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Finance for Europe

Association for Financial Markets in Europe

# AFME response to ESMA's Technical Standards in relation to the CSD Regulation

19 February 2015

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the **"Technical Standards under CSDR"** that were published by ESMA. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

**Executive Summary**

# AFME responses to Consultation on Technical Standards under the CSD Regulation

The Association for Financial Markets in Europe (AFME)[1] and its members welcomes the opportunity to respond to the above Consultation Papers published by the European Securities and Markets Authority (ESMA).

Our responses refer for the most part to the proposed buy-in rules and settlement fines. ESMA proposed that the CSDs should be the issuers of buy in notices to their participants. For AFME, this issue is viewed from the wrong perspective. Currently, a buy in is executed between trading parties where a contract (the trade) has already been formed. Central Counterparties (CCPs) are also able to invoke a buy in as they have a contractual relationship between themselves and their clearing members However, CSDs receive settlement instructions from their participants which are not contractual in nature. These instructions may relate to transactions but may equally relate to other forms of transfer not related to a trade that the CSD participant is required to undertake by its client. The proposal that a CSD could issue a buy in against one of its participants would fundamentally change the risk profile of CSD participants/intermediaries in the market and add a new layer of cost. AFME believes that the buy in should take place at trading participant level, or at a CCP where the trade is centrally cleared.

In a separate Consultation Paper relating to Technical Advice to the European Commission in relation to settlement fines, ESMA has defined broad buckets of instruments and proposed penalties for late settlement. We believe that further refinement is required if market makers in all securities are to be able to confidently make a two way price, knowing that if they sell short to facilitate a customer, lenders will not have withdrawn in case they are levied a fine for non delivery. With Capital Markets Union in the headlines, it would be ironic if post-trade legislation resulted in a lack of liquidity for SME Growth Markets. However, concerns are not confined to small cap stocks. Government debt securities will be in scope for both penalties and buy-ins.

For the implementation settlement fines to be undertaken smoothly, AFME supports ESMA's recommendation of a phase in period of 24 months, rather than 18. AFME members will be working through their Target2-Securities (T2S) program together with the CSDs. The additional six months would be welcome to mitigate the burden of a parallel implementation.

Finally, AFME would welcome an impact assessment to accompany the standards. According to the trade association that represents the CSDs, ECSDA, the total number of buy-ins per year could reach over 1.8 million, representing a total value of more than EUR 2.5 trillion. The gross amount of late

[1] AFME represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1 November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association. AFME provides members with an effective and influential voice through which to communicate the industry standpoint on issues affecting the international, European and UK capital markets. AFME is the European regional member of the Global Financial Markets Association (GFMA) and is an affiliate of the U.S. Securities Industry and Financial Markets Association (SIFMA) and the Asian Securities Industry and Financial Markets Association (ASIFMA). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

settlement penalties to be collected could total EUR 2.2 billion. If these estimates are correct, the measures will have a significant impact on European markets and its users.

**Q1. Do you think the proposed timeframes for allocations and confirmations under Article 2 of the RTS on Settlement Discipline are adequate?**

**If not, what would be feasible timeframes in your opinion?**

**Please provide details and arguments in case you envisage any technical difficulties in complying with the proposed timeframes.**

AFME agrees that timely allocation and confirmation will improve settlement performance; however there are considerations to be taken into account before enforcing a same-day (trade date) confirmation process. This is a realistic target, however, investment firms can be restricted by clients and counterparties who still adopt paper based (manual) booking processes which inherently delay confirmation and allocation, often until T+1. To make confirmation and allocation mandatory on trade date without the necessary automation will drive increased pressure on operational teams. Member firms are working with manual clients and vendor solutions to automate allocation/confirmation however this will also be dependent on client investment.

It is not clear to us why the term "written" in used in connection with confirmations and allocations of transactions. We believe that the spirit of the technical standards is to achieve automation so that confirmations are executed as quickly as possible. "Written" may portray the impression that it is acceptable to send manual faxes or email as confirmation of a trade. We would suggest that the term be replaced by "automated" or "machine readable". We recognise that not all professional clients are currently able to send via an automated method and therefore suggest a phase in period post the Regulation entering into force.

<u>Proposed re-drafting Article 2(1)</u>

2.1. Investment firms shall in their agreements with professional clients, enter an obligation for these clients to send the investment firm ~~written~~ **automated** allocations of securities or cash to the transactions, as well as a ~~written~~ **automated** confirmation of acceptance or rejection of the terms of the transaction, unless the professional client holds the relevant securities and cash at the investment firm.

The ~~written~~ **automated** acceptance of the terms of the transaction shall be sent as soon as possible after receipt of the confirmation of execution of orders by the investment firm to the professional client, and within the timeframes set in paragraph

The ~~written~~ **automated** acceptance of the terms of the transaction may be included in the allocation.

**New:** The process of automation should be undertaken within one year of this Regulation entering into force.

For the sake of clarity AFME would like to add the time zone:

<u>Proposed re-drafting Article 2 (2)</u>

2.2 The allocations and confirmations under paragraph 1 shall reach the investment firm, in the time zone of the investment firm:

(a) on the business day in which the transaction takes place; or,

(b) at the latest, by **Noon (CET)** on the business day following the business day in which the transaction takes place, in the case of time zone differences greater than 2 hours or in the case of orders executed after 4 pm in the time zone of the investment firm.

AFME notes that the responsibility is placed on the investment firm to potentially re-paper their clients to include details of these proposed timeframes which will be an onerous activity. However, there do not appear to be any clauses which ensure the client adheres to these timelines, nor any mention of clients having to affirm transactions (electronically), a necessity in order to reduce risk. The level 1 text states that measures to prevent fails shall "at least consist of arrangements between the investment firm and its clients to ensure the prompt communication....of the transaction". We would suggest that the client should bear some responsibility for their part of the process.

Proposed re-drafting Article 3

3. Investment firms shall offer their professional clients the possibility to send confirmations and allocation details under paragraphs 1 and 2 electronically, by the use of international open communication procedures and standards for messaging and reference data. The investment firms may use third party systems for confirmation and allocation. **Where the professional clients agree to such electronic systems, they should affirm the allocation within 2 hours.**

Also, for clients that do not use an electronic confirmation service (manual clients), for which a confirmation is issued but where no positive affirmation is received from the professional client, investments firms will be unaware of any potential settlement issues until the pre-settlement matching steps take place.

Not all counterparties subscribe to a Standing Settlement Instruction (SSI) database. In these cases AFME members will seek the SSI from the client directly although we would urge ESMA to propose a greater use of electronic SSI databases. Professional clients (or their outsource partner) should review the database on a frequent basis to ensure the accuracy of their SSI.

A settlement instruction should be closely aligned to affirmation: where possible, instructions should be sent to CSDs as close to T as possible to allow for investigation into exceptions, such as SSI mismatches until ISD.

Finally, we believe that a clear definition of confirmation/allocation should be made and agreed by all stakeholders to ensure the process becomes more efficient. Indeed, it is envisaged in the draft RTS that "For orders where the investment firm has received the necessary settlement information in advance of the transaction, the investment firm and the professional client may agree in writing that confirmations and allocations as specified under subparagraphs 1-3 are not to be sent" (draft RTS, Chapter II, Article 2). This is not consistent with our definition of a confirmation and of an allocation since they both relate to the agreement of the transaction itself rather than on specific settlement information.

**Q2. Do you agree with the cases when matching would not be necessary, as specified under Article 3(2) of the draft RTS?**

**Should other cases be included? Please provide details and evidence for any proposed case.**

AFME is strongly in favour of Straight Through Processing (STP), wherever possible, which we understand to be processing with a lack of manual intervention. AFME agrees that the matching

fields described in the draft RTS are appropriate. However we would like to highlight that the "already matched" status is a pure T2S technical concept and should it be used in a regulation we would support a harmonised European definition.

AFME supports the tolerance levels which are already in use today in many markets and strongly suggests that tolerance levels are harmonized across all CSDs. Ideally AFME would suggest that rather than having tolerances based on Euros, tolerances for each currency should be provided to avoid confusion. For example matching between two domestic instructions in DKK or SEK where the counter value in Euros is irrelevant.

We believe that in Art 3 (3) a, the reference to 4(2)h is not valid and should be (g).

Similarly, we think that Art 3 (3) d – reference to 4(2)f – is also invalid and should relate to (e).

We would urge ESMA to consider a phase-in period for the introduction of "transaction type" field in the settlement instructions and become a pre-requisite to the introduction of the settlement penalties and buy-in regime. This field is not commonly used by markets today and will require technology enhancements. In addition, new codes may need to be applied for. "Transaction types" however, should be a pre-requisite to the introduction of the settlement penalties and buy-in regime. The phased approach would need to be closely aligned to the settlement penalties and buy-in regime as "transaction type" is the only way that the CSDs can identify in-scope transactions for both settlement penalties and buy-ins

With respect to Free of Payment (FoP) transfers we would encourage ESMA to clarify that matching should also be possible between two securities accounts of the same CSD participant. As an explanation, agent banks may operate multiple accounts under their own name but for different underlying clients. If the underlying parties have provided instructions to transfer securities FoP between two accounts they should be matched in order to ensure that the underlying details of the instructions match. Alternatively agent banks would have to build an in-house matching mechanism to perform that check and make additional investments to hold back the receipt instruction, which may not be desired. No exception should be made for Corporate Action processing or Depositary Receipt agents.

Proposed re-drafting Article 3.2

A CSD shall match settlement instructions prior to settlement, based on the instructions sent by participants, except in the following circumstances:

(a) the settlement instructions received by the CSD are already matched by trading venues or other entities such as CCPs;

~~(b) FoP instructions which consist of transfers or financial instruments between different accounts opened in the name of the same participant.~~

**Q3. What are your views on the proposed approach under Article 3(11) of the draft RTS included in Chapter II of Annex I?**

**Do you think that the 0.5% settlement fails threshold (i.e. 99.5% settlement efficiency rate) is adequate? If not, what would be an adequate threshold? Please provide details and arguments.**

**Do you think that the 2,5 billion EUR/year in terms of the value of settlement fails for a securities settlement system operated by a CSD is adequate? If not, what would be an adequate threshold? Please provide details and arguments.**

AFME is of the view that all CSDs, whether in or out of Target 2 Securities, should look to adopt harmonized basic services and the use of the Hold & Release, Recycling and Partials functionality. AFME believes that CSDs should offer these same basic services to their clients and do not agree with

the suggested exemptions or the respective thresholds. T2S will provide this functionality and participating CSDs are encouraged to utilize this.

Moreover such exceptions would go against the harmonization efforts that the market is currently undertaking. We note that such rules could be seen as beneficial for some CSDs. However, from a participant perspective with multiple market access points, having to build different settlement processes for certain markets is not desirable.

Mandating an exception from the recycling of instructions when referring to interoperable links or CSDs that use a common settlement infrastructure would mean that in proactive manner at the end of the day CSDs would cancel instructions which a participant deems to be valid. This requires additional controls to capture CSD cancelled instructions and regenerate new instructions creating additional unnecessary operational overheads and costs and potentially introducing settlement risk if a single transaction is, or group of transactions, are missed. Not allowing recycling could also be problematic in a corporate action scenario to allow for market claims on pending transactions.

AFME is of the opinion that both "hold & release" as well as the "partial" functionality are critical to the objective of achieving high settlement efficiency as well as improving settlement behavior in other segments of the market such as Securities Borrowing and Lending (where settlement instructions are often transmitted late where lenders are awaiting receipt of collateral). In an Omnibus Account set up without "hold and release" functionality in place, CSD participants, in order to protect their other clients' assets, would not send instructions to the market without first knowing that their clients had the necessary resources to settle their transactions. As a result such participants would have to resort to a telephone pre-matching process, which is time consuming and manual. Use of the "Hold and Release" mechanism should not delay the issue of settlement instructions for pre-matching purposes. It should only prevent settlement from occurring until the participant changes the "hold" status to "release".

Without "partial settlement" functionality the market is missing a key element to increase settlement efficiency, as in some cases even a small additional amount of liquidity injected into the settlement process could help settling further transactions in the same security.

Should ESMA consider retaining its original proposal to exclude mandating 'Hold and Release' and 'Partialling' settlement functionalities for CSDs who qualify under RTS article 3(11), then the 3 month timeframe for CSDs and their participants to implement such functionalities appears rather short. In such a scenario we would not consider 3 months to be sufficient for CSDs to undergo such significant market change. In our view, an adequate period would be one year to allow the CSD, its participants and other parties in the settlement chain to implement the required changes.

The alternative is to mandate all CSDs to implement all settlement functions but those who qualify for exemption under RTS Article 3(11) to 'switch off' the 'Hold and Release' and 'Partialling' functionality until such times as it is needed. The key concern is that this may result in redundant investment and effort for some CSDs and their participants.

AFME is strongly opposed to this Article for the reasons outlined in our response to Q3 above. All CSDs should offer the same basic services to their clients. We would not agree with the suggested exemptions or the respective thresholds. In particular, T2S will provide this functionality and participating CSDs are encouraged to utilize this.

**Therefore we propose that Article 3.11 and 3.12 be deleted.**

**Q4. What are your views on the proposed draft RTS included in Chapter II of Annex I?**

AFME is broadly supportive of the proposed standards, but would like to raise the following comments:

AFME believes that a matching field "Transaction Type" introduced in Article 3.3 is currently not widely used in the European securities settlement systems. Settlement platforms only utilize the field as "mandatory" but not a matching field (i.e. a settlement instruction would be rejected should the message not contain a value). Such an approach could be sufficient if ESMA considers this for the CSD's record keeping requirement.

Adding a new mandatory matching criterion will lead to important IT developments at every stage (from the transacting parties to the CSD and T2S) and may impede matching efficiency. Therefore such change needs to have a clear rationale. At the moment we do not see the purpose (beyond the reporting) of this requirement.

If ESMA considers making the "Transaction Type" field a matching field, an agreement between all market participants is required. This would ultimately require several changes in the ISO standards which will take at least 12 months to be implemented.

As a general note, AFME considers a harmonized use of the field transaction type in the reporting would be desirable, which would require a market practice agreement on which ISO code to use for which transaction.

Investment firms would also need to seek assurance from third parties (such as CCPs), who are often responsible for issuance of instructions to agents and/or CSDs on their behalf, that the correct values are being utilized.

In Article 3 (7) we recognize that participants have been given the ability to opt out of partialling, but consider that a failing participant who has sufficient inventory to make a partial delivery but chooses not to, should be penalized on the full amount. However, if a participant has opted into partialling, only the unavailable balance should be penalized.

AFME is also of the view that the proposed Art. 3(8) should cater for those CSD participants not relying on allegement messages in order to support their processing/services.

Within T2S the allegement services are considered optional and not mandatory. Such optional requirement would prevent CSD participants from receiving too many allegment messages thereby loosing focus on the identification of the "real" pending / failing transactions.

T2S functionality may be an alternative to ESMA's proposal, e.g. Participants (upon signup to this service) are notified immediately after the first unsuccessful matching attempt. A second allegement notice may not be required as participants diligently process and act on allegement notices.

Proposal re-drafting Article 3 (8)

3.8 A CSD shall offer the possibility to inform its participants about pending settlement instructions of counterparties within 1 hour after the first unsuccessful attempt to match the instructions or immediately if the first unsuccessful attempt to match happens in the 5 hours period before the cut-off of the intended settlement date ~~and 1 hour from the beginning of the intended settlement date~~.

The latter would guarantee earlier submission of allegements on the ISD, allowing for both trading participants to send their instructions to the CSD in time.

AFME believes that points (i) to (vi) of Article 3(9) should be deleted. This is because, as set out in the answer to question 7, AFME believes that buy-ins should take place at the trading level, and that it is in practice impossible for CSDs to maintain buy-in related information.

**Q5. What are your views on the proposed draft RTS on the monitoring of settlement fails as included in Section 1 of Chapter III of Annex I?**

AFME argues that in general the information required in Article 4(1) could be used by CSDs to monitor settlement fails accordingly; however a number of points could be clarified to make the reporting by CSDs more effective. As a matter of principle AFME believes that reporting on recycled transactions is redundant as such transactions would likely reappear in the reporting part under Article 4(1) a and e.

To make better use of existing logic and reports, AFME would like to propose the following differentiation of settlement instructions under 4(1):

Proposed re-drafting Article 4 (1)

4.1 A system monitoring settlement fails shall enable a CSD to identify and to keep a record of information about the intended settlement date and the status of settlement instructions entered into the securities settlement system that it operates, covering at least the following transaction information per intended settlement date:

**a) pending instructions (which can still settle on ISD);**

**b) failed settlement instructions (which can no longer on ISD), including information on:**

**i) initiation of buy-in;**

**ii) extension period;**

**iii) deferral period;**

**iv) buy-in period;**

**v) outcome of buy-in process;**

**vi) payment of cash compensation or settlement of the buy-in transaction;**

**vii) Penalties referred to in Article 7(2) of Regulation (EU) No 909/2014.**

**c) fully settled settlement instructions;**

**d) partially settled settlement instructions, including the settled part and the missing part of either securities or cash;**

**e) Cancelled settlement instructions, including information whether it is cancelled by the system or by the participant.**

~~(a) matched settlement instructions that are not settled;~~

~~(b) settlement instructions that are not matched;~~

~~(c) settlement instructions on hold;~~

~~(d) partially settled settlement instructions, including the settled part and the missing part of either securities or cash;~~

~~(e) failed settlement instructions, including information on:~~

For each of the categories of settlement instructions above, the following information should be provided:

- Matching Status (Matched or Unmatched);
- Partial Settlement indicator (Yes or No)
- Hold & Release indicator (On hold)
- Reason code for pending or failing instruction.

This proposal provides all the information necessary for monitoring settlement fails required by ESMA in its reporting under its original proposal for reporting under article 4(1).

With regards to Article 4(2)b regarding the reason as to why an instruction is failing AFME would like to point out that in addition to lack of securities or lack of cash, there are other reasons for settlement fails (e.g. temporary restriction for settlements with a certain ISIN) which are captured by ISO codes and should be available in the reports (please refer to the attached report translating reason codes into text).

http://www.iso20022.org/standardsrepository/public/wqt/Description/mx/dico/codesets/_aFGlxdp-Ed-ak6NoX_4Aeg_-870507202)

The technical standards are not clear as to whether penalties and the buy-in regime would be applicable in all these cases. AFME invites ESMA to clarify that the penalty regime would not be applicable for fail reasons other than lack of securities and/or cash or "on-hold".

In addition, AFME would like to underline that in the case of fails due to lack of cash, CSDs do not have access to the information regarding the "missing amount" of cash in the relevant cash accounts of their participants.

In relation the top ten participants with the highest rates of settlement fails and Article 4(3), AFME suggests that ESMA proceeds with the following redrafting.

| Proposed re-drafting Article 4 (3)<br><br>4.3 A CSD shall set up a working flow with the top ten participants with the highest rates of settlement fails, as well as, if applicable, with relevant CCPs and trading venues, in order to ~~identify~~ **analyze** the main reasons for settlement fails and to establish measures to improve settlement efficiency. |
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| Proposed re-drafting Article 6 (2)<br><br>6.2 The information specified under paragraph 1 shall be published on the website of ~~a CSD~~ **the CSD**. The information shall be available at least in a language customary in the sphere of international finance, and shall be machine readable. |
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With respect to Article 16, and in particular the conditions under which a participant is deemed to consistently and systematically fail to deliver the financial instruments, AFME believes that there should be a clear methodology established in order to measure the settlement efficiency of CSD's participant (and potentially their underlying customers).

AFME proposes that settlement efficiency is calculated in reference to the percentage of fails which are due to the participant, while excluding fails which are due to counterparties or other external factors such as CSD technical failures.

| Redrafting Article 16.2<br><br>In calculating the percentage referred to in paragraph 1, both the value and the volume of settlement fails shall be considered **for fails which are caused by the act or omission of the participant, while excluding fails which are caused by an act or omission of a counterparty or other external factors.** Where either the percentage in volume or in value terms is lower than the one indicated in paragraph 1, the participant shall be deemed to consistently and systematically fail to deliver the financial instruments. |
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**Q6. What are your views on the proposed draft RTS related to the penalty mechanism? Do you agree that when CSDs use a common settlement infrastructure, the procedures for cash penalties should be jointly managed?**

AFME largely supports ESMA's proposals, but it also would like to raise the following comments and concerns.

AFME supports ESMA's views expressed in paragraph 59 that it is important to harmonize the penalty mechanism and to apply a single model across the European Union. Moreover, AFME supports the proposal that CSDs pass on relevant information to CCPs so that CCPs can charge, and compensate, their clearing members.

AFME supports ESMA's conclusion that when CSDs use a common settlement infrastructure the procedures for cash penalties should be jointly managed and that ESMA should ensure that the following information is publicly available so as to allow the penalty system to work in a harmonized way:

- a list of the ISINs of all the securities that are subject to penalty fines;
- for each ISIN, and for each business day, the price to be used for the calculation of penalties; and
- the penalty rate to be applied for a specific ISIN

The list of ISINs is necessary as without an authoritative list, each CSD would find it difficult to obtain the necessary information, and there would be a risk that different CSDs charge based on different lists. The background to this requirement is that not all securities will appear on the list, as CSDR excludes from the penalty charge securities that are not cleared by EU CCPs and that are not admitted to trading on EU trading venues, as well as securities for which the principal venue for trading is located in a third country.

Among the concerns of AFME are the following:

1. The design of the penalty mechanism may create a need for direct bilateral claims; this would be the case, for example, if the penalty mechanism generated compensation in cases where no compensation was due, so that counterparties had to correct the penalty flows.
2. The potential volume of penalty data will be very high. This will require intermediaries in the custody chain to reconcile the data and charges that they receive from their account provider, and then pass on the data and charges to their clients. Given the volumes a system should [be developed to] cater for an automatic transfer of information.
3. The current design of the mechanism, as set out in Articles 7 and 8 of the draft RTS on settlement discipline, is insufficiently detailed and precise to ensure an outcome of each CSD in Europe applying the same penalty mechanism.
4. There is the risk that under some circumstances the penalty mechanism may have the effect of creating a disincentive to send instructions to the CSD for matching.

Article 7(1) – technically instructions "on hold" are not considered a fail, as from an operational point of view they have never been presented to the settlement process. However, AFME believes that "on hold" instructions should not be exempt from the penalty mechanism and for clarification suggest the following redrafting.

| Proposed re-drafting Article 7 (1)<br><br>The CSD shall calculate penalties for each settlement instruction that fails to settle, on the intended settlement date including for settlement instructions that are on hold. Only |
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matched settlement instructions in accordance with Article 3(2) that fail to settle **that remain unsettled** on the intended settlement date, shall be subject to penalties.

AFME members would urge ESMA to recognize that there are participants in the middle of the settlement chain that should not be unduly penalized.

Furthermore with regards to Article 7(3), AMFE members would like to highlight that the RTS does not address the issue of a "threshold" when partialling takes place. Most CSDs (and it will be the case also in T2S) use a threshold in quantity and / or amount when triggering their partial settlement process.

An issue might arise when a participant has available stock on its account but the quantity available is lower than the minimum quantity set by the CSD for a partial settlement process to be triggered. It should be noted that the participant may be a CCP who should be exempt from partialling restrictions. This will raise additional issues since CCPs should not bear any financial impact linked to penalties.

Example

Participant C should deliver 600 shares to participant D; C receives from two different participants (A and B) for 200 and 400 respectively.

During the day

Since B has the 400 shares on its account, the settlement between B and C occurs for the whole quantity on the morning of ISD.

A has no stock, the settlement between A and C fails (same at each run of the recycling process)

C does not have the 600 shares on its account so the settlement between C and D fails (same at each run of the recycling process)

The partial settlement process has a threshold of 500.

Although C has available stock on its account (400) since this quantity is under the partial settlement threshold, no settlement will occur between C and D

After the close of the settlement day

A is failing for 200; A will be charged by the CSD for 200

C is the settlement counterparty of A so C will receive A's penalty

C is failing for 600; C will be charged by the CSD for 600

Net for C = - 600 + 200 = -400 (as C has also paid the 400 shares)

Therefore AFME would urge ESMA to consider thresholds that CSDs might be using currently to partially settle transactions and to clearly specify in the regulation if such thresholds shall apply in the future.

Proposed re-drafting Article 3 (7)

A CSD shall offer its participants the possibility to partially settle their settlement

instructions, **without any threshold being applied on securities positions**, as well the possibility to opt-out from partial settlement.

With regards to Article 7(4) AFME members would prefer to receive a daily report outlining the settlement penalties incurred and "compensations" received. We note that CSDs are required to produce these reports already under Article 4. This information could either be produced in a separate report or included in a statement of pending instructions.

Proposed re-drafting Article 7 (4)

The CSD shall charge and collect the net amount to be paid by each failing participant at least on a monthly basis. It shall provide, ~~at that time~~ **on a daily basis**, the details of the calculation of the penalties per account and for each failed settlement instruction.

AFME is fully supportive of a settlement penalty mechanism being jointly managed. In particular AFME believes that T2S would be ideally placed to work with CSDs to provide a single, harmonized penalty mechanism that could provide the penalty information to the CSDs for the respective collection and distribution. Non T2S markets should ideally function in the same manner as T2S markets to support the penalty mechanism on a jointly managed platform. ESMA suggests that a shared platform is to arrange for the collection and distribution of fines. From AFME's point of view a common platform like T2S should rather concentrate on the following services:

- Collect / report information on the failed transactions per CSD
- Calculate the penalties as per the RTS requirements
- Report the results to the respective CSDs for their own participants
- Issue the respective bills to the CSDs

The debiting and crediting of the amounts could be performed by the CSDs themselves as part of their billing process. Here it should be noted that CSD participants do not have a contractual relationship with T2S but only with their respective CSD.

AFME also recognizes that a similar set up would be envisaged for interoperable CSDs; however this seems to misconstrue the functionality of an "interoperable" link. In the T2S scenario CSDs clearly share a processing platform and it would be sensible to use this platform for the settlement discipline regime accordingly. In an "interoperable" link, however CSDs only have detailed agreements on how to cooperate technically whereby keeping a separate settlement platform.

Therefore, AFME would suggest deleting the reference to interoperable CSDs in the technical standard.

List of open questions that require clarification by ESMA

- Clarification on list of financial instruments in scope of the penalty regime. Ideally, ESMA to publish these regularly on its website, similar to those equities with the primary exchange being non-EU based.
- Who should provide the reference price? The above publication should also contain a reference price which could be utilized for the calculation of the cash penalty. As such all CSDs settling any of the securities would be required to use the same reference price. This could be combined with a determination on the liquidity level of the respective instrument to cater for the different level of penalty. With ESMA publishing the above reference prices and the list of in scope instruments on a central website, T2S and non-T2S CSDs would have

the same foundation on which to base their penalty calculation. This procedure should be verified by national competent authorities.

- This information should also be made available to CSD participants and other settlement chain parties to perform independent calculations and assist with internal allocation and distribution processes.
- Clarity on what is the "value date" of such reference price? Trade or intended settlement date of the failed transaction? End of day price or intraday average? As some transactions may have different trade dates than others but the same value date, we would suggest using the reference price published by ESMA for each day a transaction is pending. In addition, AFME members believe that the penalty should be calculated daily based on the daily changing reference price.
- Clarity on the timelines for calculating/collecting the penalties and how frequently? While AFME agrees that billing should be undertaken on a monthly basis to allow for netting of the penalty sums, members require daily information on the incurred penalties/ compensations. This will help the participants making necessary arrangements with the underlying trading desks and clients.
- How should "backdated" transactions be treated and penalties be calculated? If both parties send their instructions late, which party would be penalised? We appreciate that ESMA rightly concluded that instructions should be penalised if they are input late into the settlement system. We would encourage ESMA to further clarify that if both parties send their instructions late it should be the last instructing party if the instruction settles on the same day. Should it however not settle on the instruction day the CSD should determine the fail reason and apply the charge to the failing participant.

AFME would also welcome ESMA's clarification on how the CSDs will consider the 'party at fault' in a trade that does not settle on intended settlement date and how a CSD will apportion cash penalty amongst CSD participants and other CSDs in the case of cross CSD settlement (other than interoperable CSDs or T2S CSDs). CSDs will need to work with participants to systemically identify and apply penalties to the underlying transaction and account to enable penalties to be apportioned appropriately by the CSD participant.

**Q7. What are your views on the proposed draft RTS related to the buy-in process?**

**In particular, what are your views on applying partial settlement at the end of the extension period? Do you consider that the partialling of the settlement instruction would impact the rights and obligations of the participants?**

**What do you think about the proposed approach for limiting multiple buy-in and the timing for the participant to provide the information to the CSD?**

AFME supports the overall objective to enhance settlement efficiency and reduce the number of outstanding, ageing settlement fails. An adequate and harmonized buy-in regime will help to achieve that objective.

When analyzing the ESMA draft proposals in detail, AFME has a number of strong concerns around a number of key areas, which will make the implementation of the proposed rules extremely difficult and in a number of cases impossible. Most of these concerns stem from the approach taken by ESMA to have buy-ins purely applied at CSD settlement level, and consequentially the role of CSDs.

AFME believes these concerns can be addressed by an alternative approach outlined below, which is still in line with the Level 1 text.

AFME believes that the definition of a transaction to which a buy-in would be applicable would help prevent misunderstandings between counterparties before the buy notice is sent. AFME has provided a suggested definition in section 1.b below.

**1. <u>Exact scope of the buy-in rules:</u>**

A buy-in is a very costly process that has a profound impact on relationships, contracts, and the "economic viability" of trades. As a consequence, any mandatory buy-in provisions need to provide answers to the following questions:

a) Buy-in definition

b) Which transactions are in scope?

   i. What is the geographical reach of those provisions?

   ii. Which parties are involve/responsible for buy-ins?

Unfortunately, neither CSDR level 1 nor the RTS provide sufficient clarity on a number of key aspects, which could lead to uncertainty and disputes. Key areas for further clarification are:

*a)* **<u>There is no clear definition/objective of the mandatory buy-in</u>**:
With the exception of reference made in the CSDR preamble (15) to the need to "*require failing participants to be subject to a compulsory enforcement of the original agreement"*, there is no definition of a buy-in in the CSDR or RTS. *Art 12.3 of the draft RTS does make a reference to "allow the participant to provide the identification of its failing client or underlying client for which the buy-in shall be executed", seeming to indicate that buy-ins are the enforcement of a contract concluded by the underlying client.*
*The lack of definition raises a number of fundamental questions and issues, such as:*

i. <u>Which agreement is to be compulsory enforced/subject to a buy-in</u>:
- is it the trading agreement between trading counterparties?
- a (non existing) agreement between settlement agents?
- or is it something else?

ii. <u>Who are the failing participants:</u>
CSDR defines failing participants as "p*articipants that cause settlement fails*" (CSDR Art 7.3), and participant as "*any participant... in a securities* settlement system"

For the most part, trading counterparties use one or more levels of intermediaries such as custodians and agent banks to settle securities and cash in the securities settlement system of any particular CSD. These custodians/banks act in the capacity of settlement agent[2], and do not assume responsibility for the performance of the trading contract obligations of their clients or their clients' underlying clients, of which they are often not aware. Moreover, these settlement agents do not have (nor need) any agreements with other settlement agents (hence the reference above to a non-existing agreement) which can be enforced.

Agents also do not usually 'cause settlement fails': it is their clients (or underlying clients of their clients) who due to lack of securities (or lack of cash) cause their delivery instructions to fail and they are often subject to a mandatory buy-in under the original trading agreement.

This creates a fundamental mismatch between:

[2] Directive 98/26/EC defines 'settlement agent` shall mean an entity providing to institutions and/or a central counterparty participating in systems, settlement accounts through which transfer orders within such systems are settled and, as the case may be, extending credit to those institutions and/or central counterparties for settlement purposes;

- Which contract needs to be enforced: trading contract between counterparties or settlement contract arrangements?
- Who is held responsible for the fail and is charged with the buy-in; the settlement agent at CSD level or Settlement's agent client who has caused the fail;

If the liability of a buy-in rests with a CSD participant rather than with the relevant trading counterparty who agreed the underlying trade, the consequence is that in many cases, the mandatory buy-in provisions will be applied against CSD participants/intermediaries for the purposes of enforcing an agreement to which they are not a party, of which exact terms they have no knowledge, and to cure a fail caused by someone (an underlying client) they may not even have a relationship with[3].

Mandatory buy-ins in such cases may not serve their purpose. It will cure the immediate failing trade but will directly penalise CSD participants / Intermediaries who are not directly involved in the transaction. Intermediaries in such cases may have no knowledge of the details of trades subject to a buy-in or of the underling real failing counterparty. This will mean the intermediaries are forced to underwrite trading risk, and they will in turn need to protect themselves from this risk (through collateralisation or other form of risk mitigant). This will fundamentally change the risk profile of CSD participants/intermediaries in the market and add a new layer of cost. As this is a new parameter for intermediaries to deal with, there is no market standard today for dealing with this risk, and it will take time for a model to develop (hence the limited available quantitative data available to determine the true cost).

Ultimately, there is a fundamental question as to who needs to bear the costs and risks of a buy-in (and how to claim costs back from the party who caused the fail to the extent that an intermediary bears such costs), but it also creates issues for cross border trading and settlement (point b), and for the role of CSDs in enforcing buy-ins against CSD participants[4].

b) **The scope of transactions subject to buy-ins is unclear**

The concept of a "transaction" in Article 5(1) CSDR – to which the buy-in requirement in Article 7(3) relates – is not defined. Accordingly, we suggest that ESMA can provide guidance as to what that term means in this context, and thereby provide guidance as to when a buy-in will be required under CSDR.

AFME believes that settlements with no underlying economic value should not be subject to buy-ins under the proposed RTS.

i. Scope of transactions subject to a buy-in
AFME considers that "transaction" for the purposes of the buy-in requirement should be defined as follows: an underlying agreement between two (trading) parties to deliver securities, whereby a buy-in would achieve/enforce the objective of the original agreement However, in certain cases, a buy-in would not actually achieve any economic purpose, could be ineffective, and could lead to even greater risk. Some examples are listed in the answer to question 9 (portfolio transfers, realignment of assets, margin deliveries etc). Applying mandatory buy-ins in such cases would be meaningless and create even more risk (e.g. buy-ins on margin deliveries), and as such AFME feels strongly that these should be exempted.

ii. Cross-CSD settlement with a CSD outside the EU (territoriality)
Trading and settlement activity is internationally oriented, with trading, settlement and issuance often on a cross-border basis. As the scope of the CSDR provisions only applies to settlements in EU CSDs, this raises fundamental questions and issues on the impacts to cross-

[3] In a large number of cases, trading counterparties use global agents such as global custodians, who in turn use local subcustodians in different markets/CSDs. The subcustodian does not know and has no contractual relationship with the trading counterparty.
[4] Refer to question 11 on the additional risks that will be imposed on CSD participants under the current RTS

border settlement and if or how these provisions can be enforced on such cases.

<u>Example</u>

Party A in the US (holding securities in a US CSD) sells (US) stock to Party B in a European CSD, who then sells onwards to another Party C in another European CSD. If Party A fails to deliver to B, B cannot deliver to C, and B will be subject to penalties and buy-ins. However neither Party A nor the US CSD is not subject to CSDR, hence Party B can be bought in by Party C but cannot in turn buy-in Party A.
Similar issues arise in the reverse situation (If A buys from B who buys from C).

AFME considers that cross-border settlements, such as settlement of the transaction between Party A and Party B in the example above, should fall outside the scope of CSDR, as Article 1(1) provides that CSDR "*lays down uniform requirements for the settlement of financial instruments* ***in the Union***". AFME would welcome clarification and confirmation of this point.

Otherwise, the result is likely to be that cross-border trading and settlement between the EU and third countries will become less attractive to EU entities. They will be concerned that it will not be possible to recoup the settlement fines and buy in costs from the third country party. This will make the EU a less attractive place to trade and settle. Furthermore, this will potentially move settlement activity to non-European settlement venue altogether e.g. bond settlement in DTCC. Ultimately, this will have downstream impacts on repo markets.

iii. <u>Principal venue for the trading of shares is located in a third country (Art 7.13 CSDR)</u>
CSDR art 7.13 states that "*This Article shall not apply where the principal venue for the trading of shares*[5] *is located in a third country*".
When reviewing the draft RTS and ITS, it is unclear whether this exemption has been foreseen, and how it will be applied. AFME and its members agree that such an exemption is necessary, and should not only apply to trading in shares, but to any financial instruments.

## 2) <u>Impact of the proposed regulation on trading liquidity and bid-offer spreads</u>

According to ICMA, we expect the following impacts:

1) The risk of mandatory buy-ins will increase bond market offer prices significantly across all fixed income asset classes (sovereign, public, and corporate bonds), including those considered most liquid. Meanwhile, for less liquid bonds, including certain sovereign bonds, many market-makers will retrench from providing offer-side liquidity altogether. Based on current European bond market structure and volumes, this is likely to equate to annual cost to investors and other market users running into several billions of Euros.
2) Mandatory buy-ins will impact 45% of the current European repo market, again widening bid-offer spreads for the most liquid securities, and reducing offer-side liquidity for less liquid securities or asset classes. A conservative estimate of the cost to repo market users, based on current market size and structure, is in excess of 3.5bn Euros per annum.
3) By applying the maximum extension period of seven days to all fixed income products, regardless of a security's MiFID II/R liquidity calibration, should help mitigate some of the liquidity and pricing impact on the European bond markets, in particular for the sovereign bond markets, which in terms of overall impact are set to be most adversely impacted.

[5] Determined in accordance with Articl e16 Of Regulation (EU) No 236/2012

4) Extending the cut-off threshold for SFT exemption to 1 month (30 calendar days), would bring another 25% of the repo market out-of-scope, while reducing the overall annual cost to market users by around 2bn Euros.
5) The analysis suggests that there is a strong case for an independent and rigorous assessment of the full market impact of mandatory buy-ins, including a cost-benefit-analysis, before its implementation. Members support such an impact study with full public disclosure of the findings.

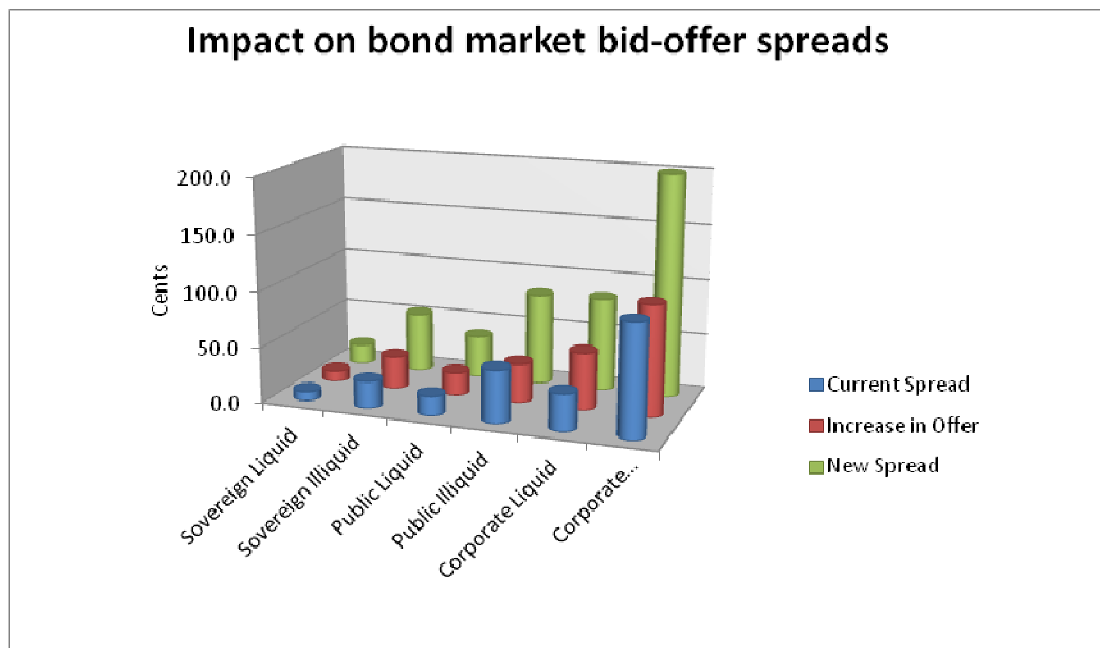


**Figure 1: ICMA – CSDR Mandatory Buy-ins Impact study results**

### 3) Proposed measures on partialling

We agree with ESMA's view that mandatory partialling would be beneficial to reduce the amount of buy-ins. However, in order to be most effective, partialling should not take place at the end of the extension period, but one day before, in order to allow interdependent chains of settlement instructions and cross-CSD settlements to benefit optimally from the opportunity to settle. Imposing mandatory partialling at an earlier moment would create too many processing and reconciliation issues.

AFME would like to highlight to ESMA that imposing a mandatory partial settlement on instructions/ transactions which do not show a "technical" partial indicator will require significant technical build on the part of the CSD (to force the settlement) and the participants (to process the results).

Furthermore, AFME believes that in an Omnibus account structure, any mandatory partial settlement of failed deliveries will conflict with client asset rules. In omnibus account structures, the CSD participant will hold assets of multiple clients within one CSD account and maintain adequate books and records of their underlying client holdings. When instructing delivery transactions, in order to protect their other client's assets, CSD participants may 'opt out' from partial settlements to protect the assets of other clients within the omnibus pool that are not party to the delivery.

### 4) Proposed approach to avoid multiple buy-ins

We agree with ESMA's view that multiple buy-ins need to be avoided, as they will unnecessarily increase costs and be counterproductive. However, with regards to the proposed process, we have a number of concerns:

a) **CSDs should not manage the buy-in process for OTC settlements**:

While it makes complete sense to have CCPs' manage buy-ins for CCP cleared transactions, given their role as central counterparty (i.e. assuming the role of 'principal' to every buyer and seller) at the trading level, the same does not apply to CSDs. This has been identified in the CSDR level 1 text also, where CSDs have only a passive role in the buy-in process.

As stated above, AFME believes that buy-ins should be enforced at trading level only, as CSDs do not have the means and expertise to manage buy-ins, and in most cases do not have even have a contractual relationship with the trading counterparties. "Passing on" the costs and risks of the buy-ins along the intermediary chain is not the optimal approach as this assumes that the ultimate trading party will accept the costs and risks when CSDR does not oblige them to do so.

This also applies to identifying settlement fail chains. While CSDs could identify on their own platform which securities will settle on the same intended settlement date across different CSD participant accounts, they have no means to identify:

- Which settlements represent trades for which a buy-in would be meaningful (see above). This also includes exemptions for short-term repos and trades done on a trading venue outside the EU
- The trading counterparties responsible for the buy-in (see above)
- In a cross-border context, CSDs are unable to determine the counterparty in the other CSD

b) **The process to identify fail chains and minimise buy-ins is unclear and may lead to disputes**

It is not clear to AFME how the process to minimise buy-ins for fail chains would work. It would introduce a large degree of discretion on the part of the CSD to identify where is the best place (and thus impacted parties) to execute a buy-in, which will likely lead to conflicts and disputes. In addition to being inefficient, this process would increase CSDs' liabilities and have a negative impact on their risk profile.

The last sentence of art.11(5) of the draft RTS in particular should be deleted ("The CSD shall reserve the relevant financial instruments available in the failing participant's account for the settlement of that instruction.") Requesting CSDs to reserve securities in their participants' accounts before partial settlement is not only unnecessary, but it will create practical problems and legal disputes. In the case of omnibus accounts in particular, it is impossible for the CSD to know whether securities are truly "available" from the perspective of the participant's client. The "reservation" process described by ESMA would thus create a risk that investors holding securities in an omnibus account at a CSD would have their holdings reserved and used for the purpose of settling the failed instructions of other investors, creating a liability issue for the CSD and CSD participants managing such omnibus accounts.

It is AFME's view that it is very difficult, if not impossible, to identify chains of transactions. However, given the proposed degree of automation of passing on buy-ins at trading level (see alternative) we feel that most of these issues can be addressed. This would also avoid multiple buy-ins for transactions chains (see alternative proposal set out in detail at section 9 of the response to this question, below)

Regarding the procedure as described in the RTS art 11.10, AFME has the following concerns:

1. It is not clear why the details of the settlement instructions need to be provided again to the CSD: for intra-CSD transaction chains (see below for cross-CSD chains), the CSD has already the full overview of the involved financial instruments, age of fail, involved (failing) settlement participants, the identification of the settlement instructions, including those for CCP transactions.

In addition to very substantial extra build required at all levels to transmit and process this information, it is also not clear how the CSD will benefit from this information (see also below), besides testing the consistency

2. It is not clear what is meant by '*the same date of expiry of the execution period*'. Is that the execution of the buy-in process, or is it the extension period?
3. How will '*the same financial instruments*': be identified? If this relates to the ISIN code, what will be the treatment for securities which have more than one ISIN code (e.g. multi-listed securities)?
4. It is not clear what is meant by '*that are causing the failure to deliver*'. There may be more than one reason why a settlement does not occur, besides lack of security on the part of the delivering party. It could be due to a lack of cash on behalf of the receiver too, or another reason. This is particularly relevant for chain fails where there could be different fail causes for each part of the chain, thus making it difficult to identify which trade should be bought in.

<u>Example</u>

A (through its settlement agent) delivers 100 stock to B (its agent), who delivers 100 to C (its agent), who delivers 100 to D (its agent) (all in same CSD): If B does not have the cash/credit, the entire chain fails.

- Would the buy-in be executed against B?
- What if C also does not have the cash? (ie the delivery from B to C fails for lack of securities and lack of cash)? Would B and C be bought in , or only B, or only C?

AFME invites ESMA to clarify that a buy-in should only be initiated in case the fail-reason is (LACK) "lack of securities" or "on-hold" by the delivering party. In the case where the buyer does not have sufficient cash available to purchase the securities the delivering counterparty should have the right to "sell-out" the securities in the same timeframe as a "buy-in" would occur.

5. For cross-CSD settlement scenarios, it is not clear to which CSD(s) the information needs to be provided, and how it will be collated. If participants along the chain have accounts in different CSDs, should they each provide that information to their own CSD? In order to 'limit the number of buy-ins, CSDs will then have to compare the information received to try to identify the entire chain. It is not clear which CSD(s) will be responsible or how they should process that information.
6. It is not clear how the CSD(s) will '*process that information in order to limit the number of buy-ins to be executed*'.
   - It is virtually impossible to identify the full settlement chain(s) in all cases, especially if these chain(s) involve settlement in different CSDs, together with CCP cleared settlements and OTC transactions, as well as interlinked cash and financing transactions (this is not uncommon). Any decision in such cases will have a discretionary nature, and thus could expose the decision maker (i.e. the CSD) to risk. As stated, buy-ins are very disruptive and expensive. Any uncertainty or degree of interpretation/discretion is likely to be challenged.
   - How will the CSD(s) determine what the best way is to minimise the number of buy-ins and if so, on what basis?

- AFME believes that this article is impractical and will not allow CSDs to prevent multiple buy-ins. We recognise ESMA wishes to avoid unnecessary buy-ins in the context of chains of failed transactions (in line with the level one text), although, given the above questions, art.11(10) is unworkable and will not achieve this aim.
- AFME therefore recommends deleting art.11(10). As an alternative, ESMA may want to consider replacing art.11(10) by a paragraph that describes a flow where the CSD informs its participants of the failed settlement transactions. CSD participants inform their own clients responsible for the failed instruction and the client instigates the buy in process as proposed in (Additional information in section "Alternative Proposal"). We believe that this is likely to limit the number of buy in that should be executed.
- Real-time transmission of the actual buy-in timing and results is key to avoid creating unintended additional market risks for the delivering parties who need it to close out any open positions (see further below)

c) **The proposed process will not function well in cross-CSD settlement scenarios**

We have similar concerns for (non-chain) cross border settlements:

- Due to the account structure that is currently used (omnibus) we believe that in a cross CSD environment the current RTS proposal will be problematic.
- It is not clear if and to whom the buy-in regime would be applied in case of a cross-border settlement between an EU CSD and a non-EU CSD. Would it only be applied if the issuer CSD is an EU CSD, or would it be applied additionally if the EU CSD is an investor CSD? ESMA is kindly asked to clarify this.

**Example (OTC transactions)**

- Participant A in DTCC sells securities (e.g. US Treasuries) to Participant B in Euroclear Bank ('EB')
- Participant B sells these securities onwards to Participant C in Clearstream Bank Luxembourg ('CBL')
- Participant A does not deliver the securities to B, who as a result cannot deliver to C. A buy-in is initiated at the level of C

Open questions/issues in relation to the above example:

- According to art 11.4, the CSD shall send a notice to both the failing and receiving participants. Which CSD(s) should do this and how:
- For the delivery between B and C: is it CBL which send the notification to just C, or will it send it to both B and C?
  If the former, will EB then send a notification to B (and on which basis?)?
  If the latter, where will CBL send the notification as it has no contractual relationship with B (who is an EB client)? Does it send the notification to EB, who then needs to forward it to B? Is EB considered a 'failing participant' responsible for the buy-in on behalf of its client B? If so, that appears to be contrary to art 11.2 of the RTS, which provides that a buy-in shall not imply any unnecessary risk taking by a CSD.
- For the delivery between A and B, the same issues arise, compounded by the fact that A is a participant of a non-EU CSD:
  Does DTCC have to comply with this regulation?

Will A be bought in, and if so, how and on what legal basis? As a non-EU CSD, DTCC is not bound by the rules in CSDR. The Same applies to A.

- The net result is that B will be bought in by C, but is not able to buy in A (though the cause of the non delivery is due to A), and will be left with all costs.
  The likely outcome of this is that EU buy-in rules will have a very detrimental effect on cross-border activity, especially between EU and non-EU CSDs: that activity is major and will make Europe less attractive as a trading and settlement location to international investors

## 5) <u>Alternative proposal: Buy-ins at trading level with reporting back to CSD level</u>

The following use case illustrates AFME's alternative high level buy-in proposal where the buy-in is handled at a trading level rather than CSD level.

<u>Assumptions</u>:

- Trading Participant A and B are not direct CSD participants
- Trading Participant A fails to deliver to Trading Participant B
- A buy-in agent is performing the buy-in
- Reporting of initiation of buy-in and result of the buy-in auction is reported to the CSD

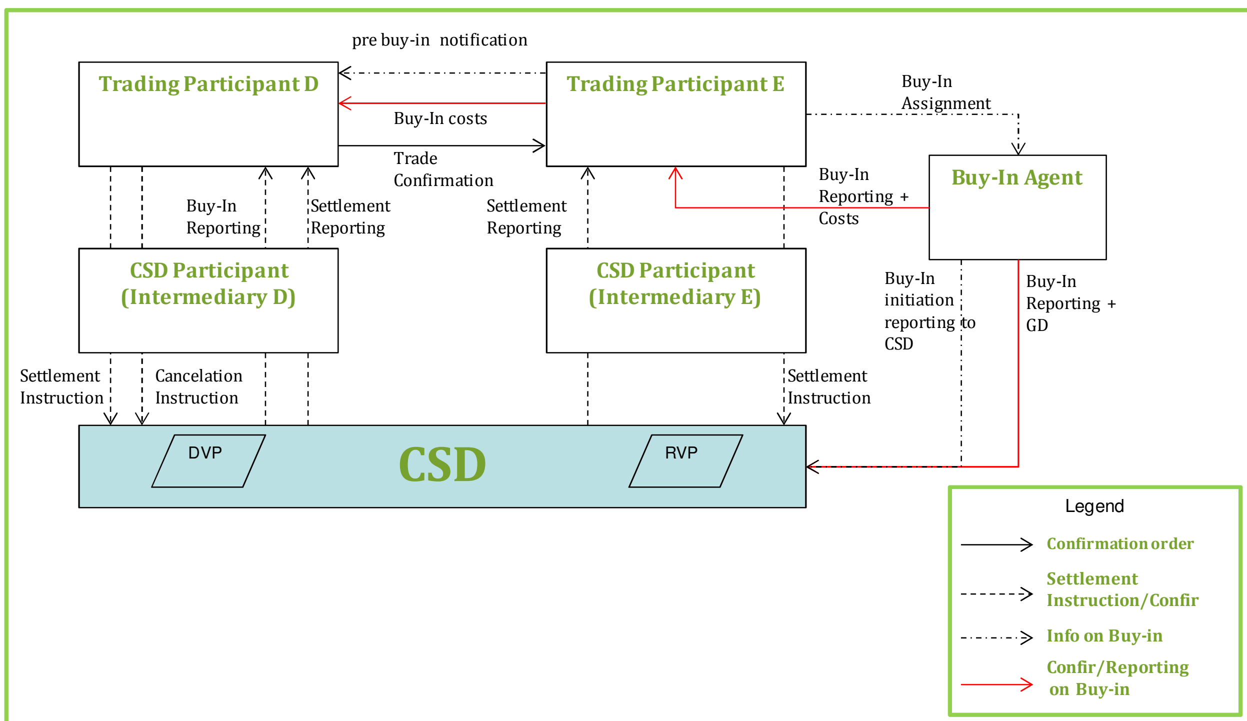


**Figure 2: Buy-in process – Alternative proposal**

| Actors | Timeline | | | |
|---|---|---|---|---|
| | TD | ISD | ISD+4 | ISD+8 |
| Trading Participant D (TP D) | •Confirms trade details with TP E<br>•Sends Settlement instruction to CSD Participant D | | •Receives pre buy-in notification | •Receives settlement update from CSD Participant<br>•Receives cost of Buy-in from TP E<br>•Sends cancelation request to CSD Participant |
| Trading Participant E (TP E) | •Confirms trade details with TP D<br>•Sends Settlement instruction to CSD Participant E | | •TP E engages a Buy-In agent to perform the Buy-in (Trade details are sent to Buy-in Agent)<br>•TP E sends pre buy-in notification | •Receives confirmation from Buy-In agent<br>•Receives cost of Buy-in<br>•Transmits cost of Buy-in to TP D |
| CSD Participant (TP D) | •Sends settlement Instructions to CSD on behalf of TP D | | | •Transmits Settlement reporting to TP D<br>•Transmits cancelation request to CSD |
| CSD Participant (TP E) | •Sends settlement Instructions to CSD on behalf of TP E | | | •Transmits Settlement reporting to TP E |
| Buy-In Agent | | | •Buy-in Agent receives info and attempts to cure the fail<br>•Reports to CSD | •Buy-in is performed as per RTS<br>•Reporting on results and costs to TP E<br>•Reporting to CSD with the Buy-in trade ref |
| CSD | •Receives instructions from CSD Participants and sends acknowledgement/ matching status messages back | •CSD Attempts to settle the trade (Fail-TP D Short of stock)<br>•Settlement results are send back to CSD Participants | •CSD Receives information on the initiation of the Buy-in Process | •Matches the Buy-in trade instruction with the pending RVP<br>•Send settlement reporting to TP D and TP E<br>•Cancels original DVP |

**Table 1: Buy-in process – Alternative proposal**

1. **CSDs should take no active role in the Buy-In process;** their role should be limited to providing the required information to trigger the buy-in, and to monitor and report back the results of the buy-ins. This is in line with Level 1 text, which only requires CSDs to have rules associated with buy ins.

2. **Buy-ins should be** enforced at trading level between counterparties to the trade. Their agreements/standard industry rules will need to be enhanced to refer to the mandatory obligations imposed by CSDR level 1 text and the RTS.
   In addition, CSDs and trading venues will include in their internal rules an obligation for their members to apply the relevant rules (Art 7(10) CSDR).
   With respect to trading venue members, this will effectively mean that such members will be liable for buy-in costs themselves (which appears sensible, given they are the trading counterparties to any relevant failed trades). With respect to CSD participants, they should be subject to an obligation (via the relevant CSD's rule book) to include in their own client agreements a requirement that their clients adhere to the CSDR buy-in regime. This

requirement should, include an obligation, for clients to document a similar requirement in their own client agreements (where relevant) to adhere with CSDR.

3. **Who will execute the buy-in**: Where a CCP becomes the counterparty to the trade; the CCP will execute the buy-in. This is current market practice. Where no CCP is involved, it should be the prejudiced receiver/buyer who is required to initiate the buy-in (unless it caused the fail). Notices of the relevant parties and modalities (extension period, deferral, quantity and timing etc) will be passed by the trading counterparties through the chain of settlement intermediaries back to the CSD for reporting and monitoring purposes

4. **Procedure**: If a mandatory buy-in is to be initiated between trading counterparties according to the timeframes and modalities of CSDR, the steps to be taken could be as follows:

- <u>Initiate buy-ins/end buy-in notification</u>; the prejudiced buyer ('C') sends a buy-in notification to the seller ('B') at the end of the extension period. That notification process already exists in certain markets (bonds) but will need to be converted into an STP format to cope with high volumes/speedy and secure transmission. A copy of that notification could be sent to the settlement agent and /or CSD so all involved parties are fully informed
- <u>Receive buy-in notification/checks</u>: the delivering party (B) will receive the notification, and take the following essential steps (as today):
  - Verify whether the buy-in is valid under CSDR rules: that step is essential to avoid executing erroneous buy-ins on trades which both parties have not agreed upon[6] or do not fall under the scope of CSDR. It will also enable elimination of buy-in notifications on settlements for which a buy-in is not useful (e.g. corporate actions, margin deliveries etc). In both cases, the seller/deliverer is required to revert immediately to the buyer to challenge the notification if it thinks that the buy-in is not warranted.
  - Verify **what caused the failure** to deliver the securities to the receiver (C). If the failure is due to the receiver (C) (e.g. lack of cash), the deliverer (B) can revert to the receiver to challenge the notification. If the failure is due to the deliverer (B), he has two options:
    - If the fail is <u>not</u> caused by an incoming receipt (i.e. the deliverer (B) is 'at the start of the fail chain'), he can simply acknowledge receipt and validity of the buy-in notification, and await the execution of the buy-in
    - If the fail is <u>caused by a failing incoming receipt</u> (i.e. the deliverer (B) is 'in the middle of a fail chain'), he should issue a buy-in notification to the party ('A') who failed to deliver into him, and advise the prejudiced buyer (C) that he acknowledges the buy-in notification, but that the failure is due to another party, and that he has "passed on" the buy-in notification to that party. In turn, that deliverer A earlier in the chain will go through the above steps, and can also 'pass on' the buy-in if he is in the middle of a fail chain to someone else.
      This step in the process avoids multiple buy-in execution for fails transactions, and avoids the pitfalls listed above re the current procedure (discretion of CSD judgment, issues with cross-CSD settlements etc). The 'pass on' process exists today, but needs to be enhanced to permit end to end STP and reporting back to the CSD for monitoring purposes.
- <u>Transaction chains</u>: the above process ensures that the buy-in process is triggered along transaction chains, up to the point where the deliverer 'at the start of the chain' (A) receives the notification. As A is unable to 'pass on' the notification, A knows that he will bear the costs of the buy-in triggered on behalf of the buyer at the end of the chain (C). The other

[6] Even if settlement instructions are matched at the CSD, it is possible that there is 'cross matching' of settlement instructions between different parties, especially if agents are used.

parties in the middle (B) will simply pass on the costs of the buy-in up the first deliverer on the back of the original notifications. The pass-on process allows a buy-in to be executed at the end of the chain and the securities being immediately delivered to the final buyer, with relevant costs being passed back to the start of the chain.

- CCP involvement: A different process applies when a CCP is involved. In this case, the above notification chain will at some point reach a CCP. As required under its rules/CSDR, the CCP will execute the buy-in (i.e. will not be able to pass on the notification). In this case, the party in the chain who is due to receive from the CCP (e.g. B) should notify the CCP that he has received a buy-in notification, and require the CCP to confirm that the CCP will perform the buy-in, and the conditions/timing thereof. That CCP confirmation can be passed down the chain to the final buyer (C), who knows that he will not have to execute the buy-in, but can wait for the CCP to perform the buy-in (which will trigger the subsequent deliveries to the end buyer). The CCP will charge the cost of the buy-in to the party or parties who failed to deliver into the CCP (A).
- Timelines: As stated above, it is essential that buy-in notification and execution information is passed on quickly and efficiently along the entire buy-in chain at trading level, in order to avoid multiple buy-ins, but also to avoid that trading parties are exposed to undue market risk. That risk arises primarily if there is a delay in the timing of confirming the actual execution of the buy-in back to the original seller.
  As a result of the buy-in execution, the seller has a redundant open sale position[7], which it needs to close immediately, to avoid market risk as a result of market price fluctuations. Unless there is an efficient real-time mechanism to transmit the buy-in execution information to the original seller (which would also arise if CSDs perform buy-ins), the entire process will create substantial additional market risk[8]
- Deferral: If the buy-in is unsuccessful, the buy-in agent advises the party who initiated the buy-in (usually the end buyer), who either has the choice to defer the buy-in once, or proceed to cash compensation.
  If the former, the initiator must send a deferral message to his seller (identifying the reason of deferral, new deferral period and end date). In a chain transaction, the seller needs to pass this on along the chain to the first seller. A copy of that deferral message also needs to be sent to the settlement agent/CSD for control purposes
- Cash compensation: If the end buyer (C) wants to proceed to cash compensation, it needs to send a message to its deliverer (B), identifying this action, the amount, and the methodology used to calculate it[9]. (B) verifies it, and can revert if it disagrees with (C). In the case of chain transactions, it can pass on the compensation to the earlier party in the chain, which is (A).
  The only exception is again if a CCP is involved in the chain: if this is the case, it should be the CCP who determines the compensation amount in line with what is written above under buy-ins[10]. Harmonisation of CCP cash compensation is required to allow participants to agree a bilateral cash compensation

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[7] The sale position has become redundant as the buy-in has effectively replaced that delivery obligation (which is also reflected by the settlement instructions being cancelled upon execution of the buy-in)

[8] Example on a buy-in of a 10 year German bund repo:
- The average price volatility of the Bund is about 10 cts in price (over 2 hours trading time)
- If a 100 MM € bund repo (common trade size) is bought in, the seller needs to close the open 100 MM sale position immediately upon execution of the buy-in. If there is a delay in notification to the seller of the buy-in execution, prices will have moved, exposing the seller to additional cost (or gain) of 100.000 €: this also demonstrates that a settlement driven buy-in is actually driving market risk and impact trading revenue.
- The Bund is possibly the lowest volatility bond in the 10yrs area

[9] . It is to be noted that such compensation mechanism is determined at the level of the trading parties, not the settlement participants (see question 10 below)

[10] The question still arises then what happens if the methodology used by the CCP to determine the cash compensation is different from what parties further in the chain have bilaterally agreed. Industry convergence is probably required

- Cancellation of outstanding settlements: As soon as the buy-in or cash compensation is executed, the parties should be informed and instruct the cancellation of the outstanding failing settlement instructions through their agents. This also provides the CSD with a final confirmation that the buy-in process is completed[11]

AFME would like to highlight that whilst the above solution has its merits, the proposed solution will have an immediate impact on:

- The obligation from trading parties and all other intermediaries in the custody chain to provide buy-in information
- Any ISO transaction code will not be sufficient. There will need to be additional mandatory matching fields/reason codes on requests for cancellation

**Recommended Redrafting of RTS**

Redrafting of Article 11 (1)

1. ~~The Buy-in process shall be set in the contractual documentation applicable to each participant of the CSD, CCP and trading venue.~~ CSDs, CCPs, and trading venues shall include in their rules that participants will be subject to buy-in rules under CSD Regulation. Their rules should also state who is responsible for appointing a buy-in agent or executing a buy-in auction

Redrafting of Article 11 (3)

3. As stipulated in the rules of the CSD, CCP or trading venue, ~~T~~the CSD, CCP, trading venue or the receiving participant shall appoint a buy-in agent or execute the buy-in by auction. The buy-in agent shall not have any conflict of interest in the execution of the buy-in. The CSD and the trading venue shall allow the participant to provide the identification of its failing client or underlying client for which the buy-in shall be executed. Securities shall be delivered to the receiving participant and the related settlement instruction shall be deemed executed. Upon confirmation of the failing participant, pending delivery instruction will be cancelled by the CSD.

Redrafting Article 11(4)

~~4. The CSD, CCP or trading venue, as applicable in accordance with Article 7(10) of Regulation(EU) No 909/2014, shall send a notice to both the failing and the receiving participants:~~

~~(a) at the end of the business day when the extension period elapse informing them that the buy-in will be initiated the following business day;~~

~~(b) on the last business day of the buy-in period at the latest, informing them of the results of the buy-in or that the buy-in is not possible.~~

Where the receiving participant has appointed the buy-in agent, the receiving participant in accordance with Article 7(1) of Regulation(EU) No 909/2014, shall send a buy-in notice to the failing participant and the buy-in agent:

(a) at the end of the business day when the extension period elapses informing them that the buy-in will be executed the following business day

(b) immediately following the execution, or attempted execution, of the buy-in, informing

[11] In T2S, cancellation of matched settlement instructions can only be done bilaterally by both parties, so if only party wants to cancel a matched settlement, it will still remain valid in the settlement system

them of the results of the buy-in or that the buy-in is not possible

Redrafting Article 11(6)

6. The partialling functionality offered by the CSD, referred to under Article 3(7) shall be applied ~~on the last~~ no later than the day prior to the final day of the extension period when the financial instruments are available in the account of the delivering participant irrespective of any opt out elected by the receiving participant. The partialling functionality shall not be mandatory for omnibus account structures when clients' ownership of assets cannot be guaranteed.

Redrafting Article 11(10)

~~10. For Transactions not cleared by a CCP, the failing participants or the trading venue shall provide to the CSD, by the day preceding the expiration of the extension period, the details of the settlement instructions on the same financial instruments and with the same date of expiry of the execution period that are causing the failure to deliver. The details shall contain the identification of the failing participants in the chain, the identification of the settlement instructions.~~

~~The CSD shall test consistency of this information with pending receipt settlement instructions in the account of the participant and process that information in order to limit the number of buy-ins to be executed.~~

10. For transactions not cleared by a CCP, where the failing participant is failing as the result of a failing receipt of securities, on receipt of a buy-in notification the participant shall pass-on the notification to the participant causing the fail, where a buy-in is possible in accordance with Article 7 of Regulation(EU) No909/2014. The participant instructing the 'pass-on' shall notify the CSD that it has passed-on the buy in and the identification of the participant in receipt of the pass-on.

Where a participant passes-on a buy-in, they will be responsible for notifying both the participant who issued them with the buy-in or pass-on, and the CSD, of the buy-in execution and results, in accordance with Article 6(4) of this Regulation.

**Q8. What are your views on the proposed draft RTS related to the buy-in timeframe and extension period?**

AFME appreciates that the CSDR Level1 text offers limited room for flexibility in defining the extension period. We advocate that the extension period should be linked to both the asset type and liquidity of the instrument, as stated in the CSDR and in the earlier ESMA Consultation Paper.

To avoid issues and discrepancies, it is crucial that extension and delivery periods are harmonised wherever possible, not just between markets, but also between different types of activity and irrespective of whether trades are settled via a CCP or OTC. This is particularly relevant due to the interconnectivity of markets and types of activity. Discrepancies would create major issues.

In this respect, we would like to highlight the following issues with the current draft RTS:

1. **It is not defined when buy-ins are to be executed**

Art 12 states that the delivery should occur 4 or 7 days after the end of the extension period, but does not indicate when the buy-in should actually be executed. Art 7.3 of CSDR only mentions that a buy-in "shall be initiated" after the end of the extension period, and the CP mentions it should "happen in a reasonable timeframe".

As indicated above, the timing of the execution is crucial to avoid creating market risk in closing off positions, so ESMA is kindly requested to define this in the RTS.

It is also required to avoid disputes in situations where the failing deliverer is able to deliver the securities after the end of the extension period but ahead of the execution of the buy-in (executing a buy-in in such scenarios would generate a double amount of securities).

The above also seems to assume that a buy-in can be readily executed after the end of the extension period, which is not realistic in many cases (we refer to ISLA's response in relation to SME Growth Markets):

- the search and appointment of a buy-in agent is not always straightforward. Some candidates such as market makers may be conflicted as part of the delivery chain
- to avoid multiple buy-ins for transaction chains, a determination needs to be made who will initiate the buy-in and for which amounts, which will take time
- The buy-in agent may not be able to immediately execute the buy-in

AFME proposes defining the delivery period relative to the execution of the buy-in, and to have a public announcement of when the buy-ins are being executed (see alternative proposal on buy-ins above).

2. **<u>There are different extension periods depending on whether transactions settle OTC or via a CCP</u>**

Art 13 of the RTS seems to indicate that there are three types of extension periods, which also depend on whether the transaction is CCP cleared or not:

- 4 days for liquid bonds and shares
- 7 days for illiquid bonds and shares
- 15 days for financial instruments traded on SME growth markets

However, if shares are cleared by a CCP, there is no lengthening of the extension period, and thus it remains 4 days.

We therefore seek clarity from ESMA on the following points:

a) What is the extension period for bonds which are CCP cleared: our reading (and our preference) is that the general rule applies: i.e. 4 days for liquid bonds and 7 days for illiquid bonds. From a Securities Financing perspective this discrepancy creates additional issues for collateral swaps where liquid securities are exchanged against illiquid securities. This creates a further disconnect and potentially introduces further market risk. Ideally, AFME would strongly recommend that all bonds (liquid or illiquid) to be subject to the same maximum allowable extension period under Level 1 (i.e. 7 business days) to minimize negative effects and possible market disruption.

b) What is the extension period for SME growth market shares which are CCP cleared: our reading is that it is 15 days

c) There is a discrepancy in extension period for illiquid shares which are cleared via CCP (where it is 4 days), and which settle OTC (where it is 7 days).
A party, who buys such shares from OTC counterparty, but sells them on exchange/via a CCP, could face a buy-in from a CCP while it cannot buy-in its own OTC counterparty. That will create fundamental issues for brokers as they will face a buy-in from the CCP before they can buy-in their client.

d) There is no delivery period defined for depository receipts, ETF's, certificates and other financial instruments not captured above, while the timeframe for the delivery period has been defined (see below).

3. **<u>Delivery of financial instruments and extension periods are not aligned</u>**

The ESMA CP (92) states that the timeframe for the delivery (4 or 7 days) should apply "irrespective of whether the shares are cleared or whether the shares or bonds are SME growth market instruments". Art 12 of the draft RTS stipulates that the delivery timeframe is:

- 4 business days for liquid bonds and shares
- 7 business days for illiquid bonds and shares
- 7 business days for depository receipts, ETF's, certificates and other financial instruments not captured above

When comparing this with the timing of the extension period (see above), this creates

a number of discrepancies, which will very likely lead to confusion among FMI's and market participants

| **Financial Instrument** | CCP Cleared (y/n) | Extension Period | Delivery Period |
|---|---|---|---|
| Illiquid Bond | Y | 7 days | 4 days |
| Illiquid Bond | N | 7 days | 7 days |
| Liquid Bond | Y | 4 days | 4 days |
| Liquid Bond | N | 7 days | 7 days |
| SME Growth | Y | 15 days | 4 days |
| SME Growth | N | 15 days | 15 days |

- For illiquid bonds cleared by CCP's, the extension period is assumed to be 7 days, but the delivery period is 4 days
- For SME growth market instruments, the extension period is assumed to be 15 days, but the delivery period is 4 days (for liquid instruments) and 7 days (for illiquid instruments)
- For DR's, ETF's, certificates and other financial instruments, the delivery period is defined (7 days), but the extension periods are not aligned.

To avoid confusion and additional complexity, AFME would recommend full alignment of the delivery periods to the extension periods.

4. **The MiFID definition of liquid markets includes many non liquid instruments, impacting the extension periods under CSDR**

As highlighted in the separate AFME submission to the proposed MiFID RTS, AFME and its members have a number of concerns, including on the definition of a large universe of fixed income products as 'liquid' when they are by most measures clearly 'illiquid' (i.e. 'false positives')

While we are in favour of aligning definitions of liquidity across MiFID and CSDR, if the ESMA MiFID liquidity definition remains as is, it will have impacts on reducing the extension period for large categories of non liquid bonds to 4 days.

AFME would therefore request further amendments to the MiFID liquidity calibrations to remedy this, absent which we would favour having a standard extension period of 7 days for all bonds in CSDR, irrespective of MiFID liquidity definitions

ECSDA recently conducted a survey of their members to gauge the impact of the current mandatory buy in proposals on current failing trades and to estimate the overall impact. At this stage its worthwhile mentioning the following important findings:

- Figures based on data from 11 CSDs for November 2014. Not possible to take into account exemptions or differences in the extension period as proposed by ESMA
- Based on the default buy-in process (buy-in initiated after ISD+4)
- 151,443 buy-ins would have been for a total value of c.EUR 214 billion.
- Equates to 7,572 buy-ins per day vs. EUR 10.7 billion
- Assuming November 2014 is broadly representative, the total number of buy-ins per year would equate to 1.8 million, with a total value of more than EUR 2.5 trillion.
- As anticipated, two ICSDs accounted for the approx 85% of the fails still pending on ISD+4
- Remaining 9 CSDs equated to 20,000 buy-ins, with 4 markets counting more than 1,000 buy-ins (highest 7,500).

**Q9. What are your views on the proposed draft RTS related to the type of operations and their timeframe that render buy-in ineffective?**

**1. In circumstances where a buy-in is ineffective**

AFME agrees with ESMA that there are circumstances where buy-ins are impossible or ineffective and that these individual cases need to be considered as out of scope. We understand ineffective to mean that although it is possible to execute a buy-in, the buy-in would serve no economic purpose to either party.

However, the circumstances are more broad than the case of short-term financing transactions, mentioned in art 7.4 (b) of CSDR. As stated in our response to question 7, there are numerous cases where a settlement does not represent an underlying contractual agreement between a buyer and a seller to satisfy a purchase against an agreed price, and where a buy-in, though technically possible would not serve any economic purposes

**Alternative proposal**

To ensure adequate control and reporting of such exemptions, the list of transaction types listed under the ITS on CSD record keeping (Table 1) can be further enhanced, using available standard ISO codes to be mapped to such circumstances (see above for some suggestions)

AFME would suggest that ESMA includes these additional circumstances in art 11 of the RTS as part of its remit under art 7.15 (e) CSDR Level 1 in a non-exhaustive list to be added to RTS art 11, so as to exclude them from the application scope of buy-ins, or otherwise specify that the following types of transfers do not constitute a "transaction" for the purpose of Article 5(1) CSDR, and therefore are not in scope of the mandatory buy-in regime under Article 7(3):

- Portfolio transfers between accounts of the same client at different custodians (ISO code: PORT).
- Realignment of assets between securities accounts held at the same CSD or different CSD's (depot transfers) (ISO code OWNE/OWNI)
- Allocation of assets across different funds, or in different tax pooling accounts.
- Collateral movements and margin deliveries/reimbursements (ISO Code COLI/COLO/CNCB/AUTO).
- Settlement as a result of a corporate action etc. (ISO code: CORP, CONV, CLAI, PLAC etc)
- For Mandatory Corporate Actions with Options (ISO code:CHOS) no buy-in should be initiated, as the underlying security has a limited existence period and buyer protection would ensure that the buyer's rights can be executed.
- In the event of a Voluntary Corporate Actions (ISO Code: VOLU) no buy-in should be executed. Here the concept of Buyer-Protection would ensure that the buyer receives the anticipated outcome

2. **On the exemption for short-term Securities Financing Transactions (SFT)**

AFME and its members believe that the current exemption for short-term financing transactions as contained in art 7.4(b) is highly inflexible, and will lead to a severe distortion of bond markets (whether cash, lending or repo).

Mandatory buy-ins will substantially increase the costs of market makers and investors active in institutional lending and repo markets reduce market liquidity and supply of inventory for lending (which in turn will also impact the ability to cure fails).

From the perspective of a lender or SFT intermediary, the potential cost of a buy-in, even if afforded very low probability, will far outweigh any potential income from engaging in SFT activity.

These markets play a vital role in supplying market liquidity and supplying settlement efficiency. They are low margin, and therefore extremely sensitive to cost increases (which buy-ins will impose).

In this respect, we support the positions and arguments made in the ICMA submission. Without repeating them, in our view the major impacts are:

1. An overall reduction in trading and liquidity in bond markets, especially in less liquid instruments and long dated financing transactions, as lenders and market makers may withdraw wholly or partially from transactions which have a higher risk of buy-ins.
2. A substantial increase in bid-offer spreads, to cover the potential costs of buy-ins for intermediaries making markets. This will impact investors as well. Please refer to the ICMA market survey for quantification of impacts.
3. The creation of a two tier/financing market, where participants will be driven to short-dated financing as a result of the exemption. This also seems to contradict the efforts of the Basel III Net Stable Funding Ratio, which seeks to reduce financial institutions' reliance on short-term funding and to encourage the use of longer term sources of finance (such as term repos).
4. The negative impact on cash markets, and discrepancies between related financing and cash transactions as a result of the exemption for short-term financing transactions. Cash bond markets and securities financing markets are very much interlinked, and any –even partial-

exemption on SFT's side which does not have an equivalent on the cash side, will lead to serious distortions.

Example:

- B is a market maker in bonds, offering two way prices. He has limited inventory, but cannot predict whether clients buy or sell beforehand, and counts on his ability to source securities in the SFT markets.
- Client C buys a substantial quantity of bonds from B (cash transaction)
- B has insufficient inventory and sources the bonds through a short-term repo or stock loan from another counterparty A
- A fails to deliver the bonds to B, as a result of which B cannot deliver to C
- If B cannot find the bonds elsewhere, C will buy in B after 4(7) days
- B cannot buy in A, as the short-term repo between A and B benefits from the exemption under CSDR
- B suffers a substantial loss as a result of the buy-in, even though he was not the cause of the fail Going forward, B will either widen bid offers spread substantially or even withdraw completely from making two way prices

It is to be noted that the above type of activity is very prevalent in bond (and equity) markets

**Alternative proposal**

AFME advocates that the current exemption for short-term repos should be extended to cover longer dated transactions up to 30 business days. In addition, and though CSDR level 1 imposes limitations, the exemption should apply to all bond transactions, not just SFT's to avoid the issue highlighted in the above example

3. **Treatment of open ended SFT's**

Art 14.3 of the RTS excludes open-ended repos or stock loans. In these cases both parties have not agreed an end (return) date for the transaction, and often determine this later in the lifecycle of the trade. Until the open ended repo/loan is recalled, both parties are comfortable in extending the transaction, and do not see the need to enforce settlement.

As both parties can close the transaction at any time, which may be within the extension period, we advocate that the art 14.3 of the RTS deletes the phrase "*where no intended settlement date is set for the second transaction of the operation*".

4. **Price compensation for price decrease**

Art 7.6 CSDR provides that the failing participant needs to pay the receiving participant the difference between the agreed price of the shares and the buy-in execution price where the agreed price of the shares is higher than the buy-in execution price.

We note that current market practice is as follows, taking simple cash trade as an example:

- Party A agrees to sell shares to Party B for €100 but Party A fails to deliver those shares. Party B buys in equivalent shares from a third party.
- Since the original transaction is on a DvP basis, Party B does not pay Party A the original purchase price for the shares, as Party A never delivered the shares to Party B. The original transaction is effectively cancelled.
- If the buy-in execution price paid by Party B is €80 (i.e. the agreed price of the shares is higher than the buy-in execution price) under Article 7.6 CSDR, Party A as the failing party is required

to pay the difference of €20 to Party B. The effect is that Party B receives the benefit of the lower buy-in price twice – once because it only had to pay €80, not €100, to buy in the shares and again when Party A is required to pay the difference under Article 7.6. It is not clear to us what Article 7.6 is therefore intended to achieve. Is it intended to compensate Party B for lost opportunity cost where the market price of the shares has fallen between the intended settlement date and the buy-in date?

- On the other hand, if the buy-in execution price paid by Party B is €120, Article 7.6 CSDR does not apply. Nevertheless, Party B would look to Party A to reimburse it for the €20 difference between the buy-in price and the agreed price under the original transaction.

Though we are aware that this is already set in Level 1, and is only mentioned in par 103 of the RTS explanations we strongly disagree with Article 7.6 CSDR (which is also mirrored in the price compensation mechanism below), as it only favours the buyer, without being exposed if prices go up. This will create the potential for abuse of buy-ins, which the seller cannot protect himself from.

**Q10. What are your views on the proposed draft RTS related to the calculation of the cash compensation?**

AFME members agree with ESMA that there is a need for cash compensation in case of a failed buy-in. AFME also agrees that participants can pre-agree on a compensation methodology, provided these are the trading parties and not the CSD participants.

Settlement participants (acting in an agency capacity) should also not be involved in this process of establishing a compensation mechanism, as it would expose them to undue risk, and create room for potential dispute by their underlying clients.

Trading parties can also agree that the cash compensation pre-agreement could include other additional factors to compensate potential financial loss e.g. corporate entitlements, funding and other operational costs, accrued interest, FX exposure etc.

ECSDA recently conducted a survey of their members to gauge the impact of the cash penalty proposals on current failing trades and to estimate the cash penalties. At this stage its worthwhile mentioning the following important findings:

- ECSDA data on settlement penalties -November 2014 volumes based on data collected from 17 CSDs
- Accumulated gross late settlement penalties would have amounted to more than EUR 183 million (approx. EUR 9 million a day).
- Translates into annual gross late settlement penalties of close to EUR 2.2 billion.
- The two ICSDs hold the largest share of late settlement fines to be collected (around 75%).
- Excluding the ICSDs, the remaining CSDs would on average each account for more than EUR 3 million per month.
- Among these CSDs, figures range between virtually zero and EUR 15 million per month. Only 5 CSDs would have collected less than EUR 100,000 worth of penalties.

In addition, the RTS does not clearly identify who will be responsible to judge whether a buy-in has failed or not (or if it is deferred), and in which circumstances. Further clarity is required as well as an exhaustive list of operations types that render the buy-in ineffective.

Examples of such cases where buy-ins are impossible, and cash compensation is the alternative, are:

1. The security which is subject of a buy-in ceases to exist, or changes in nature or characteristics:

    a) Securities come to the end of their life

b) Asset classes that are convertible and redeemable when they are close to their redeemable/convertible dates

c) Securities bought with certain rights (e.g. additional rights, cum dividend) lose those attached rights, or change in nature.

d) The resultant security contains a covenant restricting ownership by investor type, market or region or the investor is restricted from holding the resultant security.

e) Securities can no longer be traded and / or settled e.g. listing at exchange / trading venue is suspended

2. Even though the security still exists, there is insufficient liquidity in the market to permit a successful buy-in. The loss of liquidity can be temporary or permanent. Some causes (non exhaustive) are:

a) Trading liquidity disappears as a result of a temporary market event e.g. dividend season.

b) The demand for securities exceeds supply: bid offer spreads widen, and securities might be temporarily unavailable e.g.:

- Over futures expiry periods, certain lines of securities become the "cheapest to deliver" and demand for those securities peaks
- The re-composition of certain market indices (e.g. FTSE, DAX), triggering large demands for certain securities

c) Securities are temporarily blocked and cannot be delivered or settled any longer: e.g. as a result of corporate actions or international sanctions:

- OTC Market Maker Securities with limited inventory (requiring private placements)
- Depository Receipts with no headroom to convert from liquid underlying to the Depository Receipt

3) Cross border settlement via a CSD link between an EU and non-EU CSD
See also the response to Question 7)

Further ESMA should consider providing guidance as to the circumstances in which a buy-in can be considered impossible because securities are offered to the buy-in agent at prices above a reasonable level. Whilst the need to ensure settlement discipline is an objective, a framework under which buy-ins can be executed at extremely high prices could act as a strong deterrent to the provision of liquidity by market makers

**A. <u>Cash Compensation for price decreases (RTS art 15 (d)</u>**

Similar to the arguments made under Q9 with regard to extra compensation by sellers to buyers for price decreases, but not for increases in price, AFME and its members have strong concerns on the proposed compensation mechanism in RTS 15 (d), which states that "*where under point (a) to (c) the price of the settlement instruction is equal or higher than the price determined by the buy-in agent or the pre-agreed price, the cash compensation shall be null*".

Our concerns are as follows:

- Parties should be able to agree beforehand any compensation mechanism. To limit this flexibility is contrary to the provisions of art 15 (a), and also implies that trading parties are not able to judge the effect of price variations on their trades.
- This mechanism only works one way:
  - The seller needs to compensate the buyer if market prices increase (in order to make the buyer whole)

- But the buyer does not need to compensate the seller if market prices decrease. Note that the buyer would have been impacted by price decreases if the settlement had happened.
- AFME believes that this provision could allow the buyer can take advantage of price increases, whilst being sheltered against price decreases.
  The key principle is that the prejudiced party should receive financial compensation for the non-conclusion of the original contract (i.e. the settlement of the securities.), but not speculate on being compensated on prices dropping.
  The very purpose of a trade is to lock in a contractually agreed price between seller and buyer. If a price decreases, the buy-in fails and cash compensation is the only solution, it should work in both ways: if prices increases, the seller needs to make the buyer whole by compensating the difference, but the reverse also applies: if prices decrease, the buyer needs to compensate the seller. Otherwise the buyer can speculate on price increases, while not being exposed to price drops.

5. It is also not clear why different terms and benchmarks are used for the 'original price' in art 15 of the RTS. This will lead to confusion:
   - Art 15(a) and 15(b) refer to the 'price set for the failed transaction': is that the trade price as agreed between trading parties?
   - Art 15(d) refers to the 'price of the settlement instruction'. Is that the amount of the settlement consideration (which in the case of free of payment transactions is zero?)

**Alternative proposal**

AFME suggest amending art 15 RTS as follows:

- Replace participants by trading parties throughout art 15 (and throughout all of the Articles on buy-in)
- Insert a clear determination of the cases when the buy-in is impossible, and who/when it is determined. See also alternative proposal under Q7
- Delete paragraph (d) completely, as may lead to arbitrage by buyers and could create undue risk for sellers.
- State that cash compensation procedures need to be harmonised between OTC and CCP cleared transactions

**On Exchange non-CCP trades**.

- The buyer and seller initially agree the terms of the cash compensation including a reference price plus other additional factors to compensate potential financial loss e.g. corporate entitlements, funding and other operational costs, accrued interest, FX exposure etc.
- If the reference price generates a sufficient profit for the prejudiced party to recover all associated transaction costs (and financial benefits e.g. cash entitlements) then no other financial claims or cost / loss factors should be included in the cash compensation value
- If the reference price is on par with or below the original trade price, then the original trade price is used and all other transaction costs incurred by the prejudiced party can be claimed from the defaulting party.
- In the event that a reference price cannot be agreed then the trading venue where the trade was executed should be the arbiter to provide a suitable reference price and other all conditions for recovering transaction costs / financial as stated above apply.

**OTC Trades (off exchange, non cleared)**

- As above. However, the key difference is that there is no trading venue to act as a reference price arbiter unless both parties agree to use a specific trading venue to source a reference price (if available)

Where no 3rd party reference price can be sourced from a regulated trading venue then the original trade price is used and all other conditions e.g. transaction costs and financial losses are recoverable through the cash compensation process as stated above.

**Q11. What are your views on the proposed draft RTS related to the conditions for a participant to consistently and systematically fail?**

While AFME and its members agree there needs to be a monitoring mechanism against 'systemic offenders' , we have serious concerns about the definitions and scope, the methodology used, and the impacts/risks created by the regime proposed under art 16:

**Definition and scope**

The different roles of participants in the settlement chain needs to be recognised in the RTS – i.e. they can settle their own proprietary activity or third party activity. Participants settling third party trades are considered intermediaries acting as direct agents on behalf of their underlying clients and this is fundamentally different from those settling proprietary activity. If ESMA imposes a suspension of participation on the former due to high fail rates, they incur a proprietary risk which is inappropriate for their role in the settlement chain.

For third party agents, there is often limited control with respect to the settlement efficiency and trading patterns of the underlying clients. In fact, settlement agents are at times forced to withhold settlement of certain client settlement transactions by placing them at 'Hold' status in order to protect positions of other clients or where Hold and Release is not available, or they may be forced to wait to present the trades to the market for matching until the necessary resources are available. This can have the following consequences:

- Late input of settlement instructions as agents would delay client settlements as long as possible until the cash/securities are confirmed in place for fear of being penalised/suspended. Even if instructions are released with an 'on hold' flag, they would still be included for suspension calculation purposes.
- Late matching of settlements and resultant impact on settlement efficiency, as the agent of the receiver/buyer would input his instruction, but the agent of the deliverer/seller would only release its instructions once it is sure that its client has the securities available in its account. In markets where there is a significant amount of turnaround/back to back chain activity, this would lead to a decrease of STP processing (holding back the instruction) and consequently, decreased overall settlement efficiency, inadvertently creating the opposite effect of what CSDR is intended to achieve.

These agent banks are usually (very) large institutions, for which a suspension triggered by low settlement efficiency would have far-reaching systemic consequences on the markets. Suspension of a settlement agent bank due to failures caused by an underlying client would have a detrimental effect on that settlement agent's other clients, who may be effectively denied access to the market unless and until they are able engage the services of an alternative settlement agent. It would also lead to these agent banks being unable to finance themselves via the repo or stock lending market, and, in a worst case scenario, could lead to a default. By imposing buy in and suspension risk against participants who are acting as custodians/settlement agents for third party clients, the regulation is changing the risk structure of these entities and moving settlement risk away from the trading party and onto the participants.

As a directed agent, these participants are simply acting as "channels" to allow their underlying clients (ultimate trading members or participants to trading contract) to access to the relevant CSD/settlement system. However the obligation to ensure provision of securities to enable settlement of these delivery settlement obligations has always been and should continue to be the responsibility of the trading party and not the CSD participant who is enabling access of that trading party to the CSD.

ESMA's RTS moves that obligation onto the CSD participant making them quasi principal to the transaction.

In doing so, these participants would then need to ensure that they take cater for this additional risk in their business model by margining these transactions which could take the form of additional collateral/extension of credit etc. This will of course add to the cost of trade to the underlying client. Indeed in certain scenarios it will involve collateral/margin being taken at multiple points in the settlement chain to support single trade.

As such, by placing buy in and suspension risk on the CSD Participant/custodian, this will result in increased cost to underlying investor.

Without this recognition the RTS will significantly increase the risk-profile of CSD participants who are acting as settlement agents, which they can influence only partially. Moreover such suggestions lead to a requirement of settlement agents to take on proprietary risk by having to guarantee trades of their clients. This could be even more critical in situations where a CSD's participant becomes insolvent, and the trade is bought in. At this point the settlement agent has no party from whom to recoup the incurred costs.

**<u>Risks</u>**

Art. 7.9 CSDR Level 1 states that CSD, CCPs and trading venues shall establish procedures for suspension, and disclose identities only after giving that participant the opportunity to submit observations.

AFME suggests that participants or representatives thereof need to be involved in the drafting and approval of these procedures, which need to include clear criteria, processes, and methodology to support the portability of positions and settlements.

**<u>Alternative proposal</u>**

We would strongly advocate that any monitoring of settlement efficiency and subsequent measures like suspension make a clear distinction between whether the participant is acting as agent, as broker or as proprietary trading entity.

Only in the last instance is the settlement participant able to fully control its settlement efficiency, and as such, any suspension measures should be limited to those instances where the participant acts in a principal capacity or where it is clear that the participant has directly caused the fails on a systemic basis even when acting as an agent.

*Assessing a CSD participant's performance should be undertaken in conjunction with the account type, i.e. if it is an "own account" type the CSD participant is managing its own activity, but on "omnibus account" or "individual client segregation" a CSD participant is only managing activity of its client, based on the instructions the agent receives.*

**<u>Methodology</u>**

AFME has the following concerns regarding the methodology proposed under art 16 of the RTS:

- Art 16 does not clearly specify how this benchmark rate will be established, by whom and how it will be made available to participants. In order for participants to measure whether they approach this threshold, this information is essential.
- As stated above, suspension should only occur for participants when they act as settlement agents for their own principal/proprietary trading. The application of art 16 should exclude cases (and activity) where participants act as settlement agents for third parties.
- CSDs should alert their participants as they reach certain thresholds prior to any agreed percentage which triggers suspension.
- AFME believes that only a competent authority should suspend a participant with the CSD being the executing force. This combination would avoid any risk of the CSD being sued.

Settlement efficiency under this article should only consider those transactions, which the CSD participant can actually control. In a very extreme scenario a long-only investor could be suspended if his purchases do not settle despite him having the necessary cash available, if the failures are caused by short positions of his counterparties.

**Q12. What are your views on the proposed draft RTS related to the settlement information for CCPs and trading venues?**

We support ESMA's proposal to specify settlement information relating to the current status of the instruction sent by the CCP or the trading venue. In most cases, this is current practice. We welcome that ESMA renounces the segregation of the accounts of all trading and clearing members as this would have triggered a complex and costly new infrastructure which would not be necessary.

It may be helpful to specify what the trading venues will do with this information.

We particularly support ESMA's view set out in Para 114 that settlement information for CCPs and trading venues should be instruction/transaction-related. With respect to Art. 17 SD-RTS, we have the following suggestions:

**Art. 17(1) (c) SD-RTS:**

Replace "participants" with "CSD participants"; the rationale is that the CSD can identify the receiving and delivering CSD participants in a securities settlement instruction or transaction, but may not know the participants of the trading venue or the CCP. This is especially relevant if the settlement participant is not the same entity as the clearing member and/or the trading member.

**Art. 17(1) (d) SD-RTS:**

Replace the current text by "The number and identification of the financial instruments **for which settlement did not occur**". CSDs can provide these figures but may not have the more granular information required at CSD participant level.

**Art. 17(1) (e) SD-RTS:**

Replace the current text that identifies five points in time by text that specifies that CCPs and trading venues should be able to receive updated information at least once per business day. CSDs will not necessarily have the relevant information allowing them to identify the points in time proposed by the current text; our suggestion provides for a more generic requirement.

**Art. 17(1) (f) SD-RTS:**

We believe that this is a duplication of Art. 17(1) (d) and should therefore be deleted.

**Art. 17(2) SD-RTS:**

Trading parties may not have a reference from the trading venue that they can include in the settlement instruction. The word "any if available" should be added in front of "reference".

**Q13. What are your views on the proposed draft RTS related to anti-avoidance rules for cash penalties and buy-in?**

We note that if any CSDs or CCPs needs to change their settlement models to ensure consistency with the proposed anti-avoidance rule, this will likely require technical changes for both the market infrastructure and its participants.

We have taken note of ESMA's concern that market participants could try to circumvent the requirements of the RTS when designing buy-in processes or penalty mechanisms. Provided the RTS is clear, there should be no room for circumvention.

However, we are concerned about the wording of art 19 of the RTS, as it could give rise to uncertainty, and also limit the abilities of participants and CCPs to optimize settlement and net trades, specifically to:

- Exercise their right to bilaterally cancel transactions, as provided for in art 7.3 of CSDR
- For CCP's, choose a netting and settlement model which is most suitable to their type of activity and client base. CSDR and the RTS should not be used to force CCPs to all adopt the same netting model or to try to erase the beneficial effects of such netting models, most of which have been specifically designed to optimize settlement efficiency and allow offsetting trades, thereby reducing risk and avoiding fails.
  If certain CCP's are concerned that they will be placed at an economical disadvantage, they are free to review the way they operate, but it should not be part of the RTS standards

We therefore strongly advocate that **Article 19 SD-RTS** should be deleted in its entirety.

If Art. 19 RTS is not deleted, it may cause uncertainty, confusion and disorientation on how to properly build such processes and mechanisms. It will negatively affect all parties involved in the trading, clearing and settlement process and create a risk that any efforts to further enhance settlement efficiency will be damaged. All existing and future procedures or mechanisms at CSD, CCP or trading venue level aimed at improving the settlement efficiency – and thus avoiding buy-ins and penalties – will be threatened to be deemed a circumvention tool.

The procedures and mechanisms on settlement discipline will be part of the authorization and supervision of CSDs, CCPs, trading venues and their respective participants. In our view, no explicit wording is required.

In paragraphs 115 and 116 of the Consultation Paper, ESMA states that all existing settlement models should continue to operate, including those that continuously recycle the instructions, when it is ensured that the cash penalty is applied "from the first day of the settlement fail and for as long as the fail remains outstanding and the timeframe for the buy-in process should be computed in the same manner pursuant to the regulation". We warmly welcome these considerations. These should, however, be positively addressed in Section 2 and 3 of Chapter III of the RTS rather than by the introduction of a vague circumvention rule which would also affect transactions other than CCP-cleared.

Finally, it is not clear on what basis ESMA is mandated to include specific anti-avoidance rules in the RTS, nor is it clear what the consequences are of a buy-in process or penalty mechanism being "deemed to have been designed to circumvent the application of the RTS".

**Q14. Do you agree that 18 months would be an appropriate timeframe for the implementation of the settlement discipline regime under CSDR? If not, what would be an appropriate timeframe in your opinion? Please provide concrete data and evidence justifying a phase-in for the settlement discipline measures and supporting your proposals.**

AFME agrees with ESMA on the need for sufficient time before implementation of RTS takes place as well as for a phase-in implementation. This will allow all industry participants (CSDs, CCPs and CSD participants) to perform all necessary adaptations to their systems and operational processes to be in line with the requirements of CSDR Level 2 measures.

AFME believes that the impacts stemming from the CSDR RTS on CSDs and CSD participants will be significant and system/process adaptations will be required to become fully compliant. Major impacts are listed below.

Key impacts of CSDR on CSD participants and other parties involved in the settlement chain (non-exhaustive)

- Prevention of settlement fails
  - Adaptation of information contained in the allocations sent to investment firms by their professional clients (Article 2 (1))
  - Adaptation of SLAs between investment firms and their clients to reflect new transmission timeframe of settlement details (Article 2(4))
  - Adaptation of investment's firms systems to adopt all mandatory matching fields required under the new RTS (Article 3 (3)) – requirement for a new field to be incorporated, a new ISO harmonised use is to be agreed and tested
  - Adaptation of systems and internal processes to allow investment firms to monitor real time gross settlement (RTGS) throughout each business day (Article 3 (10))
- Cash settlement penalties
  - Development of systems/processes for managing cash settlement penalties (pass on cash penalties to clients)
  - Redrafting and re-negotiations of contracts with clients to cater for pass-on of charges
  - Potential changes needed to existing settlement pending reports to cater for additional information on incurred / received penalties
- Buy-ins
  - Development of systems/processes to facilitate the necessary exchange of information to support the buy-in process
  - Creation of new message types in ISO standard to support automated processing of buy-in notices
  - Re-drafting of GMRA's and GMSLA's to incorporate mandatory buy-in requirements (as necessary.) This has a global impact and not just on European repo and SBL counterparties.
  - Testing of new processes to ensure designed processes and messages work as envisaged
  - Preparation of legal basis in the underlying custody contracts

Additionally AFME is aware that the requirements also impose significant challenges to CSDs. These also need to be taken into consideration when determining the best time to apply new settlement discipline rules or additional functionality such as "hold and release" or "partial" settlement. While the new functionality will probably be covered to a great extent by T2S, non-T2S CSDs will also have to comply with those requirements.

As a result AFME would like to emphasize that for reasons that are analyzed above an implementation period of 18 months is likely to be insufficient to allow CSDs and CSD participants to implement changes required by the RTS.

In addition to the complexity of above elements, there are concerns to be raised with respect to the proposed timeline of 18 months after the publication of the RTS, which would point to an implementation deadline around mid-2017. The main concern relates to how this timeline would align with the migration activities for T2S, which will extend until February 2017 for the 4th migration wave, and possibly up to May 2017 in case an emergency migration wave needs to be adopted. Moreover it is foreseen that following completion of the T2S migration a phase of monitoring system stability and performance will be conducted. This will allow all market participants to get used to the platform and revised settlement process. AFME members believe that T2S will be the logical place for the implementation of a central operational utility for the management of settlement penalties across all participating CSDs. Nonetheless and given the current planning stage it is very unlikely that the technical specifications, system development, testing, implementation and assessment of any operational impacts may all be completed within only 3-4 months after the end of the T2S migration period. Requesting market participants to mobilize additional resources to cater for the parallel introduction of settlement discipline functions at multiple levels would endanger the successful migration towards T2S.

On current time lines it is anticipated that the "last-wave" CSDs would have to implement changes to their (legacy) systems around February 2017 while they are in the middle of their migration to T2S. Once migrated T2S would probably provide some of the required services, which would incur significant "throw-away" costs not only for the CSDs but also for participants active in those markets.

ESMA should consider that the implementation of the proposed buy-in regime, which would cater for an efficient handling of the buy-in process, may also require certain development time and resources. To our knowledge currently no electronic messaging system exists which would provide for a "straight-through-processing" of buy-ins within firms. Such process would ideally also incorporate the communication within any chain including CCPs. In addition CSDs would have to cater to receive copies of the messages to be informed of the status of the buy-ins. The development of about 30 new messages in the context of T2S required extensive agreement amongst the standard setting entities, i.e. SWIFT / ISO as well as coordination within the industry to agree on the content of the messages and lasted significantly longer than the 18 months, currently suggested by ESMA in its RTS.

In addition, AFME has coordinated a survey amongst its members and has tried to quantify the impact in terms of budget required as well as time needed. The feedback was provided by a broad spectrum of industry participants active within AFME. (Figure 3)

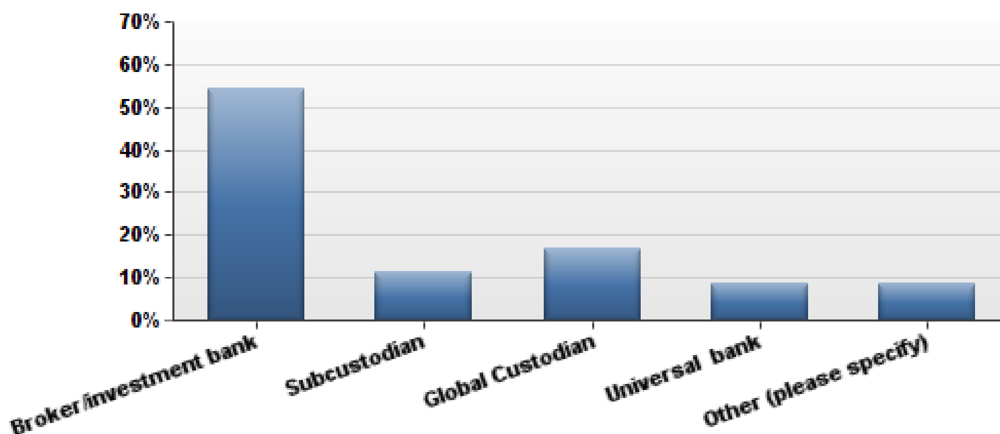

**Figure 3: Survey participants**

The results have shown that:

- 56% of respondents estimate that processes/systems adaptation for compliance with the proposed ESMA's RTS will cost to firms between 1 and 5 million Euros.
- 96% of respondents have stated that the proposed RTS will have a high (negative) impact on their organization.

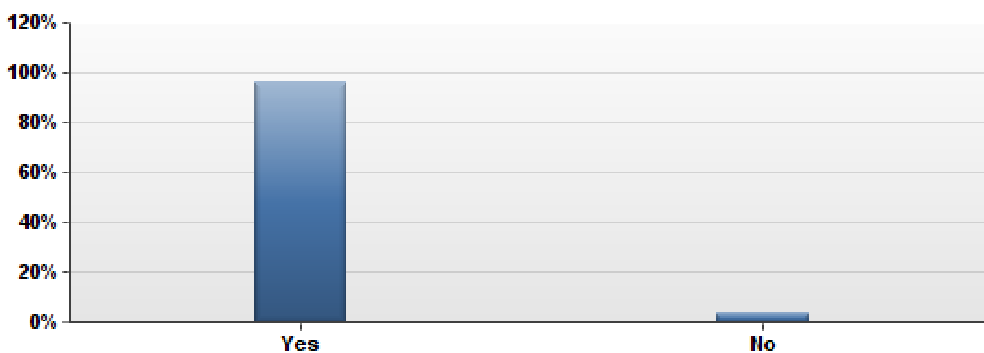


**Figure 4: Impact of RTS**

- 93% of respondents have said that the proposed buy-in regulation will bring additional risks to their organisations of which 77% have said that the risks imposed are not covered by their existing arrangements (i.e. the institution is not a direct CSD participant and does not have sufficient arrangements in place with its agent or clients to cover the additional responsibilities under CSDR). Participants are anticipating that in order to cover the additional risk:
    a. additional collateral will be required to cater for risks stemming from the settlement process; and
    b. significant re-work of the custody contracts will need to take place

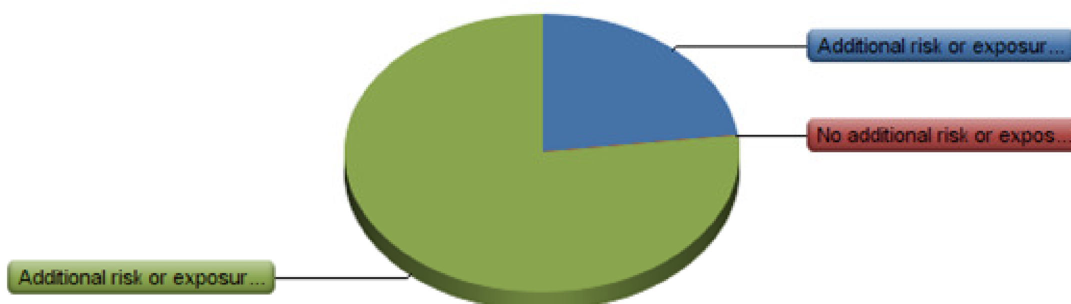


**Figure 5: Risk Associated with ESMA's proposed RTS**

- 70% of AFME's members have reported that based on the current proposals and the complexities outlined above implementation would require a timeframe of more than 18

months for CSD participants to implement in-house solutions to handle impacts stemming from ESMA's RTS.

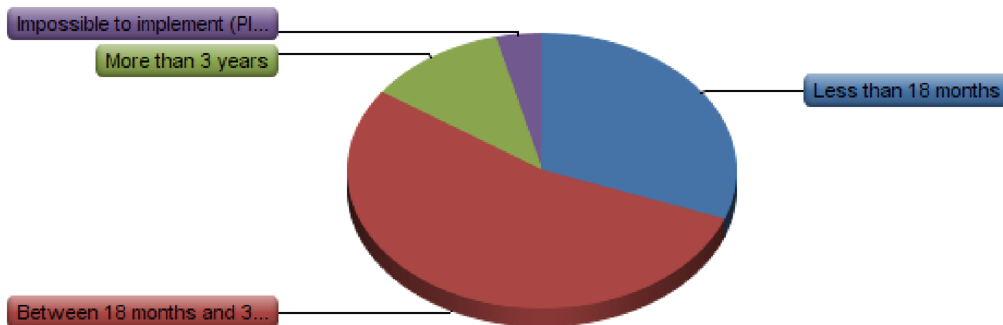


**Figure 6: Expected timeframes**

We would therefore recommend that a longer period of time should be allowed for the full implementation of the new settlement discipline measures, <u>at least up to one full year after the completion of the T2S migration (i.e. at least up to end of Q1 2018, or up to end of Q2 2018 in case of use of the emergency migration wave</u>). In addition AFME members suggest that before the new standards come fully into force, there should be a monitoring period of at least 6 months where fines and other sanctions are reported but not ultimately charged. This adaptation period would allow competent authorities, CSDs and CSD participants to analyse the consequences of the new procedures and make necessary alignments to their processing. To this extent and in order to cater for a harmonised application of the above rules, the delayed implementation should be valid for all markets irrespective of their participation in T2S. AFME is also very concerned by the European Commission's remarks in the public hearing on January 14, 2015 at ESMA's premises in Paris. In particular this relates to the perceived legal obstacle to provide for a phased-in approach, arguing that the level 1 text would require prompt entry into force of the RTS on settlement discipline. We are confident that ESMA [and the Commission] will take all relevant factors into account when undertaking a prudential evaluation and assessment of the technical standards of a settlement discipline regime – including the appropriate timing for its implementation. Otherwise, the co-legislators would have set specific dates like they did regarding other aspects of the CSDR [T+2, book entry]. The mandate to develop tailored technical standards cannot reasonably refer to the procedures only but must also comprise all relevant aspects of their timely implementation. Any other approach seems to be purely formalistic and disproportionate.

**Q15. What are your views on the proposed draft RTS on CSD authorisation (Chapter II of Annex II) and draft ITS on CSD authorisation (Chapter I of Annex VI)?**

AFME agrees with these proposals.

With respect to the RTS Art 5, our view is that Art 5(5) (b) should be deleted, as it is the responsibility of the competent authority, rather than the CSD, to develop and establish the resolution plan in respect of the CSD. In that regard, it should not be necessary (nor appropriate) for the CSD to submit the resolution plan to the competent authority. In our view, this requirement is superfluous. The references to the resolution plan in the draft ITS on CSD authorization should also be deleted, for the same reasons.

We would also suggest that RTS Art 50(1)(g), and item 10 in Annex II table B are deleted, as the competent authority should obtain the resolution plan from the relevant resolution authority pursuant to Directive 2014/59/EU.

With respect to the RTS Art 13, the mandate of the User Committee should also explicitly indicate the duration of the mandate of each committee and of all its members, which should never be in excess of three years at the maximum. Member re-election criteria should also be clearly specified in the mandate.

**Q16. What are your views on the proposed draft RTS on CSD review and evaluation (Chapter III of Annex II) and draft ITS (Chapter II of Annex VI)?**

AFME agrees with these proposals.

In RTS Art 42, in addition to the statistics indicated about settlement transactions (letter e) and buy-in transactions (letter f), CSDs should be asked to provide data about settlement efficiency in each system that they manage, including settlement rates, settlement fail rates, etc for each of the relevant phases in the operational day cycle.

The statistical data provided by the CSDs should be made public to the participants in the settlement systems that they operate, so as to facilitate the risk assessment analysis by each participant

**Q17. What are your views on the proposed draft ITS on cooperation arrangements as included in Chapter III of Annex VI?**

AFME agrees with these proposals.

The rules relating to cooperation arrangements between the competent authorities of Home and Host Member states should be aligned with similar rules contained in EMIR and in other legislation relating to FMIs, so as to ensure that the same principles and the same practical/operational supervisory criteria will be in place for all entities in the post-trade business flow in each market.

Appropriate consideration should also be given to extraterritoriality applicability of these arrangements.

**Q18. What are your views on the proposed draft RTS on CSD recognition (Chapter IV of Annex II)?**

**Q19. What are your views on the proposed approach regarding the determination of the most relevant currencies?**

AFME agrees with these proposals.

**Q20. What are your views on the proposed draft RTS on banking type of ancillary services (Chapter VI of Annex II) and draft ITS on banking type of ancillary services (Chapter IV of Annex VI)?**

AFME agrees with these proposals.

In particular, AFME welcomes the confirmation of RTS requirements for ensuring that the collateral given by a CSD participant as security against any financing received should be immediately available and accessible to that credit institution. This sort of arrangement will be extremely important to ensure adequate protection to the financing services offered by the credit institution,

and for the benefit of mitigating the overall systemic risk of the settlement system even when credit is granted by the CSD via its appointed credit institution.

In the context of the provision of banking-type ancillary services, AFME would also like to note that another critical part of the analysis of these technical standards will consist in the regulatory standard for the prudential requirements (additional risk based capital surcharge, etc.) that will be established by EBA for CSDs and/or the appointed third-party credit institution, as per CSDR Art 54.8. AFME will inform ESMA of any additional comments around this topic that may arise following the publication and review of EBA's proposed standards.

**Q21. What are your views on the proposed draft RTS on CSD participations (Chapter II of Annex III)?**

**Q22. What are your views on the proposed draft RTS on CSD risk monitoring tools (Chapter III of Annex III)?**

**Q23. What are your views on the proposed draft RTS on CSD record keeping (Chapter IV of Annex III) and draft ITS on CSD record keeping (Annex VII)?**

**Q24. What are your views on the types of records to be retained by CSDs in relation to ancillary services as included in the Annex to the draft RTS on CSD Requirements (Annex III)? Please provide examples regarding the formats of the records to be retained by CSDs in relation to ancillary services.**

**Q25. What are your views on the proposed draft RTS on reconciliation measures included in Chapter V of Annex III?**

**Q26. Do you believe that the proposed reconciliation measures where other entities are involved in the reconciliation process for a certain securities issue within the meaning of Article 37(2) of CSDR are adequate? Please explain if you think that any of the proposed measures would not be applicable in the case of a specific entity. Please provide examples of any additional measures that would be relevant in the case of specific entities.**

**Q27. What are your views on the proposed reconciliation measures for corporate actions under Article 15 of the draft RTS included in Chapter V of Annex III?**

AFME invites ESMA to review the text of Article 6, paragraph 4, and to modify this text so that it allows CSDs to comply with the Market Standards for Corporate Action Processing and with the T2S Corporate Actions Standards.

AFME suggests the following redrafting:

| Proposed re-drafting<br><br>1. A CSD shall not initiate the processing of a corporate action that would change the balance of securities accounts provided ~~maintained~~ by the CSD until the reconciliation measures specified under Article 14 and, where applicable, under points a) and b) of Article 16(1) are completed. ~~at the end of settlement on the respective business day~~. |
|---|

*Proposed re-drafting*

*2. When a corporate action has been processed, a CSD shall ~~perform an additional reconciliation ensuring~~ ensure that all securities accounts provided ~~maintained~~ by the CSD are updated correctly*

**Q28. What are your views on the proposed draft RTS on CSD operational risks included in Chapter VI of Annex III?**

**Q29. What are your views on the proposed draft RTS on CSD investment policy (Chapter VII of Annex III)?**

**Q30. What are your views on the proposed draft RTS on access (Chapters I-III of Annex IV) and draft ITS on access (Annex VIII)?**

**Q31.What are your views on the proposed draft RTS on CSD links as included in Chapter IV of Annex IV?**

**Q32. What are your views on the proposed draft RTS on internalised settlement (Annex V) and draft ITS on internalised settlement (Annex IX)?**

1. **The requirement to report the value and number of failed transfer orders is not included in the mandate that is given to ESMA**

Art. 9.1 of Regulation 909/2014 provides that settlement internalisers report "*the aggregated volume and value of all securities transactions that they settle outside securities settlement systems.*" However, in art. 2(j) of the draft RTS, ESMA intends to ask settlement internalisers to report also:

- the number and value of failed transfer orders, knowing that a "transfer order" defined in Directive 98/26/EC includes cash and securities settlements through a securities settlement system and
- a comparison of the settlement fails that occur as part of settlement internalisation and the settlement fails in the system

This goes beyond the mandate that the European legislator has given to ESMA under art. 9.2 of Regulation 909/2014.

We therefore advocate the deletion of art. 2(j) of the draft RTS, as the reporting in number and value of the transactions is already included in articles 2(f) and 2(g). In addition, this requirement corresponds to none of the fields in the annexes of the draft ITS.

2. **The scope of the reporting obligation**

Art. 2.1.f).vii and art. 2.1.g).iv provide that "others" need to be reported as part of respectively the type of financial instruments and type of securities transactions. Where a settlement internaliser doesn't report "others", he will be in breach of the RTS. It is therefore important that the term "others" is either deleted or replaced with more specific elements to be reported.

We would ask for absolute clarity in terms of the reporting scope i.e. should it be made more specific to state that only securities issued in a Central Securities Depository operating in a Member State of the European Union should be subject to the reporting obligation, or does it refer to all transferable securities settled in an EU CSD, irrespective of where they were issued? It is to be noted that the inclusion of transfer orders per country where the securities have been issued would present a challenge for settlement internalisers as clients' instructions only include the place of settlement. There is no indication where the securities were issued.

- All settlements related to on-exchange activity should be excluded. A General Clearing Member provides the clearing service for their clients and receives netted instructions from the CCP containing multiple transactions. The resulting allocations to the respective client should not be considered internalised settlement
- All settlements that are subsequent to corporate actions should be excluded, such "bookings" refer to the reflection of externally (by the CSD) performed activities and are no internalisation – those are mere "allocations" received from the CSD;
- All settlements that relate to collateral management programs should be excluded as they do not reflect any possible centralised settlement;
- Securities, which are not issued in a Central Securities Depository, should not be included in the declaration. This is for example the case of such as certain units of UCITs and AIFs after subscription.
- A settlement in the books of a CSD can correspond to transactions entered into by several clients. The CSD participant that settles at central level may choose to aggregate clients' settlement instructions and then send them to the CSD for settlement. As a result, one settlement instruction in the SSS may correspond to multiple settlements in the books of the CSD participant. The latter should not be considered as settlement internalisation.

The proposed RTS would gain clarity if this were made more specific.

3. **The content of the reporting obligation**

- Type of securities transactions

  The identification of the type of transactions based on the suggested terms should be aligned to the ISO transaction codes, that ESMA has already suggested in Articles of the settlement discipline RTS. As ESMA rightly pointed out these are not used in a consistent way. Without this harmonised use. Custodian banks/settlement internalisers most often don't know the nature of the underlying transaction. To comply with the proposed standards a market practice would have to be used and it would have to be ensured, that the initiating parties to a settlement instruction fill the transaction type correctly.

- Types of clients

  It is also unclear to us whether the split per client means the entity which executed the trade or the settlement internaliser's direct client. In case ESMA means the latter (the settlement internaliser's client), the report may not be accurate as the trades will not be reported as the correct entity level (we will report for instance as investment firm which is our client but the trade may actually be for a UCITS). If ESMA means the former (the entity which executed the trade) then the settlement internaliser does not have the documentation to classify this entity as it is not contractually related to it.

- Split by country where the securities have been issued

  The split of transfer orders per country where the securities have been issued would also require a systemic enhancement for settlement internalisers as clients' instructions only include the place of settlement. There is no indication where the securities were issued.

- Aggregated volume and value

  It is our understanding that based on the data and categorization proposed by ESMA, a transaction settled internally by a settlement internaliser will be double-counted in the report. For example, if client A buys 100 shares from client B and the settlement internaliser settles this, it will need to include 200 in its aggregate value reporting to reflect the trades settled for both client A and client B. We would like to ensure that this is ESMA's intention.

4. **Format of the reports**

The template format of the reports that ESMA provided in the annexes are not precise enough and leave room for interpretation by national authorities, as happened with EMIR reporting. A standard template across all NCAs is critical to ensure one system build and no duplication of effort.

5. **Competent authority**

ESMA states that reports must be submitted by settlement internalisers established in the Union, their branches established in a third country and branches of third country entities operating in the Union but it is not clear to us whether the reporting will be to the home State or host State authorities i.e.:

- A US legal entity with an EU branch (London branch) settling Italian trades should report to whom? FCA, Bank of England or Italian competent authority?
- Should an EU legal entity with multiple branches consolidate reporting to the single competent authority of the legal entity or to the NCA of each and every branch?

6. **Time of implementation and submission of the first report to the competent authority**

There is an additional concern about the timing of implementation. The required reporting is very detailed and will require systemic enhancements from the settlement internaliser in order to be able to produce the reports.

The timeframe between the finalization of requirements and the first report submission won't be enough to enable system enhancements, report build and testing to be ready for the first reporting on time. Ideally the applicability of the reporting requirements is aligned to the phase in of the RTS on settlement discipline. With similar adjustments to be made to the use of the Transaction Types institutions are required to make significant changes to their processing. A phase in period of a minimum of 6 months should be considered.

7. **The original legislative content is to evaluate whether additional systemic risk results from internalised settlement compared to centralised settlement**

The term "systemic risk" is very broadly defined in the CPSS-IOSCO Principles for financial markets infrastructures, par. 2.2 p. 18. as "*the inability of one or more participants to perform as expected could cause other participants to be unable to meet their obligations when due*."

Such subsequent inability to perform occurs both in centralised settlement and in internalised settlement, e.g. a purchaser doesn't receive the purchased securities and therefore cannot deliver in a subsequent sale.

We would like to point out that:

- Where a settlement occurs centrally, the cash settlement and the securities settlement occur in 2 distinct institutions (CSD and Central or commercial bank)
- Where the settlement is internalised, the cash and securities settlement occur in the books of a same entity.

Therefore, when cash is not paid to the settlement internaliser, securities are not delivered and vice versa. As a result, settlement risk can occur as well as the same level of systemic risk as in a centralised settlement (impacting subsequent sales). However, in no case can counterparty risk

occur, i.e. the risk that the securities are delivered without the cash being paid, putting the counterparties at risk for the nominal value of the transaction.

8. **The aggregate reports on internalised settlements will result in an incomplete image of the internalised settlements that take place in reality**

The definition of "settlement internaliser" in Regulation 909/2014 refers to settlements that occur outside a securities settlement system. As a result, settlements that occur in a central securities depository in securities for which that central securities depository doesn't fulfil the central custody function fall outside the reporting obligation, including where the cash payments settle in cash accounts opened in the books of a commercial bank.

As "transfer orders" as defined in art. 2(i) of Directive 98/26/EC include cash settlements in the books of commercial banks, the reports under the draft RTS and the draft ITS on internalised settlement will give an incomplete picture of the aggregate of internalised settlements that take place in the EU because a large part of the institutions that operate internalised settlements fall outside the scope of the reporting obligation.