EFAMA

European Fund and Asset Management Association

EFAMA's REPLY TO THE CONSULTATION ON THE REVIEW OF THE REGULATION ON IMPROVING SECURITIES SETTLEMENT IN THE EUROPEAN UNION AND ON CENTRAL SECURITIES DEPOSITORIES

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Executive Summary

EFAMA supports the main objectives of CSDR to increase the safety and efficiency of securities settlement, including:

- Shorter settlement periods,
- Prudential and supervisory requirements for CSDs and other institutions providing banking services ancillary to securities settlement,
- The imposition of a penalty regime under CSDR as an important step towards improving settlement efficiency in European capital markets.

However, it should be noted that the volume of failed trades has decreased substantially in recent years and therefore parts of the proposed disciplinary sanctions set in the regulation and implementing texts are no longer proportionate to the remaining risks, especially considering the fact that firms already have, and continue to make use of existing contractual remedies to deal with settlement fails (such as buy-ins or termination rights).

Against this background, our comments in response to this Consultation Paper are essentially focusing on the following points:

- Applying the mandatory buy-in regime is likely to impact negatively the efficiency of European capital markets , leading to wider bid-offer spreads, reduce market efficiency and remove incentives to lend securities in the securities lending and repo markets, and may ultimately favour the settlement in non-EU CSDs of less liquid securities. For these reasons, **we strongly advocate for the removal of mandatory buy-ins** and instead opt for measures that better protect investors from being impacted by downstream issues with settlement which are out of their control and influence. Should buy-ins be considered as potential settlement measures this could only be on a voluntary basis as in many cases they can lead to unintended harmful impact.
- On a related point, we are commenting on the **negative impact the mandatory buy-in regime would have on ETP primary market transactions**, as an example of the need to revise the scope and application of the settlement discipline regime.
- We also invite the Commission to **proceed cautiously as regards any significant amendments to the CSDR text in respect of the use of new technologies**. Our main concern is that, while emerging technologies such as distributed ledger technology (DLT) offer potential efficiencies in terms of trading and settlement (e.g. 'atomic' settlement) as well as greater transparency, implementing significant amendments to the CSDR framework to accommodate such emerging technologies, where they remain untested on the scale at which they would have to operate in

the context of wholesale financial markets, could complicate and hinder the provision of securities settlement services and the entry into force of the settlement discipline regime in the EU.

- Lastly, We seek for **urgent clarification from the Commission on the proposed timeline** for the legislative review of the CSDR and how that may impact the expected application of the settlement discipline regime currently foreseen for 1 February 2022 (subject to non-objection by the European Parliament and Council as regards the Commission's Delegated Act with that effect). We recommend that the industry has clarity on the final rules at least one year before entry into force because the changes that are expected in the market are significant and at least one year is needed for implementation.

CONSULTATION QUESTIONS

IV. CSDR and Technological Information

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

	1 (not a concern)	2 (rather not a concern)	3 (neutral)	4 (rather a concern)	5 (strong)	No opinion
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))	☐	☐	☒	☐	☐	☐
Definition of 'securities settlement system' and whether a blockchain/DLT platform can be qualified as a SSS under the SFD	☐	☐	☐	☐	☒	☐
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;	☐	☐	☐	☐	☒	☐
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)	☐	☐	☐	☐	☒	☐
Definition of 'book entry form' and 'dematerialised form'	☐	☐	☐	☒	☐	☐
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	☐	☐	☐	☒	☐	☐
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)	☐	☐	☐	☒	☐	☐
What entity could qualify as a settlement internaliser, that executes transfer orders other than through an SSS	☐	☐	☐	☒	☐	☐

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

Given the potential transformational impact of crypto assets and related technologies across the financial services industry, and beyond, it will be important for EU authorities to develop an appropriate framework which encourages innovation while ensuring a high level of investor protection.

In this regard, so as to ensure that the CSDR framework continues to function as intended, both in terms of how it is applied currently and will apply following the forthcoming review, we believe that the European Commission and EU policymakers should proceed cautiously as regards any significant amendments to the CSDR text in respect of the use of new technologies. Our main concern is that, while emerging technologies such as distributed ledger technology (DLT) offer potential efficiencies in terms of trading and settlement (e.g. 'atomic' settlement) as well as greater transparency, implementing significant amendments to the CSDR framework to accommodate such emerging technologies, where they remain untested on the scale at which they would have to operate in the context of wholesale financial markets, could complicate and hinder the provision of securities settlement services and the entry into force of the settlement discipline regime in the EU.

Hence, we support the policy intention behind the European Commission's September 2020 Digital Finance Package and, in particular, the standalone proposal for a Regulation on a PILOT Regime for market infrastructures based on DLT. We believe that this targeted approach to the regulation of such entities will ensure that the services they provide, and the underlying technologies, are fit for purpose, scalable and supervised appropriately.

Indeed, calibrated correctly at Levels 1 and 2, a standalone regime for market infrastructures based on DLT, supplemented by the proposed Regulation on Markets in Crypto Assets (MiCA), would allow for many of the outstanding legal and regulatory questions around crypto assets and related services facilitated by DLT to be developed in a more targeted and considered manner. As a reference point, the October 2020 report of the Cambridge Centre for Alternative Finance on 'Legal and Regulatory Considerations for Digital Assets' sets out a number of questions for policymakers and regulators to consider around the clearing and settlement of crypto assets.

Finally, it will also be important to ensure a level playing field for entities providing the same or similar services, whether in relation to traditional financial instruments or crypto assets, or via traditional or DLT-based market infrastructures.

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 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".

	1 (not a concern)	2 (rather not a	3 (neutral)	4 (rather a concern)	5 (strong)	No opinion
Rules on settlement periods for the settlement of certain types of financial instruments in a SSS	☐	☐	☒	☐	☐	☐
Rules on measures to prevent settlement fails	☐	☐	☐	☐	☒	☐
Organisational requirements for CSDs	☐	☐	☒	☐	☐	☐
Rules on outsourcing of services or activities to a third party	☐	☐	☒	☐	☐	☐
Rules on communication procedures with market participants and other market infrastructures	☐	☐	☐	☐	☒	☐
Rules on the protection of securities of participants and those of their clients	☐	☐	☐	☐	☒	☐
Rules regarding the integrity of the issue and appropriate reconciliation measures	☐	☐	☐	☐	☒	☐
Rules on cash settlement	☐	☐	☐	☐	☒	☐
Rules on requirements for participation	☐	☐	☐	☐	☒	☐
Rules on requirements for CSD links	☐	☐	☒	☐	☐	☐
Rules on access between CSDs and access between a CSD and another market infrastructure	☐	☐	☐	☐	☒	☐
Rules on legal risks, in particular as regards enforceability	☐	☐	☐	☐	☒	☐

VI. Scope

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

☒ Yes

☐ No

☐ Don't know / no opinion

Question 31.2 If you answered "yes" to Question 31, please specify what clarifications/targeted measures could provide further legal certainty.

We believe that certain requirements in CSDR would benefit from targeted measures providing legal certainty on their scope of application. The European Commission (or ESMA mandated by the Commission) should make absolutely clear, by providing a definitive list of ISINs/securities' listing details, the scope of transactions to which penalties for late settlement and buy-ins would apply.

For example, in our view, the scope of transactions to which buy-ins would apply should be clarified to facilitate the identification of in-scope instruments and transactions.

Indeed, the scope of transactions to which buy-ins would apply should only extend to outright purchases on the secondary market and should therefore exclude securities financing transactions (SFTs) such as securities lending transactions.

We acknowledge that in Article 7(4)(b) of the CSDR it is stipulated that "for operations composed of several transactions including securities repurchase or lending agreements, the buy-in process referred to in paragraph 3 [Article 7(3) of the CSDR] shall not apply where the timeframe of those operations is sufficiently short and renders the buy-in process ineffective".

However, we also note that Article 7(5) of the CSDR states "Without prejudice to paragraph 7 [Article 7(7) of the CSDR], the exemptions referred to in paragraph 4 [Article 7(4) of the CSDR] shall not apply in relation to transactions for shares where those transactions are cleared by a CCP". So as to ensure absolute regulatory clarity, we advocate that the buy-in process (whether mandatory or voluntary) should not apply to securities lending activities where a failure to deliver securities has occurred. This is because such SFTs are already governed by clear contractual terms that include legal remedies in the event of a settlement failure.

Such a measure would therefore foresee an extension of Article 7(4)(b) of the CSDR to all securities lending activities, and a removal of Article 7(5) of the CSDR. Subsequent amendments would be required in relevant legislation, including Commission Delegated Regulation (EU) 2018/1229 on settlement discipline.

We would also argue for the European Commission to remove primary market transactions – e.g. the creation/cancellation of exchange traded product (ETP) and investment fund units – from the scope of transactions to which buy-ins would apply. Further detail in this regard can be found in our response to Q33.

Finally, we advocate for the European Commission to move to standardise settlement and buy-in periods, as well as messaging requirements to all parties including buy-in agents. We also believe

that the extension periods proposed in Article 7(3), in respect of financial instruments traded on regulated and SME Growth markets, should be aligned so as to avoid confusion around interpretation and implementation of the rule.

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

☒ Yes

☐ No

☐ Don't know / no opinion

Question 32.1 If you answered "yes" to Question 32, please specify which provisions are concerned.

We believe that the scope of certain requirements could lead to unintended consequences on the efficiency of market operations.

We believe that unintended consequences/market inefficiencies could arise as a result of the mandatory buy-in regime as explained further in Qn 34.1. This affects a broad range of asset classes including corporate bonds, sovereign bonds, securities lending / repo transactions and ETPs. It is our view that the mandatory buy-in regime could detrimentally impact execution costs, liquidity and likelihood of settlement in the case of ETP's.

Other unintended consequences could include challenges arising from instances where a failing settlement chain extends beyond the EU, due to conflict with the local settlement regime in the relevant jurisdiction. This frequently will be the case where the instrument concerned is issued in a third country, including where the chain involves accounts held by an EU CSD/ICSD in the CSD of that country. In order to avoid such complications, transactions in such instruments should be excluded from the EU settlement discipline regime.

VII. Settlement Discipline

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

☒ Yes

☐ No

☐ Don't know / no opinion

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

☒ Rules relating to the buy-in

☒ Rules on penalties

☐ Rules on the reporting of settlement fails

☒ Others

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

We believe that a revision of the settlement discipline regime of CSDR is necessary because, as currently drafted, there is insufficient clarity on how the rules would operate in practice, in particular around the proposed mandatory buy-in and penalties regimes.

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

	1 (disagree)	**2 (rather disagree)**	**3 (neutral)**	**4 (rather agree)**	**5 (fully agree)**	**No opinion**
Buy-ins should be mandatory	☒	☐	☐	☐	☐	☐
Buy-ins should be voluntary	☐	☐	☐	☐	☒	☐
Rules on buy-ins should be differentiated, taking into account different markets, instruments and transaction types	☐	☐	☐	☐	☒	☐
A pass on mechanism should be introduced	☐	☐	☐	☐	☒	☐
The rules on the use of buy-in agents should be amended	☐	☐	☐	☐	☒	☐
The scope of the buy-in regime and the exemptions applicable should be clarified	☐	☐	☐	☐	☒	☐
The asymmetry in the reimbursement for changes in market prices should be eliminated	☐	☐	☐	☐	☒	☐
The CSDR penalties framework can have procyclical effects	☐	☐	☐	☒	☐	☐
The penalty rates should be revised	☐	☐	☐	☐	☒	☐
The penalty regime should not apply to certain types of transactions (e.g. market claims in cash)	☐	☐	☐	☐	☒	☐

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

We consider that the Settlement Discipline regime, as currently enacted but not yet applied, should be reviewed, ahead of any implementation, as regards its appropriateness with respect to current market conditions operation given the significant improvement in settlement discipline in recent years as demonstrated by the ECB's T2S 2019 activity report.

Such a review should also be used as an opportunity to consider any potential unintended consequences in the introduction of a settlement discipline regime with respect to the global competitiveness of EU financial markets.

Applying the mandatory buy-in regime is likely to impact negatively the efficiency of European capital markets , leading to wider bid-offer spreads, reduce market efficiency and remove incentives to lend securities in the securities lending and repo markets, and may ultimately favour the settlement in non-EU CSDs of less liquid securities.

Furthermore, there are several issues with the way the mandatory buy in regime is currently structured:

(i) Payments are currently not symmetrical and therefore do not always reflect economic loss/gain to each party,

(ii) The mandatory buy-in regime does not allow for the possibility for pass-on mechanisms for all asset classes including corporate bonds, sovereign bonds and ETPs,

(iii) The scope is too wide, and it should be confirmed that UCITS and AIFs ancillary settlement instructions, SFTs and OTC derivatives margin transfer are out of the scope of article 5,

(iv) Cash settlement mechanism at the end of the buy-in provision can result in a worse position for both parties. Cash compensation will not reflect the economic profile of holding the asset itself and forcing this outcome may not be in the interest of the buyer that it aims to protect,

(v) The appointment of a buy-in agent must not be mandatory, and it should be confirmed that the appointment of a buy-in agent can be negotiated on a case-by-case basis.

For these reasons, we strongly advocate for the removal of mandatory buy-ins and instead opt for measures that better protect investors from being impacted by downstream issues with settlement which are out of their control and influence.

Should buy-ins be considered as potential settlement measures this could only be on a voluntary basis as in many cases they can lead to unintended harmful impact.

In addition, we would suggest that the European Commission mandate ESMA to carry out further work in this regard.

The potential negative impact of the mandatory buy-in regime on ETP primary market transactions is one example of the need to revise the scope and application of the settlement discipline regime.

As highlighted in our response to Q31, the current scope of the settlement discipline regime could give rise to unintended market inefficiencies. For example, 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 (BIA) may need to acquire the ETP units from another Authorised Participant (AP).

In the event that these units are not readily available on the secondary market, the secondary AP may need to subscribe for the ETP units with the ETP provider. This is because 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 ETP units just to receive these same units back through the buy-in process. These ETP units would then subsequently be cancelled.

As we believe that buy-ins should be voluntary with settlement failures being remediated by the counterparties involved at the initiative of the receiving party, we urge the European Commission to reconsider the appropriateness of the requirement for a buy-in agent. At present, there are no buy-in agents that can act in a global capacity and there is a lack of clarity as to whether an EU buy-in agent would be able to act on behalf on a non-EU listing of and EU-domiciled ETP. As such, we believe that receiving parties should be permitted to source alternative liquidity subject to an obligation to provide best execution to the failing party.

Finally, as regards the payment and attribution of penalties, we encourage the European Commission to clarify whether entities that are net recipients of penalties have discretion as to whether such monies are ascribed to the relevant fund (and so the performance of the relevant fund is impacted via positive tracking difference) or to the Management Company (and so the performance of the relevant fund is not impacted).

To summarise:

We support

- Shorter settlement periods,
- Prudential and supervisory requirements for CSDs and other institutions providing banking services ancillary to securities settlement,
- The imposition of a penalty regime under CSDR as an important step towards improving settlement efficiency in European capital markets.

We are opposed to the implementation of mandatory buy-ins or termination rights as:

- They are no longer relevant as the volume of failed trades has decreased substantially,
- Our concern is that mandatory buy-in would persistently reduce market liquidity and increase costs for end investors without providing additional benefit to markets or investors,
    - Due to the risk of being bought-in and incurring significant costs, broker dealers will become less willing to make markets in securities that buy-side firms and their end

investors demand. Extrapolated across different asset classes and markets, there will be an overall decline in market liquidity,
  - The decreased availability of securities to buy-side firms means that end investors will pay a liquidity premium to purchase securities if and when a broker-dealer might be willing to make the market,
  - Applied across all asset classes and markets in the EU, this could have a profound cooling effect on capital markets activity, precisely at a time in which EU policymakers are rightly seeking to develop these markets via the Capital Markets Union.
- The mandatory buy-in regime is likely to impact also certain types of ETPs, and may ultimately favour the settlement in non-EU CSDs of less liquid securities

- During the March 2020 financial markets turmoil, application of mandatory buy-ins would probably have increased tensions on some parts of the market if they had been already applicable.

Overall, we find that current market arrangements work effectively. The existing mechanics work well for market liquidity and the pricing of trades, while ensuring that when trade settlement fails do happen, they are addressed in a timely manner. We therefore recommend that:

- Cash penalties alone are implemented, followed by an impact analysis to determine if settlement failures have been sufficiently reduced,

- The requirement to appoint a designated buy-in agent should be dropped - receiving parties should be free to seek the liquidity from any suitable broker, given a duty to provide best execution to the failing party,

- The buy-in obligation could be replaced by a right for the receiving party to either buy-in or close-out the failing transaction (close-out being effected by way of a notional sale of the instruments back to the failing party at their prevailing value).

- If further actions are considered, this should be analysed in an expert group consisting of policymakers and industry representatives before deciding on any mandatory buy-in regime that should be considered only as a last resort tool,

- Counterparties should be able to agree upon a settlement cycle longer than T+2 when executing a transaction in a less liquid instrument,

- Neither buy-in nor close-out should trigger any transaction reporting obligations under MiFIR,

- Application of the regime (penalties and buy-in) should not be applicable to corporate actions, collateral transfers or primary market transactions, including in ETFs,

- ESMA should build in powers to temporarily suspend the settlement obligation in certain exceptional situations The timing of the buy-in or close-out should be at the discretion of

the receiving party, having regard to the need to manage the risks associated with the failing transaction.

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.

During the March 2020 financial markets turmoil, application of mandatory buy-ins would probably have increased tensions on some parts of the market if they had been already applicable.

To be more specific, a mandatory buy-in would have detrimentally impacted liquidity when it was most needed and would have done so at the peak of the Covid-19-related market volatility in March/April 2020. In our view, a mandatory buy-in would only have served to amplify the liquidity pressures which arose during that period, and would have been most detrimental on segments of the market in which it became most difficult to trade – i.e. most bond markets and certain segments of the equity markets – where, in our experience, brokers became less willing to provide liquidity. We believe that brokers would have been even less willing to provide liquidity had there been an increased likelihood of mandatory buy-ins during the period, thus amplifying liquidity pressures.

For example, as regards ETPs, were mandatory buy-ins to apply under normal market conditions, it is conceivable that we could see an increase in spreads in ETPs tracking the most impacted market segments of around 5-10bps. In periods of stress, while it is very difficult to quantify the precise impact of mandatory buy-ins, it is likely that there would be a much more significant increase in spreads in such ETPs , while it is conceivable that liquidity providers could step away completely from certain market segments where they feel mandatory buy-ins are increasingly likely.

In addition, and with specific regard to the trading of ETF shares, the market inefficiencies outlined above would, in our view, be compounded as a result of the hinderance they would place on ETFs’ ability to act as a price discovery vehicle, in particular during periods of stress (as has been recognised by various institutions’ analyses of the recent period of market volatility related to Covid-19 in March/April 2020).

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.

See our response to Question 34.1.

IX. Other areas to be potentially considered in the CSDR review

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

We seek clarification from the European Commission on the proposed timeline for the legislative review of the CSDR and how that may impact the expected application of the settlement discipline regime currently foreseen for 1 February 2022 (subject to non-objection by the European Parliament and Council as regards the Commission's Delegated Act with that effect).

Given that a significant focus of this consultation is on the scope and application of the settlement discipline regime applying from February 2022, it seems likely that the European Commission will seek to implement legislative amendments to the regime. However, given that a legislative proposal on the review of the CSDR is not foreseen until later in 2021, we strongly encourage the European Commission to provide clarity as soon as possible in respect of its expectations around the implementation of the current settlement discipline regime and any subsequent legislative changes. We recommend that the industry has clarity on the final rules at least one year before entry into force because the changes that are expected in the market are significant and at least one year is needed for implementation. Many asset managers cannot even begin to implement until infrastructures such as CSDs and custodians are fully implemented and therefore sufficient time is needed for all this.

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About EFAMA

EFAMA, the voice of the European investment management industry, represents 28 Member Associations, 60 Corporate Members and 24 Associate Members. At end Q3 2020, total net assets of European investment funds reached EUR 17.6 trillion. These assets were managed by more than 34,200 UCITS (Undertakings for Collective Investments in Transferable Securities) and almost 29,400 AIFs (Alternative Investment Funds). At the end of Q2 2020, assets managed by European asset managers as investment funds and discretionary mandates amounted to an estimated EUR 24.9 trillion.

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