Association for Financial Markets in Europe

AFME's response to ESMA's request for Technical Advice in relation to the CSDR

19 February 2015

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the **"Technical Advice under the CSDR"** that was 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 Advice 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 Paper published by the European Securities and Markets Authority (ESMA).

On the 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to confidently make a two way price, knowing that if they sell short to facilitate a customer, lenders will not have withdrawn in case they are levied a fine for non delivery.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.

In a separate Consultation Paper relating 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.

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 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.

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[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.

Q1: What are your views on the proposed basis for the cash penalty calculation?

AFME believes that a reference price is the best method of taking into account the objectives of the penalty system. It is likely to produce the most fair and effective results where a chain of transactions is involved and parties in the middle of the chain are liable to pay and to collect the penalties.

The population and distribution of this reference price should be daily and unique. The issuer CSD of the instrument appears to be most likely to determine the price although we recognise that this will be challenging. If multiple reference prices are determined, the process is unlikely to be successful. A unique price per day per designated entity will be essential for the cash penalty calculation methodology to succeed in a chain transaction.

We believe that ESMA should ensure that the following information be publicly available:

- 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.
- the penalty rate to be applied for a specific ISIN

Q2: What are your views on the proposed approach regarding the categories of financial instruments and the penalty rates? In particular, do you consider that these penalty rates could dis-incentivise trading in small caps? Please provide evidence to support your views.

AFME does not believe that ESMA's proposed categories are appropriate. We believe that the proposal fails to adequately account for SME and illiquid securities as required under the Level 1. This will adversely impact the liquidity of these securities which is counter to the Level 1 text which seeks to incentivise good behaviour without damaging the market in theses less liquid securities.

AFME would support a differentiation in the penalty rates (as outlined below) rather than an extension for buy-in periods.

Potential impact

ECSDA recently conducted a survey of their members to gauge the impact of the current failing trades to estimate the cash penalties.

In 2013, the 30 ECSDA members that are established in the EU collectively processed around 350 million delivery instructions. In terms of value, these delivery instructions represented close to EUR 1.1 quadrillion. Despite generally high settlement efficiency rates across EU CSDs, the volume and value of instructions at stake means that the impact of the settlement discipline regime is likely to be substantial.

According to November 2014 data, the accumulated gross late settlement penalties to be collected by the 17 CSDs would have amounted to over EUR 183 million or around EUR 9 million a day. Assuming that the month of November is representative, this translates into yearly 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%). However, when excluding them, the remaining CSDs would on average still each account for more than EUR 3 million per month. Among these CSDs, figures range between very close to 0 and EUR 15 million per month, and only 5 CSDs would have collected less than EUR 100,000 worth of penalties.

The impact on the market of the number of penalties will be dramatic. For this reason alone, we would urge ESMA to allow for a phase in period during which cash penalties are calculated/published but not charged. This will allow the market to adapt to the new measures.

AFME believes that trading and settlement of liquid and illiquid securities is not comparable. Whilst liquid shares are traded frequently and in reasonable size, this is not the case for illiquid and SME Growth stocks which may not trade on every day. The lack of liquidity at trading level is also reflected by an inability to borrow securities.

Whilst ESMA recognises the challenges of buying in these securities by proposing longer buy in and extension regimes (up to 7 and 15 days respectively), the design of the penalty regimes does not recognise these differences. It is unlikely that market makers, on whom the market depends for pricing of these securities, would continue to quote in anything but the most liquid equities and bonds for fear of being charged for long periods at rates varying from 0.25 to 1.0 bps per day.

There could be greater definition and varying rates for less liquid securities in the design of the penalty mechanism.

AFME believes that a more appropriate categorisation regime would be:

Equities

- Liquid Shares:
- Less Liquid Shares:
- SME Shares

Fixed Income

- Government bonds
- Corporate and other bonds (e.g. municipal)

Other

- DR's, ETF, Certificates
- Cash

Of equal importance to the design on the penalty regime is the daily penalty rate. AFME recommends that an escalating scale be employed, with SME and less liquid securities and shares at the lower end of the scale, the overall effect being the same total cost for any security that runs to buy in. AFME proposes the following rates should be considered:

Liquid Shares:	**1.0bp**
Less Liquid Shares:	**0.5bp**
SME's Shares:	**0.25bp**
Government bonds:	**0.25bp**
Corporate & other bonds:	**0.5bp**
Cash:	**Discount rate per currency**

AFME does not believe that the penalty rates should be aligned with MiFID 2. Our MiFID2 analysis shows many securities have been classed as liquid (for reporting purposes) that would be considered as illiquid for trading purposes. AFME would welcome a review of this approach.

We recognise that the growth of both the covered bond and corporate bond market is essential to growth initiatives such as CMU and the health of the current bonds markets, particularly in Scandinavia.

- The covered bonds market is very robust in Scandinavia as it is the cornerstone of the Scandinavian real estate market. Fails rates are therefore very low. We therefore view a 0,5bp penalty rate as excessive and are of the opinion that covered bonds should carry the same penalty rate as government bonds.
- With regards to corporate bonds, we feel that this categorization is too broad given the nature and diversity seen in the corporate bonds markets in Europe. We would therefore welcome further investigation by ESMA of the possibility to differentiate between investment grade corporate bonds and non-investment grade corporate bonds.

AFME would strongly support a phased implementation of the fines with an initial period of reporting without charging to allow the market to adjust and recognise the potential impact.

A mechanism to periodically review the penalty rates should be established to ensure that they have the desired effect of penalising failing parties, without lending activity being negatively impacted by the size of the penalty.

Q3: What are your views on the proposed approach regarding the increase and reduction of the basic penalty amount?

AFME is broadly supportive of the general approach. Participants require a reliable system of penalties.

Moreover a decreased / increase settlement penalty could lead to imbalances within the settlement system and would hence be difficult to be reconciled. Should a CSD have to balance those “imbalances” it might be taking on risk that is not justified.

Also it should be noted that insufficient settlement efficiency is clearly an item for discussion between trading participants as the subsequent costs will be addressed and should lead to improved settlement efficiency.

Further AFME members welcome the opportunity to exempt certain transactions from a settlement penalty. AFME believes that penalties should not apply to transactions subject to buyer protection and where the instruction is place on hold. The pending instruction subject to buyer protection will eventually be cancelled by the CSDs/CCPs and converted into one or more new instructions by the CSD/CCP as per the EU corporate action standards).

In order to ease the process and calculations for CSDs we believe that exemptions for not charging should be defined by a general, harmonised approach rather than case-by-case issues. It should not be less expensive to fail on one CSD than any other.

This general approach should include the reason codes and cater for situations where the CSD participant is not in control of the settlement of the transaction. e.g. if an account is blocked / security suspended / corporate action processing.

ISO offers a number of reason-codes for why a transaction has not settled. In the view of AFME only those codes relating to a lack of Cash or Securities as well as an instruction placed on hold by the Participant should be considered for a penalty.

Q4: What are your views on the proposed approach regarding the cash penalties in the context of chains of interdependent transactions?

AFME broadly supports the proposed approach. The charge should be redistributed. Which entity should be responsible for the (re)distribution of penalties is less clear. A participant may incur both operational and (potentially) tax issues. Therefore AFME proposes that CSD participants would be best placed to analyse their underlying clients and the potential to pass a penalty through the custody chain.

The potential for regulatory arbitrage (where participants migrate to the “cheapest” CSD), could provoke instability in the system.