bank, which operates cash accounts in commercial bank money.

In the context of a DLT-based security token settlement, technical solutions might be utilised to achieve DvP, or something similar. We note research by the Bank of Japan and European Central Bank into how to technologically achieve DvP in a DLT environment[7]. On the assumption that the technical solutions are workable, we welcome clarification on the possibility from a legal perspective.

Clarification is required on what the exact set-up and applicable DVP model is, who the provider of cash services is, what the interface model is, and what the credit and collateral management services are. The applicable provisions of CSDR, and regulatory technical standards on prudential requirements for CSDs and designated credit institutions offering banking-type ancillary services should also apply to such set-ups and institutions.

v. Definition of settlement internaliser

A settlement internaliser is an entity (acting as a custodian for both parties to a trade) that receives a settlement instruction from a client but does not forward it on to another entity in the securities holding chain. Instead, the settlement instruction results in a transfer of securities from one account to another across the books of the settlement internaliser itself without the movement taking place on an external securities settlement system of the CSD. On the assumption that the CSD acts as the operator of the DLT network, the same principles would apply, albeit the benefits of internalisation may be less clear in a DLT context.

Question 18.2

Do you consider that any other changes need to be made, either in CSDR or the delegated acts to ensure that CSDR is technologically neutral and could enable and/or facilitate the use of DLT?

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

Question 18.3

If yes, please indicate the provisions and make the relevant suggestions.

We believe that the DLT Pilot Regime will be useful in identifying areas in which changes are required to CSDR in order to facilitate the use of DLT. As highlighted in AFME's response to the consultation on the Pilot Regime, we are supportive of the proposed exemptions which aim to remove regulatory barriers to the development of DLT solutions. The Pilot Regime should also allow market participants to pursue other exemptions (in addition to the six identified), subject to approval by NCAs and ESMA supervisory convergence review.

We believe that as the market develops, there may be further examples where exemptions are needed to support innovation and encourage the development of different business models (e.g. exploring opportunities for peer-to-peer transactions and the development of different custody solutions). While it would be difficult to identify an exhaustive list of exemptions, because there is not enough experience with the adjustments required for DLT issued securities, we believe a certain degree of flexibility should be built into the Pilot Regime to ensure it remains fit for purpose as the market develops.

[7] Joint bank of Japan and European Central Bank Research Project - Securities settlement systems: delivery-verses-payment in a distributed ledger environment (March 2018). https://www.boj.or.jp/en/announcements/release_2018/data/rel180327a1.pdf

To ensure a consistent approach across the EU, these additional exemptions may require further safeguards, such as ESMA's approval. In this regard, it will remain important to ensure any risks in conducting activities in the Pilot Regime phase are sufficiently identified and mitigated, and to ensure any risks created by the granting of exemptions are made public to market participants.

Further to this, AFME also supports the introduction of a more frequent review during the Pilot Regime, to provide an opportunity for evaluation and timely legislative changes, or interpretive communications, to introduce legal certainty and regulatory clarity. This review period should also provide the opportunity to evaluate whether the Pilot Regime could be shortened, if feasible.

Question 19.
Do you consider that the book-entry requirements under CSDR are compatible with crypto-assets that qualify as financial instruments?

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

Question 19.1.
Please explain your answer to question 19.

The concept of book-entry form under CSDR appears to be workable in the context of security token settlement on a DLT.

Article 3(1) of the CSDR provides that "*any issuer established in the Union that issues or has issued transferable securities, which are admitted to trading or traded on trading venues, shall arrange for such securities to be represented in book-entry form as immobilisation or subsequent to a direct issuance in dematerialised form*". Security tokens are inherently dematerialised and should thus meet this book-entry requirement. However, it would be helpful if regulators confirmed that securities recorded on a DLT ledger fall within the meaning of securities issued in "dematerialised form" that fulfil the book-entry requirements.

Article 3(2) requires that where a "*transaction in transferable securities takes place on a trading venue, the relevant securities must be recorded in book-entry form in a CSD on or before the intended settlement date, unless they have been so recorded*". The requirement to record the security tokens in book-entry form does not appear to be inconsistent with DLT based records.

In light of Recital 11 according to which the Regulation does not intend to "*impose one particular method for the initial book-entry recording, which should be able to take the form of immobilisation or of immediate dematerialisation*", the only constraint imposed by the regulation is that this recording on an account should take place via an authorised central depository.

CSDR therefore does not oppose the recording of security tokens in the central depository taking place via a DLT network and not via an account as understood from an accounting viewpoint. However, routing via the intermediary represented by the CSD remains an obligation. As things stand at present, a platform listing security tokens should therefore perform settlement and delivery either via another market participant authorised as CSD or by being itself authorised as CSD.

Although some Member States have considered CSDR book-entry requirements equivalent to the holding chain of a block of security tokens, what a book-entry system really means in a DLT environment needs some clarification.

Question 20.

Would you see any particular issue (legal, operational, technical) with applying the current rules in a DLT environment? Please rate each proposal from 1 to 5, 1 standing for "not a concern" and 5 for "strong concern".

Rules on settlement periods for the settlement of certain types of financial instruments in a SSS	3
Rules on measures to prevent settlement fails	3
Organisational requirements for CSDs	3
Rules on outsourcing of services or activities to a third party	4
Rules on communication procedures with market participants and other market infrastructures	3
Rules on the protection of securities of participants and those of their clients	2
Rules regarding the integrity of the issue and appropriate reconciliation measures	2
Rules on cash settlement	3
Rules on requirements for participation	3
Rules on requirements for CSD links	3
Rules on access between CSDs and access between a CSD and another market infrastructure	3
Rules on legal risks, in particular as regards enforceability	3

Question 20.1.

Please explain your answers to question 20, in particular what specific problems the use of DLT raises.

The principles set out in CSDR are conceptually workable in the context of a CSD operating in a DLT environment. However, clarifications may be needed on the following:

i. Rules on outsourcing of services or activities to a third party

In a DLT context, it is possible that some functions are not performed by a central entity (traditionally a CSD), but by other actors, either alone or in collaboration. This is especially relevant where the mining or recording and validation of transactions can be performed by different processes and actors. Clear guidelines must be established on the parameters and criteria for the outsourcing of such functions, and what roles the CSD must retain, or how some of the functions performed should be understood in a distributed environment.

ii. Rules on communication procedures with market participants and other market infrastructures

Platforms should be interoperable. Further consideration should be given to promote common standards that enable interoperability.

iii. Rules on cash settlement

Most CSDs offer settlement in central bank money, in accordance with the relevant IOSCO principles, also enshrined in CSDR. Article 40 of CSDR requires CSDs, for transactions denominated in the currency of the country where the settlement takes place, to settle the cash payments of its securities settlement system through accounts opened with a central bank, where practical and available. In a decentralised construct, it may be practically difficult to identify the country where the settlement takes place. Therefore, we find that settlement is deemed to have taken place in the jurisdiction where the DLT operator is authorised and governed, as today.

Where the cash payment is executed on a DLT network, the provision of settlement in central bank money in a DLT environment will be an important aspect for consideration. Presently, central bank money is not directly issued on DLT, although this may change in the future.

Regulators and Central Banks should ensure that a DLT-based CSD could have the same level of central bank access and same access requirements as an equivalent traditional CSD, and that the rules applying to credit institutions providing banking services to current CSDs also apply to DLT-based CSDs.

iv. Rules on requirements for participation

The Settlement Finality Directive defines 'participant' as "an institution, a central counterparty, a settlement agent or a clearing house" (each with respect to the relevant designated system). An 'institution' is defined as broadly a credit institution, an investment firm (other than an exempt person under Article 2 of MiFID II), a public authority or publicly guaranteed undertaking or certain other undertakings treated as an institution.

In the same way that electronic access to centralised CSD platforms today is restricted using software, a decentralised platform can also be successfully restricted, e.g. by using a permissioned network in which only authorized parties can participate. On this basis, assuming the technological solution that is deployed is robust, we see no inherent challenges with these definitions.

v. Settlement discipline - settlement fails

Whilst recognising that DLT can drive settlement efficiency, we wish to make clear that settlement fails could still arise in a DLT context, for similar reasons to traditional CSDs, such as technology issues, errors, mismatches, or lack of credit/tokens. In a DLT context, it is conceivable that the entity performing the operator role would be able to monitor settlement fails.

vi. Settlement finality

For security tokens, we would consider 'settlement' to occur at the point when consensus has been reached according to a predefined methodology. Accordingly, we see no inherent challenges with the concept of settlement finality in a DLT security settlement environment.

vii. Rules on requirements for CSD links, access between CSDs and other market infrastructures

While the principles behind the detailed rules on CSD links in terms of access are relevant in a context of DLT platforms connecting to each other and to traditional CSD platforms, there may be a need to review how all these rules apply in practice. Given that the technical platforms may be very different, any links may be complex to establish or create unnecessary risks. Interoperability between FMIs should also apply in the context of DLT platforms.

Question 20.2.

If you consider that there are legal, operational or technical issues with applying other rules regarding CSD services in a DLT environment (including other provisions of CSDR, national rules regarding CSDs implementing the EU acquis, supervisory practices, interpretation,), please indicate them and explain your reasoning.

5. AUTHORISATION TO PROVIDE BANKING-TYPE ANCILLARY SERVICES

According to Article 54 of CSDR, the provision of banking-type ancillary services by CSDs is allowed either by themselves or through one or more limited license credit institutions, provided that some requirements are complied with in terms of risk mitigation, additional capital surcharge and cooperation of supervisors in authorising and supervising the provision of these banking services to CSD users. It seems that limited license credit institutions do not exist yet. Article 54(5) foresees an exception to conditions applying to credit institutions that offer to settle the cash payments for part of the CSD's securities settlement system, if the total value of such cash settlement through accounts opened with those credit institutions, calculated over a one-year period, is less than one per cent of the total value of all securities transactions against cash settled in the books of the CSD and does not exceed a maximum of EUR 2,5 billion per year. CSDs have voiced in the past difficulties regarding cash settlement in foreign currencies. Questions in this section aim at identifying these and other potential concerns as well as possible ways forward.

Questions for CSDs

Question 21:

Do you provide banking services ancillary to settlement to your participants?

- Yes
- No

Question 21.1

If you answered "yes" to Question 21, did you provide these services prior to the entry into force of CSDR?

-Yes

-No

Question 21.2

If you answered "yes" to Question 21, have you been authorised to provide those services under Articles 54 and 55 of CSDR?

- Yes
- In the process of the authorisation
- No

Question 21.3

If you were providing banking services ancillary to settlement prior to the entry into force of CSDR and you are not providing them anymore, or you limited their provision below the threshold as defined in Article 54(5), please explain the reasoning behind your decision.

Question 22

Do you think that the conditions set in Article 54(3) for the provision of banking-type ancillary services by CSDs are proportionate and help cover the additional risks that these activities imply?

- Yes
- No

Question 22.1

If you answered "no" to Question 22, please elaborate further and provide quantitative evidence and/or examples.

Question 23

In your view, are there banking-type ancillary services that cannot be provided by CSDs under the current regime for this type of services?

Question 24

Concerning settlement in foreign currencies, have you faced any particular difficulty?

- Yes
- No

Question 24.1

Please explain your answer to question 24 providing concrete examples and quantitative evidence.

Question 24.2

If you answered yes to question 24 and based on the quantitative evidence you might have provided to support your answer, how could the settlement of transactions in a foreign currency be facilitated? Please provide concrete examples.

Question 25

What are the main reasons CSDs do not seek to be authorised to provide banking-type ancillary services? Please explain in particular if this is so due to obstacles created by the regulatory framework.

Question 26

Have you made use of the option to designate a credit institution to provide banking type ancillary services to CSDs?

- Yes
- No

Question 26.1

If you answered "no" to Question 26, please explain why.

Questions for all stakeholders:

Question 27

In your view, are the thresholds foreseen in Article 54(5) set at an adequate level?

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

Question 27.1

Please explain your answer to question 27, providing where possible concrete examples. If you answered "no", please provide where possible quantitative evidence (including any suggestion on different threshold levels).

Question 28

Do you think that the conditions set out in Article 54(4) for the provision of banking-type ancillary services by a designated credit institution are proportionate and help cover the additional risks that these activities imply?

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

Question 28.1

Please explain your answer to question 28, providing where possible concrete examples. If you answered "no", please provide where possible quantitative evidence.

Question 29

Why do you think there are so few, if any, credit institutions with limited license to provide banking-type ancillary services to CSDs? Please explain in particular if this is so due to obstacles created by the regulatory framework.

Question 30

Are there requirements within Title IV of CSDR which should be specifically reviewed in order to improve the efficiency of the provision of banking-type ancillary services to and/or by CSDs while ensuring financial stability?

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

Question 30.1

Please explain your answer to question 30, providing where possible quantitative evidence and/or concrete examples:

We do not have any particular views to express in the context of Title IV of CSDR. However, we would like to highlight the need to ensure that any changes to the current rules should not result in a relaxation of the prudential requirements (as per the regulatory technical standards defined in the Commission Delegated Regulation (EU) 2017/390) that apply to CSDs wishing to provide banking-type ancillary services. We believe that the CSDs' critical role as central market infrastructures for core functions should remain adequately protected from any additional risks, such as credit risks or market risks, that are normally associated with the provision of banking services.

6. SCOPE

CSDR lays down a series of requirements for the settlement of financial instruments in the Union and harmonised rules on the organisation and conduct of CSDs. While the scope of rules applicable to CSDs seems clear, the requirements applying to the settlement of financial instruments has given rise to numerous questions. A certain number of these questions has been addressed by ESMA, especially in relation to the scope of requirements on internalised settlement, relevant currencies or the substantial importance of a CSD.

Article 2(1)(8) of CSDR defines financial instruments in accordance with the definition of financial instruments in Directive 2014/65/EU on markets in financial instruments (MiFID II) (i.e. transferable securities, money-market instruments, units in collective investment undertakings, various types of derivatives and emission allowances). Some CSDR provisions explicitly restrict the scope of their applicability to a subset of the above definition, e.g. Articles 3 on book entry-form (only transferable securities) and Article 5 on the intended settlement date. Other provisions are not explicit or refer generally to financial instruments or securities (e.g. Article 23 on the provision of services in another Member State).

In the case, for instance, of the settlement discipline, stakeholders have indicated that the different provisions of CSDR setting out the scope of the requirements such as settlement fails reporting, cash penalties or buy-ins are not always clear. This lack of legal certainty could potentially lead to reducing the efficiency in securities settlement. Furthermore, feedback from some stakeholders suggests that in some circumstances the drafting of CSDR in relation to the scope of the settlement discipline is clear, however, its application could bring unintended consequences.

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 which provisions could benefit from such clarification and provide concrete examples.

A. Scope of Market Actors subject to buy-in regime

The term participant including references to 'failing participant' and 'receiving participant' is used inconsistently throughout the Level 1 and Level 2 texts (e.g. Articles 7.3, 7.6, 7.7, 7.8), which may result in disparate implementation and expectations across the various actors involved from the trade through to the settlement of securities transactions. Some may interpret the participant to be a direct CSD participant. Alternatively, some may interpret the participant to be the participant to the trade (i.e. the trading party, a concept which was introduced in the RTS on Settlement Discipline to cover this gap). Without a clear distinction of what provisions relate to which actor in the 'trade through to settlement chain' the SDR may be, in its application, fraught with disputes and legal challenges.

A buy-in is a trading event which can only be addressed by the trading parties and not by the settlement agents and custodians in the chain who are not principal to the trade. This is supported by the Settlement Discipline RTS and ESMA's Final Report, for example:

- Recital 31 of the Settlement Discipline RTS states that (emphasis added) "[f]or transactions that are not cleared by a CCP, in order to set up an efficient buy-in process and to avoid that other parties in the settlement chain or participants become liable for obligations contracted by the trading venue members or trading parties, and in order not to increase the risk profile of CSDs or trading venues, the parties that originally concluded the relevant transaction should be responsible for the execution of the buy-in";

- Paragraph 116 of the Final Report, ESMA states: "As for the entity actually in charge of executing the buy-in, CSDR places the responsibility on the CCP for CCP-cleared transactions and for non-CCP-cleared transactions, ESMA proposes in its draft RTS to place it at the trading level."

Unless the trading party is itself a direct participant of the CSD where the trade is settling, the role of CSD participants, such as settlement agents, prime brokers and global custodians, should be limited to the transmission of settlement information in the buy-in process without any liability under CSDR, as the CSD participants are not themselves party to the trading agreement which is being enforced through the buy-in.

In addition, the definition in Article 1(f) of the RTS of the trading party as 'a party acting as principal in a securities transaction' would benefit from clarification that it refers explicitly to regulated entities. This would avoid any interpretation that an end investor such as a retail client in a segregated market (where each client has its own CSD account) would be required to initiate a buy-in.

B. Scope of transactions subject to buy-ins

The buy-in process mandated under Articles 7(3) to 7(8) of CSDR applies to settlement fails of certain types of transactions in financial instruments referred to in Article 5(1) of CSDR. Whilst the term "transaction" is not defined in CSDR or the RTS on Settlement Discipline, CSDR and the RTS on Settlement Discipline expressly identify the transactions subject to mandatory buy-in as being:

- "trades", such as purchases or sales of securities and transactions subject to securities repurchase or lending agreements;8 for which there is an
- "original agreement"9.

It is important to recognise that not all settlement instructions at a CSD relate to a transaction that meets these conditions. We believe that these instructions may be in the scope of the penalties regime but would not be in scope of the buy-in regime. However, in certain cases, it would be beneficial for the authorities to provide explicit clarification that this is the case. Please refer to responses by other associations for further detail on specific examples.

Question 31.2

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

A. Scope of market actors subject to buy-in

AFME recommends that L1 and L2 buy-in provisions are modified to conclude with the legal and factual reality that custodians and settlement agents act solely on their client's instructions and are not parties to a trade. Any liability and non-payment of buy-in costs should sit solely with the delivering trading party – there should be no recourse back to the CSD participant. This principle was confirmed in the ESMA report on this topic, and partially implemented in the RTS but not wholly applied due to the limitations of the language used in Article 7 of Level 1.

Further to this, provisions relating to contractual arrangements and procedures, such as Article 25 of the RTS, should be amended to make clear that the trading parties responsible for the buy-in process (not custodians or settlement agents) are required to establish contractual arrangements with their counterparties to incorporate the buy-in process. Settlement participants can acknowledge and inform their clients of such provisions, but cannot be held to enforce the provisions on buy-ins, nor be responsible for payment of any costs as outlined in the RTS on Settlement Discipline.

[8] Articles 7(4) and 7(6) of CSDR and Recitals 26, 32 and 41 and Article 35 of RTS on Settlement Discipline discuss mandatory buy-in only in the context of transactions constituting "*trades*", "*obligations to buy or sell securities*" and "*securities repurchase or lending agreements*".

[9] Recital 15 of CSDR

B. Scope of transactions subject to buy-ins

We note by way of example that Article 2(5) of Delegated Act 2017/590 contains a specific list of exemptions to clarify the meaning of a transaction for the purposes of MIFIR regulatory reporting. For CSDR, a specific definition of what constitutes (or does not constitute) a "transaction" for the purposes of the buy-in regime is necessary to provide certainty for market actors and avoid that certain types of settlement instructions which are not the result of trades are caught by the buy-in provisions. Some examples include:

1. Margin transfers

A margin transfer of securities is an example of securities markets operations distinct from a transaction in a financial instrument. The stated objective of the buy-in is to reduce settlement fails by establishing a "compulsory enforcement of the original agreement". In respect of margin transfers, the 'original agreement' is a transaction between the trading parties, such as a derivatives transaction or a margin loan, which would expose the parties to counterparty risk. A margin transfer, by contrast, provides that one party (the collateral provider) will mitigate the credit risk to which the other party (the collateral receiver) is exposed under the separate original agreement by delivering cash and/or securities as collateral. A failure to do so by the collateral provider will typically allow the collateral receiver to take steps to mitigate such credit risk by other means (e.g., triggering a default notice, close-out netting, etc) which are already included in industry standards and agreements. As such, if CSDR were read to require a buy-in of the failed margin transfer, this would not equate to a compulsory enforcement of the original agreement.

Similarly, the application of buy-in to margin transfers would not assist the collateral receiver in mitigating its credit risk in any event, would be inefficient, and may expose the receiver to additional risk: the collateral provider's obligation to deliver margin securities would be replaced by an obligation on the receiver to initiate a buy-in, appoint a buy-in agent, (pre-)fund the buy-in agent for the bought-in securities, sell these bought-in securities to another counterparty to cover the open risk, and then try to recuperate the costs from the failing delivering trading party.

2. Settlement instructions where the party acting as principal is the same for the delivery and receipt

Articles 30 and 31 of Level 2 outline the buy-in process for transactions not cleared by a CCP and not executed on a trading venue. The text refers to the failing trading party and the receiving trading party as the participants in the transaction and defines trading party as 'a party acting as principal in a securities transaction'

Article 2(1)(12) of CSDR defines the intended settlement date as being "the date that is entered into the securities settlement system as the settlement date and on which the parties to a securities transaction agree that settlement is to take place".

Thus, a buy-in presupposes a securities transaction in which there is more than one party acting as principal. Settlement instructions may be entered into a securities settlement system which do not involve two parties acting as principal in a securities transaction. For example, a Portfolio Transfer, in which a client may choose to transfer a position from one custodian to another, or an inventory realignment held by the same party in different markets. Practically speaking, it would serve no economic purpose for the instructing party, as the receiving party, to initiate a buy-in against itself, as the failing delivering party.

3. Market Claims

In the event of a distribution, a pending transaction may effect that the holder on record date is not the entitled holder. In this case, a market claim may be created separately to the original transaction, to reallocate corporate entitlements. A market claim is an example of securities markets operations distinct from a transaction in a financial instrument. For this reason, it should not be subject to the buy-in regime. The pending underlying transaction will be subject to a buy-in where applicable.

In the vast majority of cases, market claims are automatically detected and generated by the CSD itself and therefore not the result of a transfer order initiated by the trading parties of the original transaction. Note that

a claim will be bilaterally agreed by the parties to the underlying transaction, in the event that it is not automatically generated by the CSD. This happens on an exceptional basis, and the settlement instructions are input by the settlement agent/sub-custodian rather than the trading parties of the original transaction. On this basis, we do not believe any distinction should be made on the scope of a market claim based on the means by which it was generated.

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 32.2

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

A. Scope of financial instruments subject to the buy-in regime

As per Article 7(13), only shares for which "the principal venue for the trading of shares is located in a third country" are considered out of scope. This creates an uneven application of the scope based on asset class and may create additional complexities for cross-border fail chains in third-country instruments.

B. Scope of transactions subject to the buy-in regime

As a general principle, transactions which can be deemed a 'trade' between a buyer and a seller but where a buy-in would serve no economic purpose or would not contribute towards improving the efficiency of securities settlement, should be removed from the scope of the buy-in regime. More generally, the text of the CSDR and the RTS need to be updated in key parts to reflect that they concern trades instead of settlements.

For products or transaction flows for which there are existing contractual mechanisms that achieve the same objective as a buy-in (i.e., provide a remedy/resolution to a settlement fail.).an additional requirement to incorporate CSDR buy-in provisions into contracts would not serve any purpose or contribute the objectives of the Settlement Discipline Regime.

We strongly support a discretionary buy-in framework, in which the receiving trading party is not mandated to initiate a buy-in, on the basis that this would allow the buyer the flexibility to choose the appropriate "tool for the job". To explicitly remove certain products or transaction flows from the scope of CSDR buy-in rules would prevent unnecessary contractual repapering exercises and allow the industry to focus on products and transaction flows where the buy-in regime will be utilised.

Separately, in the event of force majeure, the regulation should include a provision to allow for the suspension of settlement discipline measures for all transactions, both at the level of CSDs and CSD participants.

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?

A. Scope of financial instruments subject to the buy-in regime

AFME believes that the exemption under Article 7(13) should be expanded to

a) Apply to all types of financial instrument (not only shares)
b) Apply based on country of issuance of the instrument (rather than location of principal trading venue)

A central database of in-scope securities (and the relevant reference price, penalty rate and extension period) maintained by ESMA is essential to providing clarity for all market actors and reducing the likelihood of disputes.

B. Scope of transactions subject to the buy-in regime

Where the regulators can be satisfied that alternative compensatory measures exist, these products or transactions should be exempt from the scope of the mandatory buy-in regime. Examples of alternative measures include industry standard documentation relating to trading and clearing of derivatives, which already include extensive provisions relating to the remediation of non-delivered physically settled derivatives transactions; industry standard documentation relating to securities lending and repo transactions, which already include "mini close-out" provisions to establish the right of the purchasing party to terminate a failed transaction.

Other examples where a buy-in would not contribute towards improved settlement discipline include:

1. Primary market operations such as creation/redemption processes and mark-up/mark-downs

Such types of transactions are managed through settlements instructions such as MT54X equivalent to messages also sent for regular purchase or sales of securities.

Creation or redemption of ETP units are instructed against funds transfer agents. There are several steps required before settlement can be effected which can take several days. Where an ETP creation/redemption leg of the primary market order may have failed, in order to buy-in ETP units, a Buy-In Agent may need to acquire the ETP units from an Authorised Participant (AP).

If these units are not readily available on the secondary market, the AP may need to subscribe for the units with the ETP provider, as the ETP is essentially an open-ended collective investment scheme. Such a buy-in for an AP failing to return ETP units could result in a circular scenario whereby the ETP provider creates units just to receive these same units back through the buy-in, and then cancel them.

Ultimately, such inefficiencies would weaken investor protection measures and thereby have a material detrimental impact on end-investors, both in terms of the value of their investments and the prices with which they are presented in the market.

For instructions related to increases (Mark-Up) or decreases (Mark-Down) of the issuance size, Settlements instructions are sent in the same format as purchase or sale instructions. However, those instructions are sent only to reflect the issuance or decrease of the product on the issuer account. On regular occasions, legal documentation is necessary to facilitate settlement, that can take several days.

2. Voluntary corporate actions where the outturn has an economic impact on the original transaction

Article 7.4(b) of Regulation (EU) No 909/2014 states that "for operations composed of several transactions including securities repurchase or lending agreements, the buy-in process referred to in paragraph 3 shall not apply where the timeframe of those operations is sufficiently short and renders the buy-in process ineffective."

This principle should also apply to voluntary corporate actions which generally have short lifecycles:

Example 1 – Rights Issues

Given the short lifecycle of interim securities, there is likely not to be sufficient time in which to successfully complete a buy-in. In the case of an unsuccessful buy-in, the purchasing party will lose the right to participate in the elective corporate action and will instead receive cash compensation.

Example 2 – Tenders

As above, the lifecycle of the election period could be insufficient to successfully complete a buy-in, and an unsuccessful buy-in would result in the purchasing party losing the right to participate in the voluntary reorganisation, instead receiving cash compensation.

Example 3 – Conversions

A holder of a bonds can request the conversion from a line of securities to another (144A to REGS or vice versa). Such instructions are sent to the conversion agent who must fulfil several administrative tasks between two CSDs before being able to settle the transactions, which can take up several days.

For Corporate Events, the buyer protection mechanism provides a better means by which to protect the rights of the purchasing party. As defined in the CAJWG standards, buyer protection is the process whereby a buyer who has yet to receive the Underlying Securities of an Elective Corporate Action, instructs the seller in order to receive the outturn of his choice.

3. The buy-in transaction itself

To initiate a buy-in on the transaction between a buy-in agent and receiving trading party would serve no economic purpose nor contribute towards improving market settlement efficiency.

7. SETTLEMENT DISCIPLINE

CSDR includes a set of measures to prevent and address failures in the settlement of securities transactions ('settlement fails'), commonly referred to as 'settlement discipline' measures. Application of the relevant rules in CSDR is dependent on the date of entry into force of [Commission Delegated Regulation (EU) 2018/1229 on settlement discipline][13], which specifies the following:

(a) measures to *prevent settlement fails*, including measures to be taken by financial institutions to limit the number of settlement fails as well as procedures and measures to be put in place by CSDs to facilitate and incentivise timely settlement of securities transactions;

(b) measures to *address settlement fails*, including the requirements for monitoring and reporting of settlement fails by CSDs; the management by CSDs of cash penalties paid by their users causing settlement fails; the details of an appropriate buy-in process following settlement fails; the specific rules and exemptions concerning the buy-in process and the conditions under which a CSD may discontinue its services to users that cause settlement fails.

Commission Delegated Regulation (EU) 2018/1229 was supposed to enter into force on 13 September 2020. However, in May 2020 the Commission adopted a Commission Delegated Regulation amending it, thereby postponing its date of entry into force from 13 September 2020 to 1 February 2021. This short delay was considered necessary to take into account the additional time needed for the establishment of some essential features for the functioning of the new framework (e.g. the necessary ISO messages, the joint penalty mechanism of CSDs that use a common settlement infrastructure and the need for proper testing of the new functionalities). During the COVID-19 crisis, many stakeholders asked for a further postponement of the entry into force of Commission Delegated Regulation 2018/1229. Those stakeholders argued that the COVID-19 pandemic impacted the overall implementation of regulatory projects and IT deliveries by CSDs and their participants and that, as a result of that, they will not be able to comply with the requirements of the RTS on settlement discipline by 1 February 2021. On 23 October 2020, the Commission endorsed ESMA's proposal to postpone further the entry into force of the RTS on settlement discipline to 1 February 2022.

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.

Rules relating to the **allocation and confirmation process** require some minor amendments to ensure their effectiveness – in particular the removal of the requirement in Article 2.2 of the RTS on Settlement Discipline for investment firms to confirm receipt of allocations. Please see Proposal 14 of 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:

Statement	Rating
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	5
The penalty rates should be revised	4
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.

A. Buy-ins should be mandatory / Buy-ins should be voluntary

We strongly support the proposal that buy-ins should be voluntary – i.e. the decision to initiate a buy-in is the discretionary right, not the mandatory obligation, of the purchasing party. This should apply in relation to transactions which do not involve a CCP. For cleared transactions, we believe that existing CCP mandatory buy-in rules should remain in place.

AFME shares the objective of the CSDR Settlement Discipline Regime to increase settlement efficiency. We welcome new measures relating to allocation and confirmation procedures, enhancements to CSD functionality, and the introduction of a penalty mechanism. AFME strongly believes that these initiatives alone will deliver an improvement to current settlement rates.

Further, we support the supplementation of these measures with a discretionary buy-in mechanism, which enshrines into EU law the discretionary right of the purchasing party to initiate a buy-in on a failed transaction, and sets out a high-level, harmonised framework for this process.

It is important to note that this proposal is to be enshrined in law and applies to all in scope instruments/transactions (see our response to section 6 regarding the scope of the buy-in regime). The discretionary nature of our proposal exists on the part of the purchasing party as to whether they choose to activate their right.

There are three principal advantages of a discretionary buy-in framework versus a mandatory buy-in framework.

Empowerment for the Buyer

At its core, the mandatory buy-in regime as currently drafted places the burden of regulatory compliance on the injured party, the buyer. It removes the ability for the buyer to decide when and whether to force delivery and could even force it to act against its own economic interests.

For example, CSDR mandates that if the securities cannot be sourced by the buy-in agent, the original transaction is replaced by a cash settlement, and the purchaser never receives the contractually agreed securities. The purchaser may wish to allow the seller additional time to make delivery, rather than accept cash compensation which does not allow the buyer to achieve its investment objectives.

In addition, a rigid regime fails to acknowledge that that liquidity in some instruments may vary substantially. Imposing mandatory buy-ins may leave liquidity providers more reluctant to make offer prices when they do not have ready access to inventory or increase bid-offer spreads, leading to increased risks and costs for investors (including asset managers, pension funds and insurance funds) and issuers.

Adjusting the buy-in regime to a discretionary right, underpinned by a regulatory framework, as opposed to a mandatory obligation, in combination with penalties for late settlement will allow greater flexibility for the end investor whilst preserving the original policy objectives of enhancing settlement rates.

Market Liquidity

In order to maintain liquidity across a wide spectrum of asset classes and execution sizes, the financial markets ecosystem relies on a wide range of execution mechanisms including multilateral venues, bilateral risk provision via Systematic Internalisers or OTC (where permitted) and RFQ platforms.

In many cases, and particularly across less liquid instruments, markets rely heavily on the liquidity provided by market-makers and Authorised Participants, who, in the absence of continuous, two-way, order-based prices, will provide bid-offer quotes to support the provision of immediate liquidity.

In order to provide continuous bid-offer quotes and market liquidity to buyers and sellers, it is necessary that dealers make markets in securities that they do not hold in their inventory, by running a temporary short position to meet investor needs. It is well documented that in recent years there has been a "large reduction in dealers' inventory in the corporate bond market", in part as a result of post-GFC reforms such as Basel III/IV to reduce balance sheet exposure and market risk.

As such, making offers without having the inventory at the point of trading represent a significant percentage, sometimes above 20%, of orders executed on fixed income credit trading desks, especially for less liquid instruments. Research has shown that such trades contribute to higher liquidity and pricing efficiency. The market-maker's role is the provision of liquidity for less liquid markets, and the ability to make offers without having the inventory is an important facilitator for that.

The introduction of a mandatory penalty and buy-in regime under CSDR fundamentally alters this dynamic, as it removes the flexibility for market makers to offer prices without having the inventory. It is therefore an important consideration for a trader when determining whether to make a market in a particular security and at what price. For securities not held in inventory, or which cannot be readily sourced, the trader may understandably choose to increase the offer price to offset the potential cost of a buy-in, or in extreme cases not to offer a price at all. The impact of this could be the removal of liquidity from the market. This will disproportionately impact those sectors which already suffer from lower liquidity and higher costs of trading (see also point G)

Whilst measuring the exact pricing impact in advance of the implementation of the mandatory CSDR buy-in regime is challenging, it is clear that there will be a negative effect. There are a number of factors that should be considered, and each of these factors are subject to significant variance depending on prevailing market conditions, leading to a variety of outcomes.

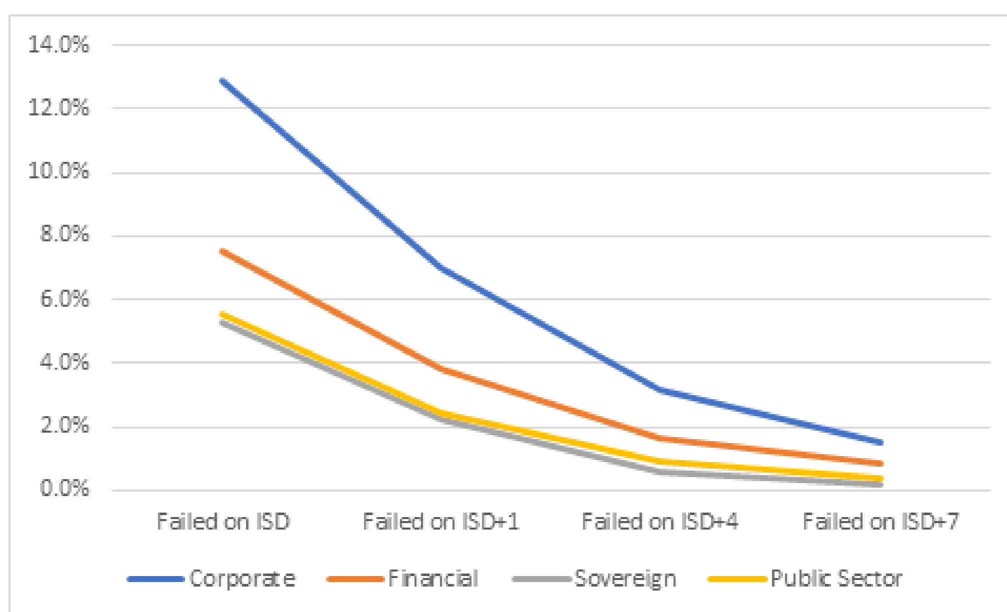
Possible considerations might include the below. We strongly recommend that further independent quantitative analysis is undertaken to calculate the impact of mandatory buy-ins in different market conditions. We also note that other responses to this consultation by AFME members or other trade associations, further explore and attempt to quantify these impacts.

1. Probability of the trade failing to settle [for 4/7 business days]
2. Availability of inventory and ability to source it
3. The introduction of new settlement penalties
4. The introduction of the new buy-in and the price differential between the original and bought-in transactions

Market-makers will need to incorporate these additional factors into the pricing of every quote. In many instances, the net effect of these incremental costs is that the final offer price quoted will simply not be economical for the purchaser, and the trade will not be executed.
It is important to assess this impact against the problem it seeks to address. Data provided by Euroclear Bank for the fixed income market in 2020 shows significant variance between different types of fixed income instrument in the percentage of settlement instructions that fail to settle on intended settlement date. A corporate bond, which typically are less liquid than SSE bonds for example, is on average more than twice as likely to fail as a sovereign bond.

The data also shows that whilst the majority of these fails are resolved before the end of the notional extension period that would apply under CSDR, those that remain outstanding are typically corporate bonds. Approximately 1.5% of corporate bonds in Euroclear Bank were still unsettled at ISD+7, compared to 0.2% of sovereign bonds. These outstanding fails will therefore most likely be in less liquid instruments (in terms of trading liquidity, as expressed in bid-offer spreads), increasing the probability that the buy-in will not be successful due to an inability to source the necessary securities. In absolute terms, this approximately equates to an estimated 1250 buy-ins per business day, for one CSD and one instrument type. In relative terms, the buy-in regime targets a small proportion of the total volume of transactions but will necessitate an impact on the pricing and liquidity on a much larger percentage of overall transactions.

Figure 1: Against payment settlement instructions failing in Euroclear Bank, for Fixed Income instruments in 2020 (%)



Source: Euroclear Bank

Adjusting the buy-in regime to a discretionary right, as opposed to a mandatory obligation, would allow greater flexibility for the end investor whilst preserving the original policy objective and enshrining the rights of the investor into regulation. Allowing the purchasing party discretion to initiate a buy-in only when it is commercially and economically rational to do so would reduce the frequency of buy-ins and therefore reduce the impact on pricing and liquidity, whilst allowing market makers to maintain liquid markets and protecting end investors and companies. Noting the link between market liquidity and the provision of market-based finance, by extension, its impact on companies and savers would also be reduced.

Flexibility

Our proposal for a discretionary buy-in based on high-level principles set out in regulation, reduces the burden on regulatory authorities and creates greater flexibility for market-driven solutions. The prescriptive nature of current Level 1 and Level 2 regulation significantly constrains the industry's ability to develop practicable and effective market practices. There are a substantial number of open issues on which the industry is reliant on urgent clarification from ESMA and the European Commission, many of which are highlighted in our response. A

simplification of the regulation, and the removal of the mandatory nature of the buy-in regime, would resolve many of these issues.
For example, removing the obligation to initiate a buy-in on a particular date provides greater flexibility for trading parties to coordinate their actions in order to minimise the number of buy-ins taking place. As mentioned in our response to Q32.1, the need for a precise and prescriptive scope for the buy-in regime is somewhat alleviated by a discretionary buy-in.

B. Rules on buy-ins should be differentiated, taking into account different markets, instruments and transaction types

Please note that we consider that this question relates only to the CSDR buy-in rules applicable to in-scope markets, instruments and transaction types. We have addressed our views regarding the scope of markets, instruments and transaction types elsewhere in our response.

In general, AFME supports the principles of harmonisation and standardisation. Buy-in rules, in the context of CSDR, should be simplified to the greatest extent possible rather than be overly prescriptive or complex.

However, it is clear that some differentiation is required in order for the regulation to be effective, and to preserve the functioning and liquidity of the market.

For example, we fully support the current proposal for different extension periods according to the liquidity of the underlying instrument. As noted in Article 7.4, for less liquid instruments, "a shorter extension period would affect the smooth and orderly functioning of the financial markets concerned."

In order to simplify the buy-in rules, we recommend that the extension period is determined only at an instrument-level, and current differentiations based on the trading venue on which the transaction was executed, or whether the transaction was cleared, should be removed.

C. A pass on mechanism should be introduced

We strongly agree that the regulation should be updated to explicitly provide that where a receiving trading party has a failing settlement of the receipt of securities and a contingent ('linked') failing onward delivery of the same securities, a pass-on mechanism can be used by the receiving trading party. Such a mechanism would allow the receiving trading party to (i) pass-on to its failing delivering trading party the consequences of a buy-in instead of triggering a buy-in against the latter and (ii) to reject a buy-in on the basis a buy-in has been / shall be initiated (for example where a CCP is involved in the settlement chain) and instead pass-on the results of the buy-in.

This pass-on should be considered as equivalent to and complying with the regulatory obligation to execute a buy-in against the failing delivering party. This is intended to reduce the number of buy-ins required to remedy settlement fails, particularly where multiple settlements are contingent on a single (failing) settlement. This is consistent with Recital (19) of the Regulation and Recital (34) of the Regulatory Technical Standards.

In addition, where a settlement chain involves a CCP, clear information should be provided to the clearing member to which the CCP fails to deliver. When the CCP informs the receiving clearing member that a buy-in has been initiated, this information can be used by the receiving clearing member to defer a buy-in relating to its failing onward delivery. This is all the more important given the central role of CCPs in market settlement and would allow a solution for the fact that CCPs cannot be bought in or a buy-in cannot be passed onto them, exposing the receiving clearing member.

An effective pass-on mechanism is important to support market efficiency and stability. This is also consistent with buy-in practice and pass-on mechanisms widely used in the European securities markets today.

D. The rules on the use of buy-in agents should be amended

We believe that amendments to the rules regarding buy-in agents are required. In particular, we recommend that the mandatory obligation to appoint a third-party buy-in agent is removed.

AFME supports the principles of best execution and fair and transparent treatment of both the receiving and failing parties involved in the buy-in. Any buy-in framework should be based on these premises, with clearly defined parameters for the buy-in agent's roles and responsibilities. The current lack of clarity is reflected in the extremely limited number of entities who have so far confirmed they will provide a buy-in agent service. We note that current offerings do not provide sufficient coverage to support all market participants. are limited in scope, and cannot meaningfully contribute to an effective implementation of mandatory buy-ins.

E. The scope of the buy-in regime and the exemptions applicable should be clarified

AFME strongly supports the above statement. A clearly defined scope is necessary to ensure the effectiveness of the buy-in regime. Please refer to our responses to Section 6 regarding Scope.

Separately, a central database of in-scope securities (and the relevant reference price, penalty rate and extension period) is essential to providing clarity for all market actors and reducing the likelihood of disputes. ESMA should be given a mandate to create and maintain such a database.

F. The asymmetry in the reimbursement for changes in market prices should be eliminated

AFME fully supports the elimination of "asymmetry" and the replacement with a new provision mandating symmetric settlement of the price difference or cash compensation.

When the price that a buy-in is executed at is greater than the price of the original trade, the corresponding difference should be paid to the buyer by the original failing seller. Where the price that a buy-in executed at is less than the price of the original trade, the corresponding difference should be paid to the original failing seller by the buyer.

The current asymmetric proposal imposes a "shadow penalty" on the failing party, above the cash penalties already accrued on the failing settlement and distorts the trade economics. Instead, the buy-in process should act as a mechanism to remediate a failing trade and restore all parties to the same economic position had the trade not failed. The establishment of 'symmetric' payments of price differentials is essential to a workable pass-on mechanism and reduces market risk for all parties. This should be applicable for both the payment of the price difference (Art. 35 of the RTS) and the calculation of the cash compensation (Art. 32 of the RTS).

G. The CSDR penalties framework can have procyclical effects

Our response is from the perspective of pro-cyclical effects on market liquidity.

We believe that the greatest pro-cyclicality effect will be as a result of mandatory buy-ins. As noted in Section A of our response to this question, the CSDR settlement discipline framework introduces additional elements that liquidity providers will need to incorporate into their pricing. This includes the potential risk of incurring cash penalties and a mandatory buy-in if the trade fails to settle.

Since some of the additional costs are related to the starting bid-offer spread, the impact of these elements will be pro-cyclical- i.e., when liquidity reduces, bid-offer spreads will be wider, thus the price increase due to CSDR will be greater, driving up buy-in costs and further reducing market liquidity, generating a negative feedback loop. This increased bid-offer spread may be caused by many different events, including market-wide shocks, such as Covid-19. Less liquid instruments, such as high-yield debt, tend to have wider bid-offer spreads at all times, and the relative impact of a buy in will be higher. Thus, a mandatory buy-in regime has a potentially compounded negative effect.

In times of high market stress (such as observed in March 2020 due to Covid-19) institutions are trying to change their portfolios and rely in the ability of market-makers to bridge supply-demand mismatches. A reduction of the ability of market-makers to 'lean into the wind' and provide liquidity due to concerns that any non-inventory sales will be subject to buy-ins and penalties, may cause a downward spiral of reducing liquidity and higher trading costs, disproportionally impacting end investors and those companies who need to rely on financial markets to generate capital to withstand shocks such as the ones caused by the Covid-19 crisis.

However, it is important to note that the other and potentially biggest impact of mandatory buy-ins, on top of worsening offering prices, is the risk of the trades not taking place at all, i.e., that buyers will not want to buy securities at the elevated price level, further reducing market liquidity.

H. The penalty rates should be revised

We believe that it is necessary to include within the regulation an appropriate mechanism for dynamic recalibration of penalty rates to ensure appropriate incentives. We consider the penalty mechanism the primary tool that regulators and policymakers can utilise to achieve the policy objectives of the Settlement Discipline Regime.

Firstly, it is necessary to ensure there is a suitable framework to measure the effect of penalties on settlement efficiency. We recommend the introduction of a mandate for ESMA to set target settlement efficiency rates, appropriately calibrated for each instrument type based on its liquidity. It should be understood that 100% settlement efficiency is not itself an achievable objective. This is especially relevant for instruments which are inherently less liquid (such as certain types of corporate bonds), for which, at the point of trade, the seller may not have the inventory, but is prepared to make an offer price to the buyer.

In the specific case of ETFs, they are typically subject to lower ISD settlement rates due to the nature of the product. In many cases, some of the underlying constituents of the ETF are in different time-zones and have different settlement cycles, which delays settlement of the ETF itself. Further consideration should be given as to how the penalty framework can be adapted to appropriately incentivise settlement of ETFs, without significantly damaging market liquidity or raising costs for end investors.

Appropriate cash penalties will serve as an adequate tool to improve settlement efficiency on a standalone basis, as they will penalise sellers while compensating buyers for late delivery. The penalty rates should be set at the right level, and with a view on the target settlement efficiency rates the regulators intend to achieve, which should be publicly defined.

If target rates are not reached, regulators can consider an adjustment to penalty rates, thereby providing a flexible yet effective tool to reach the objectives of CSDR, while avoiding the very negative consequences of mandatory buy-ins. We note that there should be a transparent framework for the recalibration of penalties rates, allowing sufficient time for market participants to prepare for any changes.

I. The penalty regime should not apply to certain types of transactions (e.g., market claims in cash)

AFME supports the introduction of the penalty regime at the earliest possible opportunity, as the key lever for delivering improved settlement efficiency. Following implementation of the penalty regime, analysis should be undertaken to identify possible refinements to ensure it applies only to types of transactions where it will incentivise settlement.

We note a previous ESMA consultation paper as to types of transactions and operations that are out of scope of settlement fails reporting "given that they are not fulfilling the objective of the settlement discipline regime (as outside of the participants' control)". Clarification is requested as to whether this same exclusion is also intended to apply to penalties and buy-ins.

a) corporate actions on stock, such as cash distributions (e.g., cash dividend, interest payment), securities distributions (e.g., stock dividend; bonus issue), reorganisations (e.g., conversion, stock split, redemption, tender offer);
b) primary market operations, meaning the process of initial creation of securities, whereby the securities are created, but they have not yet been subscribed for, so no capital has been raised;
c) creation and redemption of fund units, meaning the technical creation and redemption of fund units, unless such creation and redemption of fund units is done through transfer orders in a securities settlement system operated by a CSD;
d) T2S realignment operations.

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.

Impact of Covid-19 on Market Liquidity

One of the key impacts of Covid-19 on capital markets was a significant and long-lasting deterioration in market liquidity. This can be illustrated by the widening of bid-offer spreads, as shown in Figure 1. Whilst there are significant challenges with producing a non-biased and consistent bid-ask spread estimator, AFME has created a bespoke weighted index of 63 non-financial corporate bonds for which reliable data is available, to estimate this impact. The data suggests that in corporate bond markets, average bid-offer spreads were at their peak approximately 60% higher than pre-crisis levels.

Figure 1: European non-financial corporate bond bid-offer spreads (weighted average, HY and IG, %)

Source: Reuters

Similar impacts were observed in European equity markets. Figure 2 shows a sharp reduction in market depth - measured through the available liquidity at the first limit of the order book - concurrent with a significant widening of bid-offer spreads, for the EURO STOXX 50 index of Europe's blue-chip corporates. Market depth remained significantly lower than pre-crisis levels. Figure 3 depicts these same impacts for indices of mid-cap and small-cap stocks, which started from substantially wider spreads and lower market depth.

Figure 2: Eurostoxx50 market depth (average size, EUR) and bid-offer spread (bps)

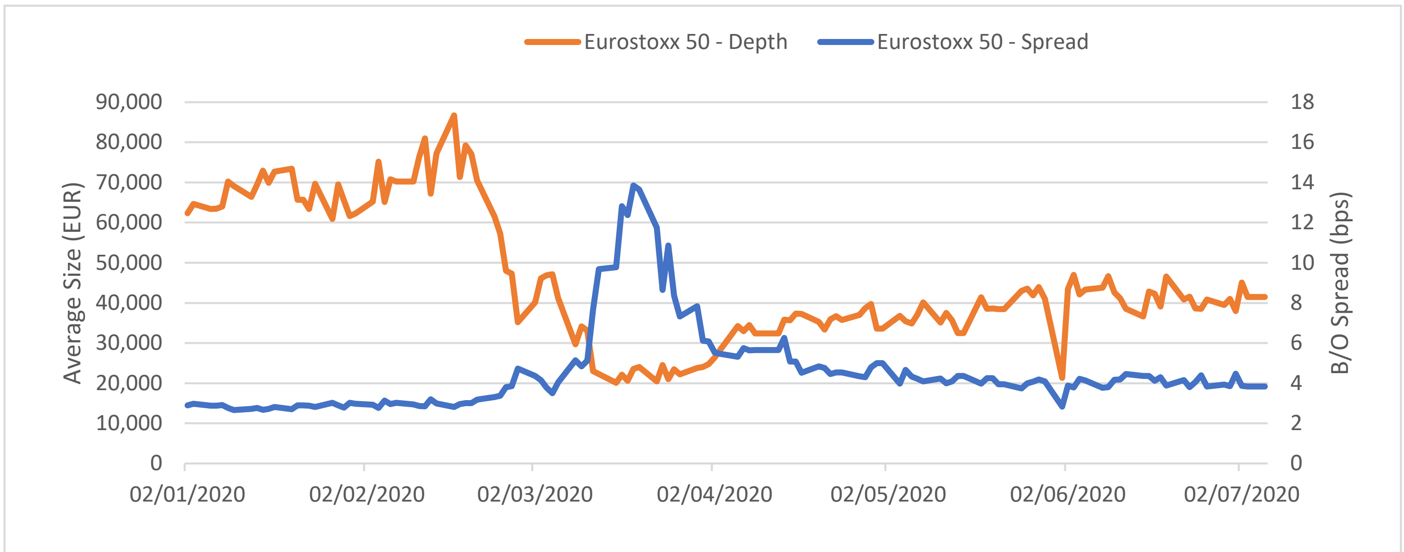
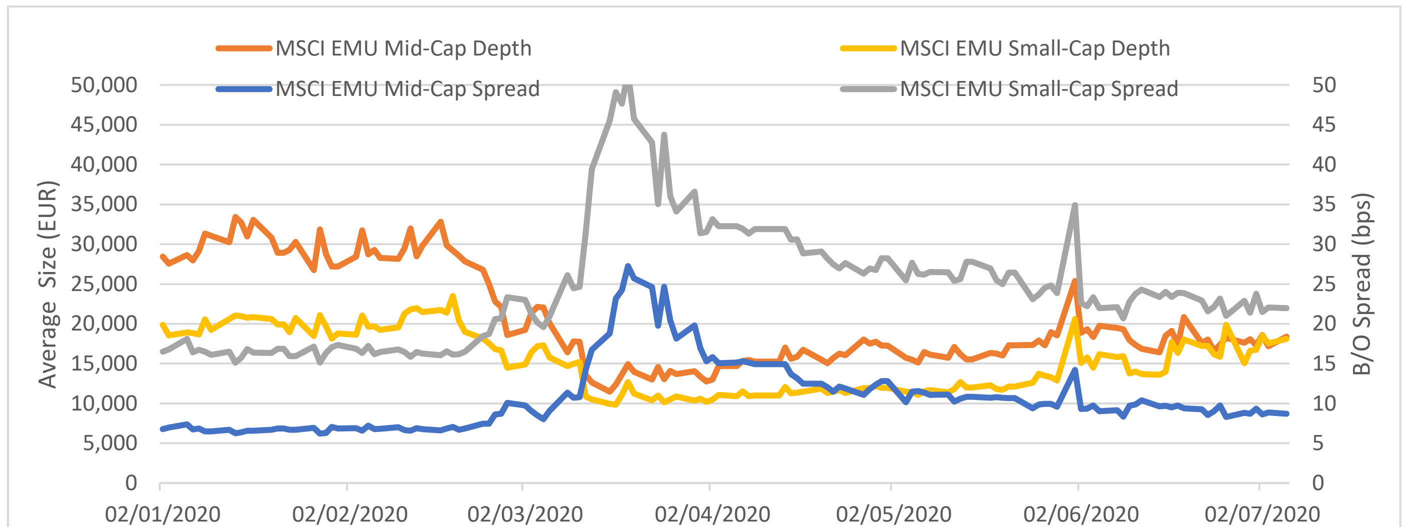


Figure 3: MSCI EMU Mid-Cap/Small Cap market depth (average size, EUR) and bid-offer spread (bps)



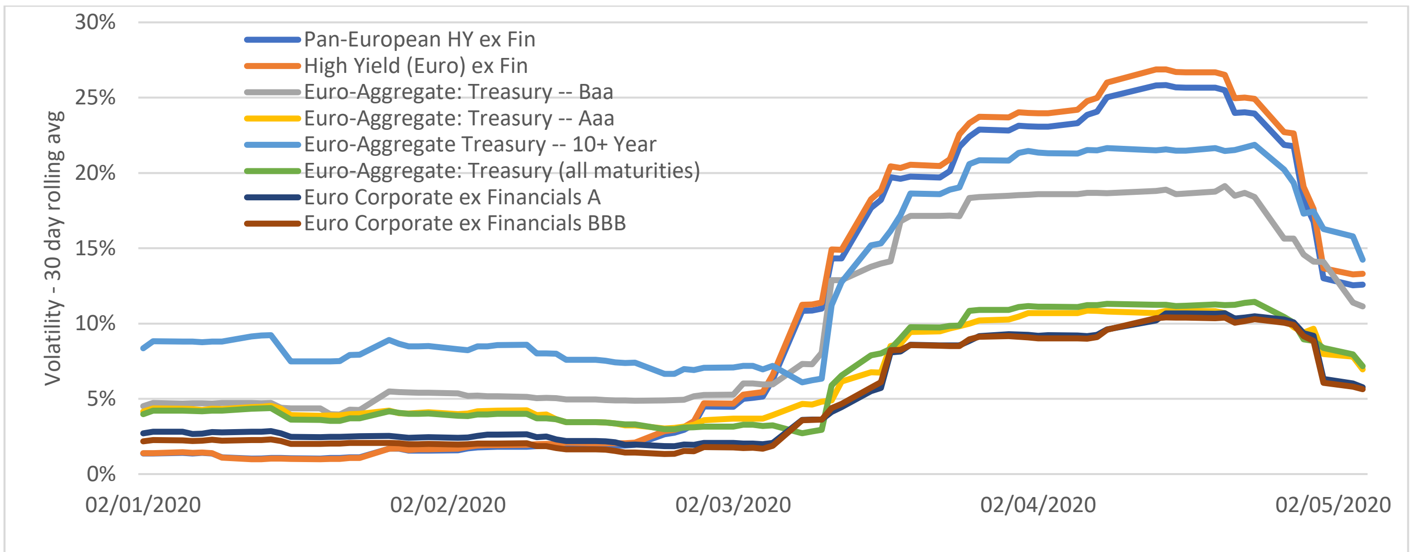
Source: Société Générale

Impact of Covid-19 on Market Volatility

In addition to increasing spreads, the Covid-19 crisis has also led to the rapid increase in volatility observed across asset classes. Implied volatility for European equities rose to levels last seen during the 2008-2009 Global Financial Crisis, with the Euro Stoxx 50 Volatility Index reaching 85.6 on 16 March 2020 vs. a 5-year average of 19.7[10]. Fixed income markets were similarly impacted, as shown by the sharp increase in volatility of selected benchmark indices, see Figure 4.

Figure 4: Market price volatility for selected fixed income asset classes

[10] Source: Bloomberg. 5-year average calculation covers the period 1 July 2015 to 1 July 2020.

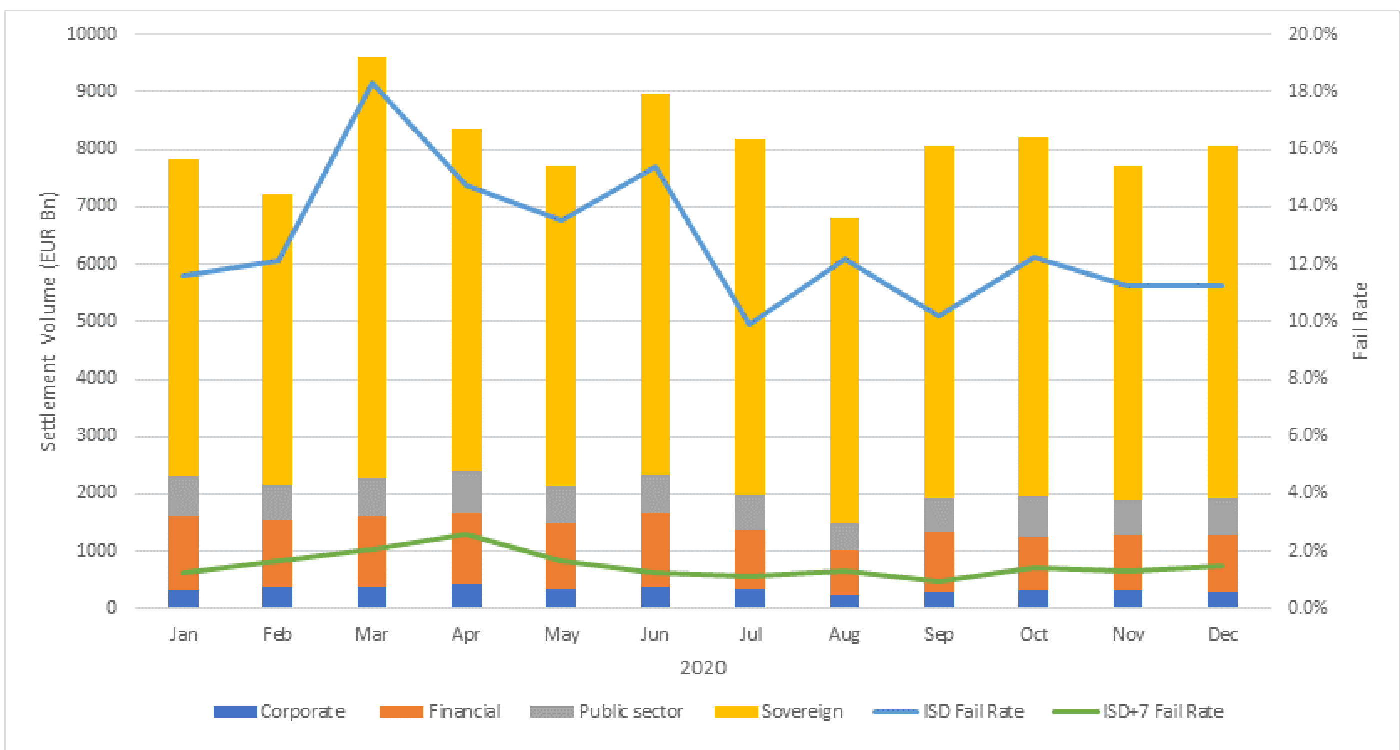


Source: Reuters

Impact of Covid-19 on Market Settlement Efficiency

Using data provided by Euroclear Bank (EB) relating to settlement of transactions in fixed income instruments, Figure 5 shows that in March 2020 there was clear increase in the volume of settlement instructions processed by EB, coupled with spike in the 'fail rate', measured by the value of against payment settlement instructions that failed to settle on intended settlement date (ISD). This decrease in settlement efficiency is more pronounced when measured based on ISD, and, by ISD+7 (i.e., the point by which a mandatory buy-in would be applicable under currently proposed rules for fixed income instruments), the majority of settlement fails continued to have been resolved.

Figure 5: Euroclear Bank settlement volumes (EUR Bn) and fail rates (%) for fixed income instruments.

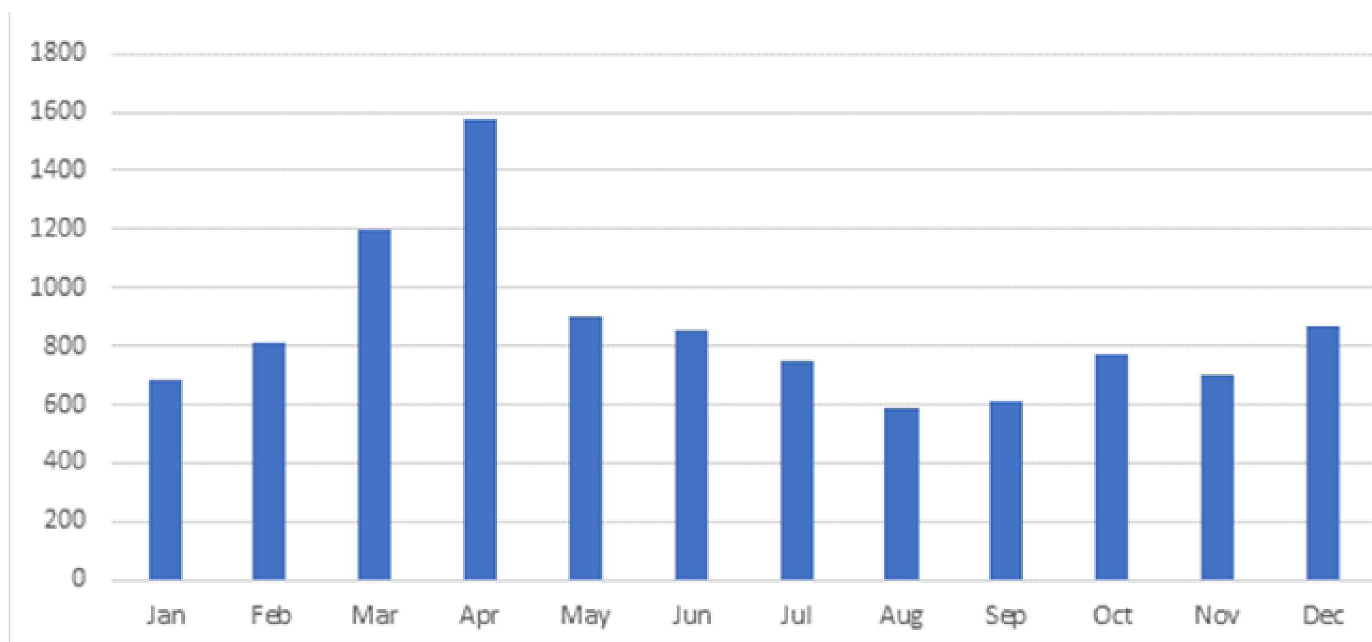


Source: Euroclear Bank

However, as depicted in Figure 6, had the CSDR buy-in regime been in place during this period, the number of buy-ins taking place would have significantly increased in absolute terms, creating further market disruption.

We note that buy-in volumes would have peaked in April, offset from the peak of ISD settlement fails in March. Please note, this is based on the gross number of failing settlement instructions, may include some transactions that fall outside the scope of CSDR (e.g. repos under 30 days) and assumes no pass-on mechanism to reduce the number of buy-ins taking place. This is based only on the available data, provided by one CSD for one type of instrument, and we encourage regulators and policymakers to conduct further analysis using additional data from other CSDs.

Figure 6: Estimated number of daily buy-ins in Euroclear Bank for fixed income instruments



Source: Euroclear Bank

Potential impact of CSDR and Covid-19

In order to improve the settlement rate for a relatively small but important percentage of trades[11], the imposition of a mandatory penalty and buy-in regime will lead to a necessary adjustment of the pricing of trades by liquidity providers, as described in Section A of our response to Question 34.1. This leads to higher transactional costs and reduced liquidity across capital markets, impacting a variety of asset classes. These effects will be particularly pronounced for less liquid instruments. It is important to note that this will be the case even in normal markets. However, against the backdrop of Covid-19, it becomes clear that if the CSDR buy-in regime exists at the same time as a period of extreme market disruption, there is likely to be a compounding and self-reinforcing negative effect on liquidity.

The introduction of the mandatory buy-in will not be beneficial to the recovery of Europe's economy from the Covid-19 crisis, nor align with the ambitions of the Capital Markets Union. The mandatory buy-in regime creates an additional cost and risk for European-settled securities that disadvantages European companies against their global peers. Wider spreads and less liquidity will reduce the investment returns of pension funds, asset managers and, ultimately, end investors, which risks driving issuance, trading and investment activity outside of the EU.

As observed during the Covid-19 crisis, a period of reduced secondary market liquidity coincided with stalling primary market issuance and an increased cost for companies to raise capital, both in absolute terms due to higher yields, and also relative to prevailing market levels, i.e., an increase in new issue premiums. There is a growing body of academic research to illustrate that the expected liquidity of a corporate bond at issuance – based on the liquidity of outstanding bonds - is priced into new debt issues.

[11] T2S 2019 Annual Report shows that on average 3.07% of daily transactions by volume were unsettled.

Conversely, a reduction in secondary market liquidity, for example as a result of wider bid-offer spreads under CSDR, will penalise issuers when trying to raise capital. Securities with a lower inherent liquidity, such as those issued by SMEs or lower-rated issuers and smaller size issuances, would be disproportionately impacted by this effect.

The appetite of investors to invest in new issues from companies seeking to raise capital is dependent on the ability to sell them in the secondary market when needed. This is highly relevant in times of high market volatility, where professional investors may need to sell assets to raise liquidity or to return funds to individual investors.

If the impact of mandatory buy-ins is, as expected, a permanent increase in the "new issue premium", combining this with another period of market disruption would likely make it more expensive - or even impossible - for some companies (especially SMEs and those on the weaker credit spectrum) to raise capital at reasonable rates.

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.

The majority of the changes that we propose are in relation to the mandatory buy-in regime. We consider that other measures, such as those relating to allocation and confirmation procedures, enhancements to CSD functionality, and the introduction of a penalty mechanism, are broadly appropriate in their current form and welcome their introduction at the earliest possible opportunity, subject to the changes suggested below. Conversely, we strongly believe that the currently proposed mandatory buy-in rules are inherently flawed and will have significant and potentially irreversible impacts on markets if implemented in their current form. Our most critical recommendation is that the buy-in is the discretionary right of the buyer, not a mandatory obligation.

Therefore, we suggest that Article 76 of CSDR is amended to separate the date of application of the revised buy-in regime from the date of application of all other settlement discipline measures. By sequencing the introduction of the revised buy-in regime to a later date, this allows an opportunity for penalties and other measures to take effect, and for their impact to be monitored and assessed by the authorities. Secondly, if there are to be significant amendments to the current buy-in rules, as we suggest, then additional time will be required by all industry participants to adjust accordingly. This may involve not only changes to technology builds but outreach to counterparties to incorporate relevant contractual arrangements.

<u>Proposed Changes to Buy-in Regime</u>

Please note that each proposal is independent but complementary. We advocate that the entire package of changes is adopted in order to create a well-functioning and robust buy-in framework.

Proposal 1: Adjust mandatory obligation to buy-in to a discretionary right for transactions that do not involve a CCP.

Trading parties should be mandated to incorporate this provision into relevant contracts. This should be supported by a Level 2 framework, in conjunction with market-led development of best practices, which lays out the common parameters for the buy-in process to ensure consistency in application across the market.

All provisions related to the operational mechanics of the buy-in process should be removed from Level 1 and incorporated in L2/L3/market practice as appropriate.

Please refer to Section A of our response to Question 34.1

Benefits: Incorporating a discretionary buy-in right into relevant contractual arrangements ensures that the purchaser has the same protection and empowerment to initiate a buy-in, without being forced to do so when it is not in their economic or commercial interests, or when they are themselves subject to a buy-in.

On the basis that there is on one hand a level-playing field and a common, transparent framework governing the buy-in process, and on the other hand, greater flexibility over the instances in which a buy-in is initiated, one could reasonably expect that there will be an increase in the number of buy-ins compared to the status quo, but less than there would be in a mandatory buy-in environment. This is important to mitigate the expected impact mandatory buy-ins on market liquidity and pricing.

Further, this simplification of the Level 1 allows for greater flexibility in the development of a functioning market-wide buy-in process and reduces the burden on regulators to provide Level 3 guidance.

Proposal 2: Refine and Clarify the scope of the buy-in regime.

Please refer to our response to Section 6 of the Consultation Paper. There are several areas where the current regulation would benefit from further refinement in order to ensure the effectiveness of the buy-in regime.

Benefits: Improves the effectiveness of the buy-in regime and limits its scope only to where it has a practical purpose. The proposed changes would also ensure that the buy-in regime does not interfere with existing contractual frameworks that appropriately deal with the non-delivery of financial instruments. By removing this uncertainty, there would also be a reduction in the number of contractual agreements that are required to be updated to incorporate CSDR.

Proposal 3: Remove regulatory requirement to appoint a buy-in agent.

Level 1 provisions should be amended to allow the receiving party to execute the buy-in themselves, supported by high-level principles to ensure fair and transparent treatment of both trading parties (i.e., best-execution, committed delivery, communication and reporting).

The current rule places the regulatory and operational burden on the buyer, who is the injured party. The burden on smaller trading counterparties themselves is particularly onerous: those who do not have significant failed deliveries – who are more likely to be receiving counterparties – will be disproportionately affected. In addition, the requirement imposed by the existing buy-in agents for the receiving trading party to post collateral prior to the buy-in even being attempted (which may well be unsuccessful) adds further operational and cost burden to these parties. Even in a discretionary buy-in situation, where a buy-in is a right for the receiving trading party to exercise, this requirement is actually likely to put such a protection out of reach of these entities.

Benefits: Creates greater flexibility and increases possibility that the buy-in can be actioned. Involved parties who are already actively trading in the to-be bought in financial instrument. This also removes issues of access to buy-in agents from a jurisdictional perspective and reduces costs and burdens for receiving parties.

Proposal 4: Inclusion of new L1 provisions to explicitly allow for a functioning pass-on mechanism.

The recipient of a buy-in notice should be permitted to:

a) Pass-on a buy-in notice (and the consequences) to a counterparty with which it has an in-scope failing receipt.
b) Reject a buy-in notice on the basis that a buy-in has already been initiated in the settlement chain, or will be initiated by a CCP.
c) Pass-on the result of a buy-in to a counterparty with which it has an in-scope failing delivery.

Benefits: This is essential for minimising number of buy-ins across a settlement chain, reducing adverse impacts to market liquidity and costs.

It also allows for a CCP to manage a single buy-in where a fail chain exists between cleared and non-cleared activity.

Finally, be able to pass-on the consequences of the buy-in (cash amounts to the failing delivering trading party, stock or cash to the receiving trading party) will enable to close outstanding settlements and thus eventually come to the same conclusion as a buy-in process.

Proposal 5: Redraft Level 1 to mandate symmetric payments of price differences in order to restore parties to the same economic position.

The current regulation creates 'asymmetric' payments for the difference between buy-in price versus original price. This means trading parties in a chain with an offsetting buy and sell can be adversely impacted based on market movements at no direct fault of their own.

This also supports the need for pass-ons to occur so intermediating parties in a chain remain risk neutral.

Benefits: The establishment of 'symmetric' payments of price differentials is essential to a workable pass-on mechanism and reduces market risk for all parties. This should be applicable for both the payment of the price difference (Article 7(6) of CSDR and Article 35 of the RTS) and the calculation of the cash compensation (Art. 32 of the RTS).

Proposal 6: Amend Article 25 of Level 2 to clarify that a CSD participant is not required to amend its contracts to ensure the enforceability of settlement discipline on its clients.

The participant is an intermediary in the settlement chain, and is not a party to the trading agreements, nor even has actual knowledge of its contents in most cases, so cannot be required to ensure the enforceability of mandatory buy-in provisions.

Benefits: Avoids commingling of distinct trading and settlement roles and removes unnecessary repapering effort.

Proposal 7: Remove the requirement of Article 25 to fully contractually incorporate the provisions of the CSDR buy–in regime. Replace this with a requirement for CCPs, clearing members, trading venue members and trading parties to establish contractual arrangements that incorporate an appropriate mechanism for the resolution of settlement failures.

For a number of markets, existing market documentation includes contractual provisions providing for resolution of settlement failures, to be utilised at the discretion of the receiving party. These mechanisms ensure that the receiving party has the discretion to determine when and how to utilise these rights in the most appropriate manner for that party. If the existing contractual provisions between the parties are sufficient to give effect to the overriding purpose of the buy-in regime, the requirements under Article 25 shall be considered met.

Proposal 8: Extension Period should be applicable at an instrument level – Level 2 and 3 provisions to be adjusted accordingly.

The longer extension period applicable to instruments traded on an SME Growth Market should be clarified to apply to any instrument for which the issuer qualifies as an SME, regardless of actual place of trade.

Similarly, the longer extension period for non-liquid securities should be applicable to CCP-cleared transactions.

Current anomalies create significant risk for intermediaries with offsetting buy and sell. The removal of asymmetric treatment of buy-ins reduces probability of discrepancies that could inherently lead to settlement failure (e.g., MIC code matching).

Benefits: Simplification of the buy-in rules would reduce risk and uncertainty and ensure symmetric treatment at an instrument-level.

Proposal 9: Clarify that the last point at which settlement can take place is the settlement cut-off on the business day prior to the initiation of the buy-in.

The buy-in process should therefore start cleanly on the buy-in date with no risk of unwanted settlement of the original fail.

This should not be based on the receiving partying issuing a buy-in notice, as this gives rise to a period of time where the settlement can take place when the intention is to initiate the buy-in process.

Benefits: Avoids ambiguity over the buy-in process and timing risk of appointing a buy-in agent and subsequent settlement of the underlying fail. Under the current rules, the industry expectation is that many buyers will place their own instruction on hold prior to initiation of the buy-in in order to prevent this risk, essentially forfeiting the cash penalty they are due. Removing this ambiguity means it is not necessary for the receiving party to place their instruction on hold. Trading parties will have greater certainly of the fail and allow sufficient time for the buy-in analysis and actions to take place.

Proposed Changes to Penalties Regime

The penalty regime as currently designed is likely to have beneficial impacts on the settlement efficiency when introduced. The proposed changes aim to bring transparency on the actual settlement rates as regards the legislator's expectations.

Proposal 10: **Introduce a new provision in the Level 1 regulation that provides a mandate for ESMA to set target settlement efficiency rates per asset class and, in future, recalibrate penalty levels if needed to sufficiently incentivise failing parties.**

The framework by which ESMA monitors settlement rates and determines appropriate calibration should be set out in detail in L2/L3 regulation. Target rates must be adjusted according to liquidity – less-liquid securities have inherently lower settlement efficiency therefore need lower target rates. This could be linked to MIFID methodology for deriving trading liquidity.

Reviews of the settlement efficiency progress should take place on an annual basis, choreographed with the annual CSD review process, with data made publicly available, and on this basis, the penalty rates per asset class may be adjusted.

Penalties are a more flexible means to achieve settlement efficiency as opposed to the 'blunt instrument' of a mandatory buy-in. The principles and operational mechanics of the penalties regime are well-founded, and we note that considerable resource has been committed across the industry towards development of processes for the calculation, reporting collection and distribution of penalties. Therefore, significant changes to the penalties regime are neither necessary nor appropriate.

However, some fine-tuning of the exact penalty rates (as set out in Annex 1 of the attached) is likely to be required post-go-live to ensure optimisation of settlement efficiency and market liquidity.

Benefits: Strengthens the effectiveness of the penalties regime as a tool for delivering settlement efficiency. Creates greater transparency for all market participants.

Costs: Requires additional work by ESMA to implement the proposed target and monitoring framework. It is important to note that we do not propose any changes to the existing methodology for the calculation or classification of penalties.

Proposal 11: ESMA to provide revised Level 3 guidance that the penalty rates referred to for "instruments traded on SME growth markets" are applicable to any instrument that qualifies as an SME as per MiFID II definition [12]

The current ESMA interpretation is that these penalty rates apply only to transactions executed on the SME venue and not any off-market leg. This anomaly creates significant market risk for an intermediary with an offsetting buy and sell.

Benefits: Ensuring a consistent penalty rate applies to any individual security allows for greater simplification and transparency across market participants.

Costs: Requires minor alteration to CSD penalties calculation methodology

Proposal 12: Removal of Article 19 of Level 2, to establish that CSD is responsible for collection and distribution of penalties relating to CCP-cleared transactions.

The current process substantially increases the complexity and technology development required by all parties involved. This creates an additional layer of actors to the collection/distribution process and will lead to less harmonisation and standardisation of the penalties process.

Benefits: Simplification of the process for market participants, eliminates the need for additional technology build by CCPs, clearing members and all parties in the chain

Proposal 13: Amend Article 39 of Level 2, to clarify that a CSD participant will be subject to a suspension under Article 7(9) CSDR only where the CSD participant itself (as opposed to its clients) meets the criteria for failure to consistently and systemically deliver securities.

The participant is an intermediary in the settlement chain and cannot influence the trading patterns of its clients and necessarily prevent settlement fails. Therefore, the CSD participant cannot be held responsible for settlement failures due its clients' trading or settlement practices.

Benefits: Ensures fair treatment and level playing field for all CSD participants.

Proposed Changes to Allocation/Confirmation Process

Proposal 14: Remove the requirement of Article 2.2 of CSDR Level 2 for investment firms to confirm receipt of allocations.

This requirement will contribute significant additional volumes of messages to be exchanged between counterparties, which will be of limited value to the recipient and do not contribute towards increased settlement efficiency.

Facilitating this process requires significant technology development on the part of investment firms, professional clients, and vendors or platforms who assist in the allocation process.

The creation of additional messages to be exchanged increases risk into existing allocation processes, and potentially obscures relevant information regarding a genuine mismatch/break.

Benefits: Significant simplification of the technology and operational changes required to ensure compliance.

[12] Article 77 of https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0565&from=DE

8. FRAMEWORK FOR THIRD-COUNTRY CSDS

Article 25(1) of CSDR provides that third-county CSDs may provide their services in the EU, including through setting up branches on the territory of the EU.

Article 25(2) requires a third-country CSD to apply for recognition to ESMA in two specific cases:

(a) where it intends to provide certain core CSD services (issuance and central maintenance services related to financial instruments governed by the law of a Member State); or

(b) where it intends to provide its services in the EU through a branch set up in a Member State.

Services other than those described (including settlement services) do not require recognition by ESMA under Article 25 CSDR.

ESMA may recognise a third-country CSD that wishes to provide issuance and central maintenance services only where the conditions referred to in Article 25(4) of CSDR are met. One of those conditions is that the Commission has adopted an implementing act determining that the regulatory framework applicable to CSDs of that third country is equivalent in accordance with CSDR.

One CSD has applied to date for recognition to ESMA, i.e., the UK CSD in the context of Brexit. At least two other CSDs have contacted ESMA and have expressed their intention to apply for recognition as third-country CSDs.

However, according to the current provisions of Article 25 of CSDR, the recognition process is only triggered once there is an equivalence decision issued by the European Commission in respect of a particular third country. In the meantime, according to Article 69(4) of CSDR, third-country CSDs can continue providing services in the EU under the national regimes.

Question 37

Do you use the services of third-country CSDs for the issuance of securities constituted under the law of the EU Member State where you are established?

-Yes

-No

-Don’t know / no opinion

Question 37.1

If you answered "Yes" to question 37, please indicate which services of a third-country CSD you use.

Question 38

Do you consider that an end-date to the grandfathering provision of Article 69(4) of CSDR should be introduced?

-Yes

-No

-Don’t know / no opinion

Question 38.1

Please explain your answer to question 38. If “yes”, please indicate what that end-date should be explaining your reasoning.

Question 39

Do you think that a notification requirement should be introduced for third-country CSDs operating under the grandfathering clause, requiring them to inform the competent authorities of the Member States where they offer their services and ESMA?

-Yes
-No
-Don’t know / no opinion

Question 39.1

Please explain your answer to question 39, providing where possible examples.

Question 40

Do you consider that there is (or may exist in the future) an unlevel playing field between EU CSDs, that are subject to the EU regulatory and supervisory framework of CSDR, and third-country CSDs that provide / may provide in the future their services in the EU?
-Yes
-No
-Don’t know / no opinion

Question 40.1

Please explain your answer to question 40, elaborating on specific areas and providing concrete examples.

Question 41

Which aspects of the third-country CSDs regime under CSDR do you consider require revision / further clarification?
Please rate each proposal from 1 to 5

Introduction of a requirement for third-country CDS to be recognised in order to provide settlement services in the EU for financial instruments constituted under the law of a Member State	
Clarification of term "financial instruments constituted under the law of a Member State" in Article 25(2) of CSDR	
Recognition of third-country CSDs based on their systemic importance for the Union or for one or more of its Member States	
Enhancement of ESMA's supervisory tools over recognised third-country CSDs	

Question 41.1

Please explain your answers to Question 41, providing where possible concrete examples

Question 42

If you consider that there are other aspects of the third-country CSDs regime under CSDR that require revision/further clarification, please indicate them by providing examples if needed.

9. OTHER AREAS TO BE POTENTIALLY CONSIDERED IN THE CSDR REVIEW

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)?