The International Securities Lending Association have responded to the following Sections of the Targeted consultation on the review of Regulation on improving securities settlement in the European Union and on central securities depositories | European Commission (europa.eu)

- **Section 3 – Internalised Settlement**
- **Section 6 – Scope**
- **Section 7 – Settlement Discipline**

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,[9] while the format of reports is outlined in Commission Implementing Regulation EU 2017/393.[10]

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.

[9] 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.

[10] 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.

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

Question 15.1: Please explain your answer to Question 15, providing where possible quantitative evidence and/or concrete examples.

ISLA members believe that the current reporting requirements do not require further amendments at this time and concur with the findings of ESMA's report on Internalised settlement, dated 5th November 2020, in which they advise that it is too early to identify any trends from the data provided to date, in order to successfully identify any risks (operational/legal) associated with the activity. ISLA members have put in place considerable technology build, in order to comply with the reporting requirements and at current, consider the data to be relevant, effective, and efficient.

ISLA notes the highest volumes of activity for internalised settlement stems from tri-party collateral managers, who provide collateral services for a significant majority of securities lending activity. This process achieves the central objectives of CSDR, by minimalizing settlement fails and providing operational efficiency. The high levels of Internalised settlement, as outlined in the ESMA report, may often merely reflect counterparties ability to utilise omnibus accounts. 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 collateral managers' books. The collateral provider delivers assets into the tri-party program (external movement from the providers custodian), after which the tri-party collateral manager (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 then considered reportable transactions under CSDR.

When assessing the risks of internalised settlements, it is important to note the following:

- Tri-party collateral is extensively used to mitigate counterparty credit risk, arising primarily from securities financing activity, but also from OTC derivatives and result in many intra-day movements.
- Reportable volume from tri-party collateral managers is very high, eclipsing other internalising activity for those entities, which is largely driven by intraday optimisation of collateral holdings, to ensure that the exposure amounts are covered by sufficient eligible collateral at all times, protecting lenders and allowing borrowers to optimise their financing and settlement needs.
- The overall fail rate is considerably low for tri-party movements, as settlements are input based on available positions.

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.

ISLA members to provide this data directly to the Commission

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?

- No

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.

ISLA members do not consider a threshold for a minimum level of settlement internalisation necessary. At this stage, tri-party collateral managers already have the necessary build in place to action this reporting requirement and implementing a minimum threshold would require the use of additional technology and operational resources.

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

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

The following clarifications, most of which are the subject of previously submitted and yet unanswered Q&A submissions, are required in order to provide further legal certainty as to the scope of the buy-in requirement:

1. **Operations composed of several transactions**. Article 7(4) of Level 1 provides that mandatory buy-ins will not apply to securities lending transactions whose term is sufficiently short to render the buy-in process “ineffective”. Article 22(2) of Level 2 clarifies that the buy-in process shall be considered ineffective where the second leg of the securities lending transaction is set within 30 business days of intended settlement date of the first leg. However, as drafted, it is unclear how this test should be applied to various transaction types such as open trades or evergreen trades, whose initial term may be contemplated to be within the 30-business day threshold, but that are automatically rolled such that they subsequently exceed it. As it is unclear on what basis the 30-business day threshold has been set, it is difficult for firms to take a reasoned approach to determining how to apply this to these transaction types. Please see results of a joint ISLA & ICMA member survey in February 2020 with regards to member firms treatment of open SFTs.

   Given that a primary function of securities lending is to improve liquidity by making securities available to facilitate market participants’ meeting delivery obligations, it is ISLA’s view that securities lending should not as a general matter – i.e., regardless of the tenor of the transaction, be subject to the mandatory buy-in requirement, as outlined in more detail in the responses to questions 34.1 & 35.1. However, if redefining the scope of the application is beyond the remit of this review, then a welcome clarification to the existing Level 2 exclusion (referred to above) would be that open trades, evergreen trades, and similar trade types, are not subject to the mandatory buy-in requirement.

2. **Contractual arrangements**. It is unclear which parties in the settlement chain are subject to the obligation to fully incorporate the buy-in mechanism into all applicable contractual arrangements pursuant to Article 25 of Level 2. It is unclear whether “parties in the settlement chain” refers to trading parties who have entered into an OTC master trading agreement, such as the Global Master Securities Lending Agreement (GMSLA). However, given

that (1) the GMSLA already has mechanisms to address settlement failures, (2) that previous consultations don't appear to have considered the potential impact of amending such agreements to include buy-in provisions on existing opinion coverage, and (3) amending all such master agreements would necessitate an enormous repapering exercise, which would be virtually impossible without the multiple clarifications being sought from ESMA/ the Commission, and a significant further delay to the go-live date, ISLA is of the view that the obligations under Article 25 of Level 2, could not reasonably apply to such trading master agreements. As such, clarification to this effect would be welcome.

The following are further examples of settlement types that should be deemed out of scope, as they do not correspond directly to commercial transactions:

3. **Margin and collateral transfers**. It is unclear whether the buy-in requirements are intended to apply to transfers of margin and/or collateral. Given that margin and collateral is typically transferred as a credit risk mitigant rather than in order to obtain a specific security, and that margin requirements would commonly change on a day-to-day basis in any event, it is ISLA's view that they should apply to neither. Applying a buy-in to collateral would inevitably increase credit risk, as under the current regime, parties would be obligated to buy-in undelivered collateral, and this can increase their exposure to the non-delivering party.

4. **Same entity transfers**. It is unclear whether the buy-in requirements are intended to apply to movements between different accounts of the same entity (e.g., transfer of securities from one custodian to another). In ISLA's view, it would not make sense to expect a party to initiate a buy-in against itself, and on that basis the buy-in regime should not apply to such transfers.

5. **Corporate actions**. It is unclear whether the buy-in requirements are intended to apply to transfers in relation to corporate actions, such as repurchase offers, takeover offers, and class actions. In ISLA's view, they should not apply to such transfers, in particular where 'the timeframe of those operations is sufficiently short and renders the buy-in process ineffective' as per Article 7 (4)b of Regulation 09/2014 (EU).

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

1. **Operations composed of several transactions**. Article 22(2) of Level 2 – extension of the circumstances in which the buy-in process would be deemed ineffective to cover transactions which are of an open or evergreen nature.

2. **Contractual arrangements**. Article 25 of Level 2 – clarification of who are the "parties in the settlement chain".

3. **Margin and collateral transfers**. Article 22(2) of Level 2 – extension of the circumstances in which the buy-in process would be deemed ineffective to cover transfers of margin and collateral.

4. **Same entity transfers**. Article 21 of Level 2 – extension of the circumstances in which the buy-in process would be deemed not possible to include same entity transfers.

5. **Corporate Actions**. Article 22(2) of Level 2 – extension of the circumstances in which the buy-in process would be deemed ineffective to cover corporate actions.

Including a new definition of "transaction" in Level 1 may also assist in clarifying some of the scoping issues. There is a key difference between 'transaction' and 'settlement', and these should be distinguished accordingly.

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

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

A primary function of the securities lending market is to facilitate the sourcing of securities in order to cover delivery obligations (which may or may not have already become due) elsewhere, either in the cash market or under another

securities financing transaction – as such, applying mandatory buy-ins to the securities lending market could not only result in multiple buy-ins, in respect of the same delivery obligation, when in fact only one party in the chain was actually seeking delivery (thus disrupting the price at which the securities are bought and the likelihood of actual delivery), but it could also reduce liquidity, because of fewer market participants being prepared to operate in the securities lending market (thus worsening settlement rates).

Article 26 – 38 of Level 2 (buy-in process) - Securities financing transactions (such as securities lending and repo transactions) are not simply operations composed of several transactions. There are a number of other features that are fundamental to these transaction types – such as funding components (i.e., loan fees and repo rates), daily margining and overcollateralization – which make the buying in of one transaction arbitrary and disruptive to the economic and commercial drivers to the transaction. The current buy-in process does not contemplate these features, and without guidance from regulators, as to exactly how they are impacted, it is difficult to see how the market will effectively introduce and exercise the buy-in mechanism in practice, even in circumstances where the current requirements do clearly impose a mandatory buy-in.

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?

Securities financing transactions should be removed from the scope of the buy-in requirement given that a primary function of the securities lending market is to improve settlement efficiency. Introduction of penalties should be a sufficient incentive for market participants to manage settlement more effectively and without the arbitrary additional risk which would be introduced by applying buy-ins to the securities lending market, it can continue to support settlement discipline. As a result of the Lehman Brothers collapse in 2008, the US Treasury Market Practices Group (TMPG), introduced a best practice for market participants, of imposing daily penalty charges for late delivery of securities, as a means to promote settlement efficiency in the US treasury market. After a broad adoption of this, the settlement fails in this market have significantly reduced over time. A similar adoption of the penalty regime under CSDR would likely have similar effects across the European capital markets, without impacting liquidity.

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 settlements 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.

[13] Commission Delegated Regulation (EU) 2018/1229 of 25 May 2018 supplementing Regulation (EU) 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on settlement discipline (OJ L 230, 13.9.2018, p. 1).

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

-Yes

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 option)

- Rules relating to the buy-in

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

N/A

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	X					
Buy-ins should be voluntary					X	
Rules on buy-ins should be differentiated, taking into account different markets, instruments, and transaction types.					X	
A pass on mechanism should be introduced [14]					X	
The rules on the use of buy-in agents should be amended					X	
The scope of the buy-in regime and the exemptions applicable should be clarified					X	
The asymmetry in the reimbursement for changes in market prices should be eliminated					X	
The CSDR penalties framework can have procyclical effects.					X	
The penalty rates should be revised					X	
The penalty regime should not apply to certain types of transaction (e.g., market claims in cash)			X			

[14] *E.g. a mechanism providing that where a settlement fail is the cause of multiple settlement fails through a transaction chain, it should be possible for a single buy-in to be initiated with the intention to settle the entire chain of fails and to avoid multiple buy-ins being processed at the same time, and that where a receiving trading party in a transaction chain initiates the buy-in process, all other receiving trading parties in that transaction chain are relieved of any obligation to initiate a buy-in process .*

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

ISLA and its members fully support the Capital Market Union's overall goal to develop and create a single EU capital market, and the core objective of CSDR, to increase settlement efficiency.

ISLA support the introduction of penalties and recognise that they are already widely utilised globally, as an effective mechanism to incentivize a more efficient settlement process. However, we strongly advocate that this measure alone would be sufficient to achieve the objective of the regulation, and that implementing a regulatory buy-in would be severely damaging to the smooth functioning of capital markets. As such, ISLA propose the following:

- Implement penalties in February 2022 as currently planned
- Decouple the regulatory buy-in requirement; and
- Allow a significant period of time for regulators and market participants to assess the impacts of penalties in reducing fails and re-calibrate rates where no significant improvement occurs.

In its current form, the regulatory buy-in requirements would have severe adverse effects on efficiency and liquidity of the market (as discussed in more detail in the response to Question 35) and would require substantial revisions and further clarity from the Commission around the scope and outstanding issues, with regards to the asymmetry of buy-in payments and cash compensation differences, as well as the ability to pass on a buy-in request. If changes are to be made, this will require extensive technology builds and trigger a further re-papering exercise to ensure the requirements of Article 25 of the RTS are met. Preparing from a technological or legal perspective for implementation in 2022, when there may be further amendments, is unfeasible and impractical for the industry. Once an impact

assessment has been performed on the effects of the penalty regime, ISLA support empowering ESMA to recalibrate efficiency rates where necessary.

ISLA do not support the introduction of a regulatory buy-in for securities financing transactions, as stock loan activity supports both an increase in liquidity and a reduction of settlement fails in the primary market. As such the scope of the SDR should distinguish between regular cash trades and securities financing transactions. The securities lending market has contractual remedies in place (GMSLA) that are designed to provide parties with the necessary optionality, in relation to failing transactions that occur, as detailed further below. Furthermore, the industry has effective market practices in place and a sufficient framework that effectively aligns with the spirit of the SDR, to improve settlement efficiency.

Buy-ins:

If a buy-in is introduced, and it is to apply to securities lending, ISLA would recommend that a voluntary mechanism be implemented that is equivalent to current standard market practice as opposed to a mandatory buy-in. As noted elsewhere in our response, a primary function of the securities lending market is to improve settlement efficiency. For this reason, securities lending transactions commonly form a link in longer settlement chains. This may then introduce a degree of settlement exposure to counterparts that would otherwise not exist. As such, having a voluntary mechanism offers parties, caught in a settlement chain, the discretion to measure and assess the impacts, and on doing so determine the most appropriate course of action. The voluntary mechanism should be exercisable in the event of a settlement fail, rather than subject to an explicit 4-, 7- or 15-day delay period as outlined in the current regulation. This would increase the flexibility with which market participants manage their settlement and market exposure.

ISLA also recognises the benefit of contractual buy-in mechanisms that provide a bilaterally agreed resolution to settlement failure. It is for this reason the industry standard master agreement for securities lending (GMSLA) includes such a mechanism, allowing loan termination and replacing delivery obligations with payment obligations (commonly referred to as a "mini close-out"). Given the existence of this contractual remedy within the securities lending master agreement, ISLA's view is that the requirement to impose a mandatory buy-in mechanism would be redundant. ISLA therefore recommend that details of a prescriptive mandatory buy-in mechanism should not be mandated, but rather the regulation should require that trading parties have contractual provisions in place (buy-ins, mini close out or similar) to remedy and resolve settlement failures which market participants can chose to initiate, when it is within their economic interest to do so.

To further improve settlement efficiency, ISLA advocates the use of other industry-led practices. For example, the use of T + 0 returns, improvements in inventory management, standardisation of automatic partial settlement and the use of hold and release functions where settlement is tied to collateral receipts. ISLA have, with market consensus, introduced best practices for the following:

- **Failure to deliver on a new loan** – Settlement rates for new loans are generally high, as lenders should only consider concluding and issuing instruction where the inventory has fully settled into their custody. As such, the frequency of matching instructions, where the lender is unable to deliver on a new loan is low. Where a lender is unable to satisfy an order, both parties retain the right to bi-laterally cancel the agreed transaction, as standard market practice. As a consequence, the borrower may then consider sourcing the securities from another lender to cover any other obligation(s).

- **Failure to deliver on a recall** – When a lender of securities issues a recall notice to the borrower, and that recall return instruction fails, the receiving party is able to elect to terminate the failing transaction using the contractual remedies contained within the GMSLA such as clause 9.1 'Borrower's failure to deliver Equivalent Securities' and 9.2 'Lender's failure to deliver Equivalent Collateral'. The receiving party may terminate the outstanding loan and determine the value of the relevant securities. The receiving party has the right to purchase equivalent securities in the market and use the current purchase price to establish the value of the outstanding loan. Clause 9.3 'Failure by either Party to deliver' then provides a mechanism to recover associated costs, including any costs received along a failing settlement chain.

- **Failure to deliver on a return leg** – Trading parties rarely, if ever, exercise a buy-in against parties that fail to deliver against a standard return as these pose no real market risk. Where appropriate, parties may agree to

cancel a return bilaterally if unable to deliver. In many cases, parties may prefer to agree and instruct a loan return on a same day basis, typically reducing fail occurrences. This improved efficiency is a result of the delivering party having the required securities physically in their account. Failure of a return leg does not impact on market liquidity and may indeed be beneficial to the failed to party, as fees may still be accrued throughout the period of settlement failure.

Rules on buy-ins should be differentiated, considering different markets, instruments, and transaction types:

ISLA strongly advocates that the securities financing market, including securities lending, be deemed out of scope for any regulatory buy-in requirement implemented. These transaction types should be excluded on the basis that SFTs are already widely utilised as an efficient mechanism to reduce settlement failures in the cash market. In addition to this benefit, SFTs are an essential element in liquidity generation. Any limitation introduced by a buy-in regime would adversely impact this market benefit and the overall efficiency of EU securities markets.

In January 2021, produced in partnership with Finadium, ISLA published the updated Regulator & Policy maker Guide to Securities Lending. The guide describes securities lending as a 'fundamental component of financial markets, as a means of meeting settlement and collateral requirements, as well as providing vital liquidity to secondary markets.' As of June 2020, Total Securities on-loan was approximately €2.2Tn with total lendable assets at €20Tn (Source: Data provided by DataLend, IHS Markit and FIS Global for the ISLA Securities Lending Market Report, 13th Edition).

There are numerous studies demonstrating the link between total assets on loan, the resulting improved bid offer spreads and increased market liquidity, for example through studies from The International organization of Securities Commissions, (IOSCO) & The Bank of International Settlements.

Pass on Mechanisms:

ISLA support industry proposals, in conjunction with other trade associations such as AFME & ICMA, that allow for an effective pass on mechanism in the regulation, in order to reduce the number of buy-ins in a settlement chain. However, implementing a pass on as part of the current regime, without also addressing the rigidness in timing of when a buy-in is initiated and the asymmetry in price differentials, would be unattainable and ineffective. ISLA consider pass on mechanisms an essential feature for maintaining functional market stability. However, such provisions should be detailed within existing contractual arrangements specific to the underlying instrument type and should not be detailed within the regulation itself. The level 1 should merely allow for such a mechanism to be in place.

In order to allow the industry sufficient time to develop a pass-on mechanism that is based on the underlying market type, the regulatory buy-in requirement should be removed from the SDR in its current form until outstanding issues are addressed by policy makers.

Buy-in agents:

ISLA members fully support the conclusions of ICMA's paper CSDR Mandatory Buy-ins & the requirement for a buy-in agent (September 2020).

Securities lending activity is supported by a bilaterally agreed master contract providing optional contractual remedies to resolve a settlement failure. CSDR SDR by contrast, mandates an alternative process undertaken by a third party. However, as of January 2021, only one agent exists that might offer this service which may introduce monopolistic hallmarks, further reducing liquidity and leading to additional costs being built in for a typical transaction.

Consideration should also be given to the inclusion of a third party between the lender and borrower, extending associated compliance and exposure considerations on parties operating in global jurisdictions. ISLA members have noted this limitation and raised concerns about the ability of a single agent and their capacity to ensure adequate coverage, with regards to cross-border licensing, as well as concerns as to whether they will be able to service all in-scope instruments.

Scope of Buy-in regime:

ISLA support a review of the buy-in scope to limit the regime to those transaction types that pose real market risk. For example, cash market sales or purchases to be included and securities financing transactions excluded. As noted in response to question 31.2, further clarity must be provided on the differences between 'transactions' and 'settlements', whereby buy-ins only apply (on an optional basis) to cash transactions (outright sales or purchases). ISLA understand that the objective of the buy-in is to ensure original trading obligations are met, and where those obligations are not fulfilled, there is a structured legal mechanism to enforce that any loss is correctly compensated. As such, contractual remedies provided for in the GMSLA should be considered sufficient for the SFT market, as they fulfil the objective of the regulation. There should also be an exclusion to cover collateral movements, margin trades and intra-entity movements, which pose no systemic market risk.

Asymmetry:

ISLA support both ICMA & AFME's requests for the removal of asymmetry for the price differentials and cash compensation (cash out) to reflect the intersection of the cash and SFT market, by an amendment to the Level 1 Text, Article 7 (6) & Articles 32 & 35 of the RTS.

The traditional buy-in process allows for payment to be made for the difference of the buy-in price and the original trade price – this should be made in either direction between trading parties, dependent on whether the buy-in price is higher or lower than the original trade price.

Buy-ins must be symmetrical in order for a suitable pass on mechanism to be developed by the industry.

CSDR penalties framework can have procyclical effects:

ISLA consider buy-ins, and to a lesser degree penalties, to have pro-cyclical effects on market liquidity. This may be identified by the high level of fails throughout the initial stages of the pandemic in 2020, referenced in the ESMA Trends, Risks and Vulnerabilities report. These may also be portrayed in more detail, in response to question 35.

Revise Penalty Rates:

ISLA members consider the current rates to be sufficient, however would request that policy makers clearly advise what level of settlement success would constitute a 'target' efficiency rate.
ISLA note that the CSDR penalty mechanism alone should be sufficient to establish increased settlement efficiency across EU Capital markets. As mentioned in other sections of this consultation, ISLA propose that policy makers conduct a thorough impact assessment of the penalty structure, post go-live (February 2022), and continue to periodically monitor that efficiency. Where there is no significant improvement, ESMA should be given authority to set target efficiency rates based on a finer measure of instrument type/liquidity type and not just asset class, which should be publicly maintained. There should also be a review process to determine; a, if the rates introduce a negative impact to market liquidity, then penalties would be adjusted and b, the need for a buy-in mechanism at all, where certain instrument types/ markets maintain target efficiency rates.

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?

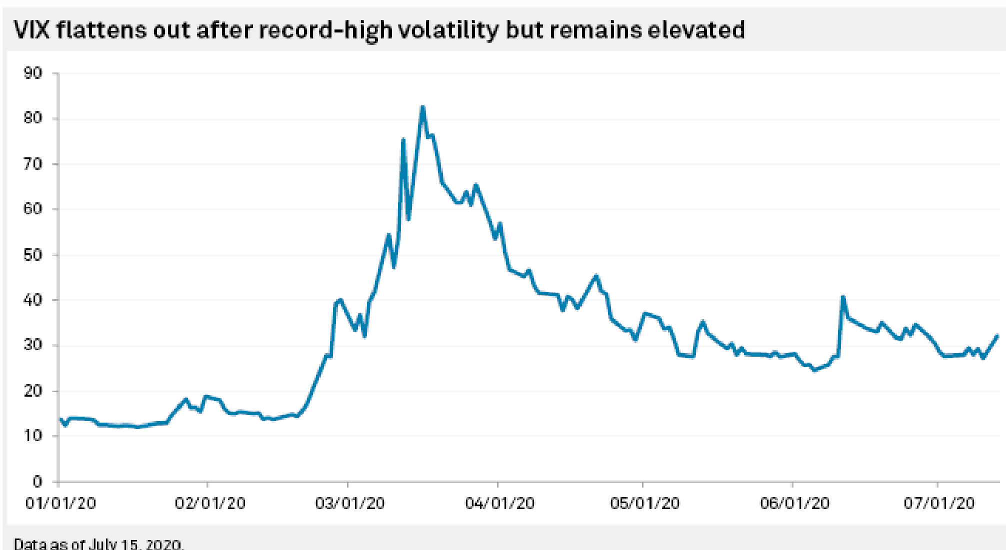
-Yes

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.

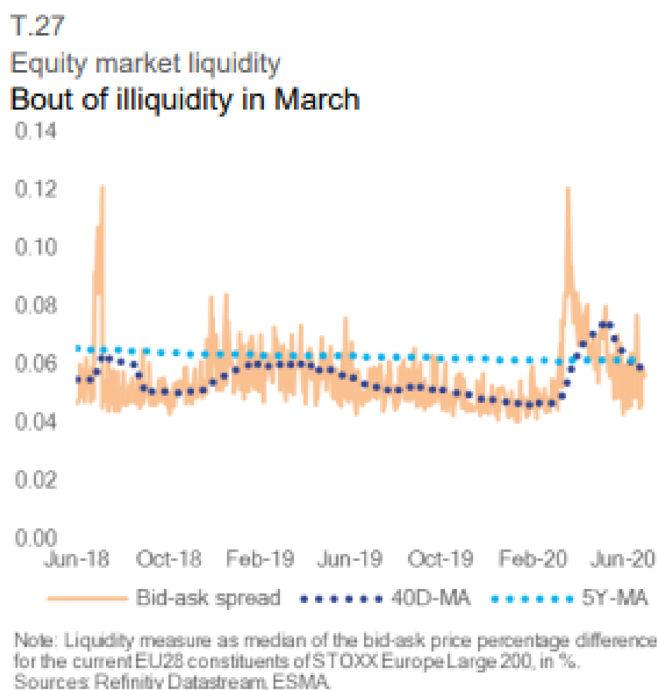
ISLA agrees with findings, that had the settlement discipline regime been in place throughout the initial COVID-19 crisis, there would have been significant negative and procyclical impact to liquidity and volatility, as conveyed in AFME's report on the Impact of COVID 19 on European Capital markets.

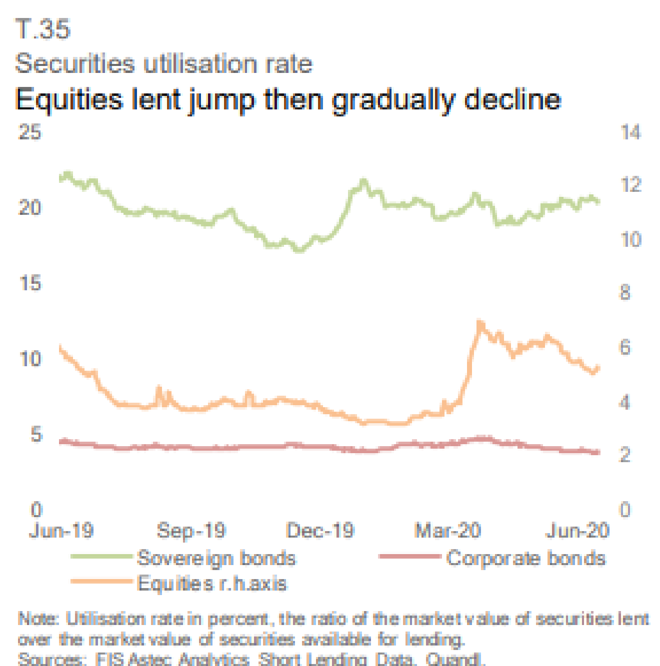
In the early parts of 2020, there were periods of unprecedented market volatility that lead to direct intervention from central banks and governments globally. In March, the CBOE VIX, a measure of expected volatility on the S&P 500,

that investors use to measure the level of stress in financial markets, reached over 80, higher than levels seen since in the 2008 financial crisis (Source: CBOE Charts & Data).



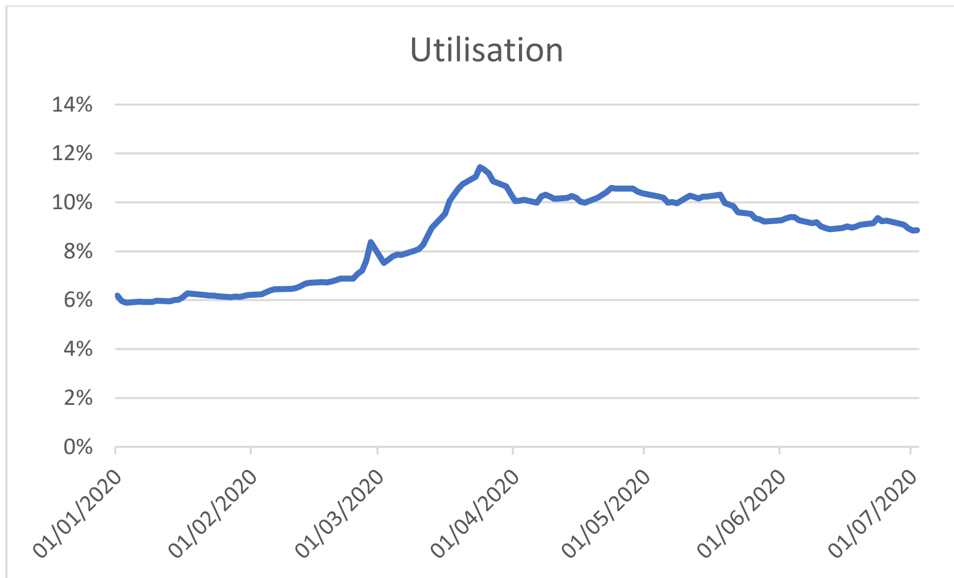
In September 2020, ESMA released its report on Trends, Risks and Vulnerabilities throughout the pandemic period, and as shown in figure **T.27**, a bout of illiquidity in March 2020.





Referring to the increase in net short positions, the report states that there was *'an increase in securities lending …The utilisation rate measures security lent over those available (The utilisation rate is a reliable proxy to measure short selling. It is the ratio between of the value of securities lent to the value of all securities available in the market. Utilisation is generally intended as a measure of demand against the supply of instrument to borrow). Since the end of February, the utilisation rate jumped sharply from 4% to almost 7% for equities, signalling increased demand* ***(T.35)****'*. COVID 19's impact on capital markets drove a drastic decrease in market liquidity, highlighted in **T.27** of the ESMA report, by the sudden increases in bid-ask spreads in March 2020 for the EURO STOXX 200 index.

Data Collected as part of the ISLA Securities Lending Market Report, 13th Edition 2020, also showed an increase in the utilisation rate over the initial COVID period, in Europe over March & April (Data Provided by IHS Markit).

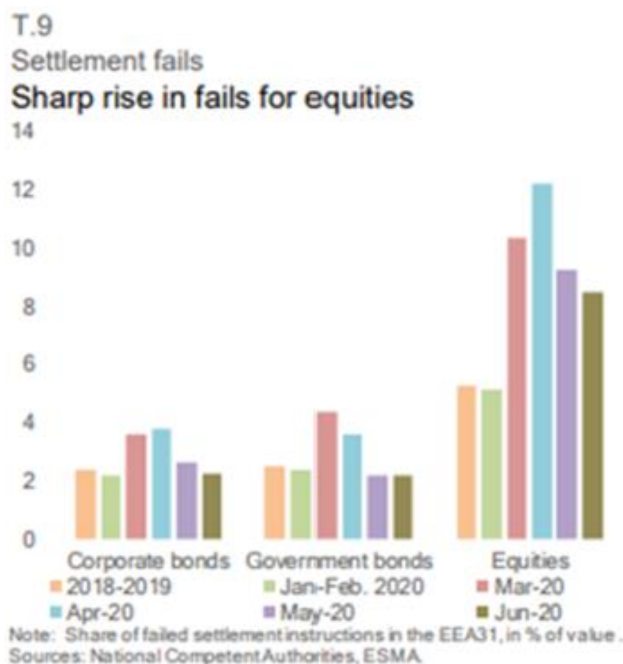


Statistics provided by Euroclear show the percentage of volume increase for securities lending, throughout March & April 2020 (where highest level of volatility occurred) vs the remainder of the year. All volumes grew substantially, with the highest increase in government/sovereign issued securities.

Euroclear Fails-Driven securities lending		
Issuer Type	**% of volume increase in March-April 2020 versus the rest of the year (excluding March-April)**	**% of total lending**
Agency	69%	3%
Corporate	67%	5%
Credit Institution	73%	7%
Municipal	30%	1%
Other Financial	63%	6%
Public Sector	76%	1%
Sovereign	83%	69%
Supranational	55%	7%
Grand Total	**77%**	

There is a clear link between the increased securities lending utilisation (% of lent assets from a lendable portfolio) and the corresponding decrease in market liquidity, which illustrates the vital relationship securities lending has in maintaining a stable market and thus imposing a ‘regulatory buy in’ via the CSDR settlement Discipline regime on this securities financing transaction type amongst others, would be detrimental to the effective functioning of global capital markets.

In a paper published by the Bank of Canada in 2010, titled; The Role of Securities Lending in Market Liquidity – they cite ‘ the securities lending market may be a potential source of contagion during times of stress’. ISLA would argue that implementing a mandatory buy-in regime as part of CSDR would most certainly lead to increased pricing of cash trades (primary market), to take into account additional risk & cost if settlement failure should occur (See T.9 showing a sharp rise in fails for equities throughout the initial stages of the pandemic adding substantial further transactional costs in times of market stress). This increase in pricing may act as a deterrent for investors in European Securities, as well as cause reduced liquidity, especially for instruments that are less liquid. This can be averted by freely allowing the SFT market to operate in its current form and utilise its existing contractual remedies to initiate buy-ins where necessary, as done today. Furthermore, the Bank of Canada advises that Securities Lending programmes are generally perceived to be low risk as they are a discretionary activity for investors to earn additional revenue. Buy-in’s that ultimately transfer additional risk onto the end investor/ beneficial owner, may deter investors from lending their securities altogether, as the perceived risk of lending increases. This will thus reduce the lendable pool of assets, decreasing liquidity in EU capital markets further. ISLA and its members believe that this ultimately defeats the aim of CSDR.



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

1) Decouple the two elements of the SDR (penalties and buy-ins) by an amendment to the entry into force of Article 7 (1-13). Implement penalties in February 2022 as planned and allow time for regulators to perform an impact assessment on settlement efficiency before the buy-in element of the SDR enters into force.

   Benefits: Overall settlement efficiency would increase, with penalties acting as a sufficient deterrent for fails, without the impact on market liquidity of a mandatory buy-in on SFTs, disrupting a smooth capital flow. The industry will require significant time to apply the new framework into legal contracts, if the requirements of Article 25 of the RTS are introduced as currently drafted, as well as undertake significant technology builds. If an approved legislative proposal from the Commission is not expected until approximately Q4 in 2021, this does not leave an appropriate timeframe until February 2022, to incorporate the outcome. If penalties and buy-ins were decoupled to enter into force at different stages, this would allow the appropriate time for the market to adjust and build accordingly.

   Costs: As outlined in the response to Question 35.1, introducing a ‘mandatory’ buy-in regime on SFTs would lead to reduced market liquidity, as securities lending is already used as a means to reduce settlement failures in the secondary market. Increased risk on the asset owners could also lead to a reduced pool of lendable assets and an increase in demand for securities in times of market stress, such as the pandemic, coupled with a decrease in supply, would reduce liquidity further.

2) Replace mandatory buy-ins with an optional buy-in ‘type’ mechanism (for in-scope transactions) - It is essential that the mandatory obligation to enforce a buy-in be removed from the regulatory text, (in particular for instrument types that have similar remedies outlined in their legal documentation, that fulfil the same objective as a CSDR buy-in, for instance clauses 9.1-9.3 of the GMSLA).

   Benefits: ISLA and its members advise that the regulation should not provide details of how a buy-in is exercised and instead, mandate that there must be sufficient contractual remedies in place (dependent on instrument type), between trading parties that allow the non-receiving party, to resolve a settlement fail with a buy-in type mechanism, at their discretion, where it is in their economic interest to do so.

3) Allow for a pass on mechanism (buy-ins only)

   Benefits: In order to reduce multiple buy-ins in a settlement chain, the regulation must allow for the ability to reject a buy-in notice, if one has already been initiated in a settlement chain and an ability to pass on a buy-in, for in scope transactions. This will reduce any impacts to liquidity.

4) Create symmetry for price differences & cash compensation **–** ISLA consider it is important, that the price differences can be settled symmetrically between parties with respect to a buy-in or in the case of cash compensation.

   Benefits: Symmetry is required to ensure all non-receiving parties are returned to their original economic position, regardless of where they sit, in the settlement chain. This will ultimately reduce market risk to intermediaries in a settlement chain (which are currently adversely impacted) and allows for a pass on mechanism to be effective.

5) Remove the requirement to appoint a buy-in agent

   Costs: Having a monopoly with just one available buy-in agent across the market, will cause increased costs to trading parties, due to the lack of competitive pricing of the service. In addition, CSDR does not only impact European trading parties, and touches any transactions that settles on an EU CSD, regardless of whether the trading party is European or not, so this may give rise to cross border licensing issues (i.e., inability and/or reluctance of the sole buy-in in agent to provide its services to entities established outside of the EU) as well as capacity constraints to cater for all market participants.

   Benefits: Allowing trading parties to execute their own buy-ins based on their underlying contractual requirements, will allow flexibility to act in the best economic interest of the non-receiving party and catered to relevant instrument types, and avoid over reliance and concentration of operational risk on a single market infrastructure entity. It also removes issues of cross border usage between EU and Non- EU participants.