

Briefing Note

26 September 2013

CSD Regulation

Executive Summary

This briefing note focuses on AFME's position on key issues of CSDR. The **rationale** of AFME's position is primarily guided by the view that CSDR should

- provide a sound balance of safety and efficiency
- contribute to a level playing field and eliminate / avoid competitive distortions
- accommodate different requirements for securities settlement of certain asset classes and transaction types to reflect the way financial markets work in practice.

Based on these principles, it is **AFME's position** that

- in regard of standard settlement cycle (Art 5):
 - for trades in transferable securities, executed in a regulated market or a similar trading venue (e.g. MTF, OTF), the intended settlement date should be no later than T+2;
 - for trades bilaterally agreed between the counterparties outside of a regulated market or similar trading place (i.e. in the OTC space), the counterparties should have the flexibility to agree on a different settlement period; if no agreement is reached, the default cycle should be the same as the lifecycle on the regulated market / trading venue where the same instrument is traded;
- both brokers and clients should match/affirm transactions electronically on trade date (Art 6);
- buy-ins should only be made at the request of the receiving CCP or trading system participant or at the request of the underlying buyer, and longer periods than 4 days after intended settlement date should be possible for less liquid instruments and certain types of transactions; detailed regulation should be at level 2 after in depth analysis of the implications of settlement discipline regimes on the asset classes covered by CSDR (Art 7);
- provisions regarding segregated accounts should relate to CSDs only (Art 35);
- ESMA should determine the cases and criteria when settlement in Central Bank Money is not practical and available (Art 37);
- the capital requirements in Art 44 should only apply to CSDs that do *not* provide banking type of ancillary services; capital requirements for CSDs that provide banking type of ancillary services should be determined by banking regulation;
- the freedom to issue in any CSD in the EU should not be subject to legal requirements other than the law continuing to apply under which the securities are constituted (Art 47);

- the prudential requirements in Art 57 should only apply to CSDs that have obtained an additional authorisation to provide banking type of ancillary services (1+2 model); designated credit institutions under the 2+2 model should be subject to banking authorisation, regulation and supervision and should be out of scope of CSDR; a participant's unhindered and timely access to unencumbered securities held in a securities account with a CSD under the 1+2 model should be explicitly warranted in the recovery and resolution rules (Art 52);
- CSDs should be liable for the loss of a financial instrument caused by the CSD's negligence or intentional failure (Art 59);
- reports and review (Art 69) should reflect the finally adopted version, in particular regarding Art 7, 52, 53 and 57;
- The timing for securities dematerialisation (Art 70) should be considerably shortened (e.g 2020).

Introduction

AFME is a trade association whose members conduct domestic and cross-border securities operations in the EU/EEA area in their capacity as financial institutions, in a wide range of banking activities for their customers and for their own account. AFME's members are securities account providers in the context of European and national regulated activities. The AFME Post Trade Division is the European post trading centre of competence of the Association for Financial Markets in Europe (AFME). Its members are the major users of international securities markets. The Post Trade Division acts as an agent for change, providing and supporting solutions in securities clearing, settlement and custody, to reduce risks and increase efficiency for market participants, representing its members' views towards market infrastructure organisations and public authorities. AFME shares the overriding objective of a single and integrated post trading system in Europe through harmonisation and competition.

Of the broader AFME membership (see www.afme.eu) the following members – investment banks, global custodians and universal banks – actively participate in the Post Trade Division: Banco Santander; Bank of America Merrill Lynch; Barclays; BNP Paribas; BNY Mellon; Citi; Commerzbank; Credit Suisse; Deutsche Bank; Goldman Sachs; HSBC; J.P.Morgan; Kas Bank; Morgan Stanley; Nomura; Nordea; Northern Trust; RBS; Société Générale; UBS; UniCredit.

AFME's position in this note considers the version of CSDR agreed on by the ECON Committee of the European Parliament in February 2013 as well as the latest compromise text of the Lithuanian Presidency dated 18 July 2013.

The ECON Committee of the European Parliament and the deliberations in Council to date indicate a general consensus that would enable (I)CSDs to provide banking type of ancillary services within the same legal entity (co-existence of the 1+2 and 2+2 models). In its previous position, AFME advocated the separation of the provision of CSD core and related services from ancillary banking services in different legal entities; we attach the respective position paper for information (Annex 1).

AFME's considerations and position on key issues

Intended settlement dates (Art 5)

- **Considerations**

- As outlined in AFME's paper 'Impacts of implementation of T+2' of 23 May 2013 (attached, Annex 2), AFME is fully supportive of the implementation of T+2 as the shortened settlement cycle of T+2 will contribute to increased efficiency and reduced risk in post trade.
- Where feasible, particularly on regulated markets for cash equities, settlement cycles should be harmonised, currently at T+2.
- However, a rigid T+2 cycle does not fit all asset classes or certain specific types of transactions, such as repos, or stock loans, including regulated markets for such specific types of transactions. More generally, it is important to point out that flexible settlement dates are used as a key tool to manage risk in these markets.
- The possibility for counterparties to bilaterally agree upon a different settlement cycle would provide for this flexibility, without unduly creating additional risks.

- **AFME's position**

- For trades in transferable securities, executed in a regulated market or a similar trading venue (e.g. MTF, OTF), the intended settlement date should be no later than T+2;
- For trades bilaterally agreed between the counterparties outside of a regulated market or similar trading place (i.e. in the OTC space), the counterparties should have the flexibility to agree on a different settlement period; if no agreement is reached, the default cycle should be the same as the lifecycle on the regulated market / trading venue where the same instrument is traded;

Measures to prevent settlement fails (Art 6)

- **Considerations**

- In order to minimise the risk of settlement failure and ensure the counterparty risk is reduced, the trade economics need to be matched and affirmed at the earliest point in the trade lifecycle by both parties of the transaction, i.e. including clients.
- The European Parliament's proposed text covers these requirements.

- **AFME's position**

- Both brokers and clients should match/affirm transactions electronically on trade date.

Measures to address settlement fails (Art 7)

- **Considerations**

- The statement whereas '*settlement failure is always a deliberate and voluntary action by the failing counterpart*' is not reflective of the way financial markets work in practice. Rather, financial institutions have a large and vested interest to have an efficient settlement process with as few fails as possible.

- Settlement efficiency rates in Europe are very high, approximately 98% according to an ECSDA survey.
- The proposed buy-in regime, guided by the 'one size fits all' principle will likely have the unintended consequences of increasing the volume of fails and making less liquid markets even less liquid and it does not reflect market practice in certain types of transactions, e.g. repos.
- CSDs and CSD participants may well have no contractual relationship with the underlying trading parties. Accordingly, it may not be adequate to impose obligations on them to enforce buy-ins. Buy-ins can only be enforced by exchanges, CCPs and underlying buyers. Therefore we are not in favour of mandatory buy-ins as this could penalise CSD participants who act on behalf of underlying clients.
- Any settlement discipline regime should not hamper the core requirement that a settlement system provide safe and efficient settlement.
- In today's markets, many settlements happen in transaction chains. This is not only the case on regulated markets, where CCPs stand between buyers and sellers, but also for bilateral transactions. Any regulation should consider the unintended effect of enforcing multiple buy-ins across all parts of the transaction chain, which would drive up costs and reduce liquidity. In this respect we would advocate that buy-ins are only enforced at the start of the transaction chain, and that CCPs, who are an integral part of such chains, are not exempt from the buy-in provisions.

- **AFME's position**

AFME takes the view that

- buy-ins should not occur until at least 4 days after intended settlement date, and potentially longer for less liquid instruments and for certain types of transactions, e.g. repos (as defined by ESMA);
- buy-ins should be made at the request of the receiving CCP or trading system participant, or at the request of the underlying buyer, i.e. not be made mandatory and not be automatically executed by financial market infrastructures;
- the drafting of detailed rules (including conflict of law rules in the context of close-out netting arrangements) should be assigned to ESMA to ensure that the detailed settlement measures are compatible with an efficient and safe settlement process.

Protection of participants' and investors' securities (Art 35)

- **Considerations**

- CSDR regulates CSDs, not their participants. Provisions regarding segregation should follow this principle too and therefore exclusively relate to CSDs.
- Provisions on commercial terms and legal implications, if any, should be delegated to ESMA.

- **AFME's position**

- Provisions regarding segregation should relate to CSDs only, not to their participants, except for the segregation between participant's own securities and securities of clients.

Cash settlement (Art 37)

- **Considerations**

- The priority of settlement in Central Bank Money is one of the CPSS-IOSCO Principles.
- At European level the terms 'practical and available' need to be defined.

- **AFME's position**

- ESMA should determine the cases and criteria when settlement in Central Bank Money is not practical and available.

Capital requirements (Art 44)

- **Considerations**

- In the current versions of the EP and Council no distinction is made between CSDs with or without the additional authorisation to provide banking type of ancillary services

- **AFME's position**

- The capital requirements in Art 44 should only apply to CSDs that do *not* provide banking type of ancillary services; capital requirements for CSDs that provide banking type of ancillary services should be determined by banking regulation.

Freedom to issue in a CSD authorised in the EU (Art 47)

- **Considerations**

- To eliminate Giovannini Barrier 9, Recommendation 15 of the Legal Certainty Group should be considered.
- A commingling of substantive law – the law under which the securities are constituted – and aspects of conflict of laws is undesirable.

- **AFME's position**

- The freedom to issue in any CSD in the EU should not be subject to legal requirements other than the law continuing to apply under which the securities are constituted.

Provision of banking type ancillary services (Art 52, 53 and 57)

- **Considerations**

- The ECON Committee of the European Parliament and the deliberations in Council to date indicate a general consensus that would enable (I)CSDs to provide banking type of ancillary services within the same legal entity (co-existence of the 1+2 and 2+2 models).
- The current LT Presidency compromise text provides for essentially the same authorisation criteria for both the 1+2 and the 2+2 models. The terms and conditions for a designated credit institution (limited purpose bank) under the 2+2 model appear highly unattractive and it is therefore unlikely that this model will come into effect at all. This in turn would not

be suited to the notion of level playing field and increased competition for the benefit of participants.

- **AFME's position**

- In our view, designated credit institutions under the 2+2 model should be subject to banking authorisation, regulation and supervision and should be out of scope of CSDR.
- As a consequence, the prudential requirements of Art 57 should exclusively apply to (I)CSDs under the 1+2 model.
- The issue of unhindered and timely access to unencumbered securities held in a securities account with a (I)CSD under the 1+2 model in a crisis remains unresolved as Art 52 appears too vague. This issue should either be resolved through a respective expansion of Art 52 , i.e. continuity of critical services, or through respective rules in a recovery and resolution regime¹ to which (I)CSDs under the 1+2 model would be subject.

Administrative sanctions and measures (Art 59)

- **Considerations**

- Market users cannot recognise plausible reasons why market infrastructures should be excluded from being liable for losses caused by negligence or intentional failure.

- **AFME's position**

- CSDs should be liable for the loss of a financial instrument caused by the CSD's negligence or intentional failure.

Reports and reviews (Art 69)

- **AFME's position**

- Reports and review should reflect the finally adopted version, in particular regarding Art 7, 52, 53 and 57.

Implementation (Art 70)

- **AFME's position**

- The timing for securities dematerialisation (Art 70) should be considerably shortened (e.g 2020).

¹ AFME will provide a position paper shortly, setting out our views on recovery and resolution for financial market infrastructures including CSDs.

AFME contacts

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