Position Paper

Review of the CSDR – Delivering settlement discipline and supporting liquid and well-functioning European capital markets

February 2021

Executive Summary

1) **The introduction of mandatory buy-ins presents a significant risk to Europe's recovery from the Covid-19 crisis and will likely disproportionately impact on SMEs and less liquid securities.** Mandatory buy-ins for non-centrally cleared transactions will lead to higher issuance costs and reduced access of issuers to primary markets, and to increased costs, reduced liquidity and reduced investment returns for investors. The periods of high volatility and low liquidity observed during Covid-19 crisis would have been further exacerbated by the existence of a mandatory buy-in regime.

2) **AFME supports the introduction of settlement discipline measures, but not a mandatory buy-in requirement.** Rules requiring CSDs to facilitate partial settlement and "hold and release", new requirements for trade confirmation and allocation, and a penalty mechanism applied to failed trades, will all contribute towards improving market settlement efficiency. AFME supports this objective.

3) **The mandatory buy-in regime is a disproportionate measure to address settlement fails**. The purpose of the mandatory buy-in is to ensure remediation of the small percentage of trades that continue to fail for multiple business days. The impact of the mandatory buy-in regime will be wider spreads and less liquidity, meaning more expensive and less efficient capital markets for Europe's issuers and investors. The negative effect is clearly disproportionate to the problem the mandatory buy-in is trying to fix – especially at a crucial period in Europe's economic recovery from Covid-19.

4) **The buy-in should be a discretionary right of the receiving party, not a mandatory obligation.** This provides sufficient protection to the buyer without enforcing an action that may be against its economic or commercial interests. A discretionary buy-in regime will mean the buy-in is only used in cases where it is necessary and effective and will avoid significantly damaging market liquidity.

5) **The scope of the settlement discipline regime and details of its operational process should be further clarified and refined**. AFME has proposed a number of amendments to the legislative text as part of our CSDR review consultation response, available **here**. It is important that the settlement discipline regime is workable in practice and effective in achieving its goals at the moment it goes live.

6) **The industry needs urgent clarification on the implementation timeline of a reviewed settlement discipline regime.** Significant amendments to the legislation are necessary, but the current implementation date of February 2022 doesn't allow sufficient time for these changes to be passed into law and incorporated into industry participants' development projects. AFME supports a phased approach, with penalties and other measures introduced in February 2022 and revised buy-in rules deferred to a later date. There are two principal advantages to this sequencing:

   - Penalties and other measures can take effect, and their impact monitored and assessed by the authorities.
   - If there are to be significant amendments to the current buy-in rules, additional time will be required by all industry participants to adjust accordingly. It is impractical and inefficient for the industry to prepare for implementation based on the existing requirements.

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Recalibrating the settlement discipline regime

The Covid-19 crisis and current economic environment

There is a renewed urgency to reinvigorate Europe's economy and promote greater access to market-based financing for European corporates. AFME and PwC have estimated that Europe needs to bridge a gap of *€450-600bn* in equity needed to prevent widespread business defaults and job losses as COVID-19 state support measures are gradually reduced[1]. Capital markets instruments must play an increasing role to enable European businesses to recover from the economic crisis and invest in their long-term growth.

The introduction of the CSDR mandatory buy-in requirement, as currently designed and due to apply in February 2022, will be harmful to Europe's economic recovery and the ambitions of the Capital Markets Union. The mandatory buy-in regime creates an additional cost and risk for European-settled securities that disadvantages European companies against their global peers. Wider spreads and less liquidity will reduce the investment returns of pension funds, asset managers and, ultimately, end investors, which risks driving issuance, trading and investment activity outside of the EU. A reduction in liquidity will translate to higher costs, and reduced market access for European companies seeking access to market-based finance. Importantly, these impacts will disproportionately impact the trading and issuance of less liquid securities which are routinely issued by smaller companies.

AFME has produced analysis[2] discussing how European capital markets have been impacted by the Covid-19 crisis and what lessons can be learned if the mandatory buy-in regime would have been in place during periods of market stress in 2020. Against the backdrop of Covid-19, it becomes clear that if the CSDR buy-in regime exists at the same time as a period of extreme market disruption, there is likely to be a compounding and self-reinforcing negative effect on liquidity.

The buy-in should be a discretionary right not a mandatory obligation

We strongly believe that the decision to initiate a buy-in should be the discretionary right, not the mandatory obligation, of the purchasing party. This should apply to transactions which do not involve a CCP. For cleared transactions, we believe that existing CCP mandatory buy-in rules should remain in place.

AFME shares the objective of the CSDR Settlement Discipline Regime to increase settlement efficiency. We welcome new measures relating to allocation and confirmation procedures, enhancements to CSD functionality, and the introduction of a penalty mechanism. AFME strongly believes that these initiatives alone will deliver an improvement to current settlement rates.

Further, we support the supplementation of these measures with a discretionary buy-in mechanism, which enshrines into EU law the discretionary right of the purchasing party to initiate a buy-in on a failed transaction, and sets out a high-level, harmonised framework for this process. There are three principal advantages of this approach, discussed below.

<u>Empowerment for the Buyer</u>

At its core, the mandatory buy-in regime as currently drafted places the burden of regulatory compliance on the injured party, the buyer. It removes the ability for the buyer to decide when and whether to force delivery and could even force it to act against its own economic interests.

For example, CSDR mandates that if the securities cannot be sourced by the buy-in agent, the original transaction is replaced by cash compensation, and the purchaser never receives the contractually agreed securities. The purchaser may wish to allow the seller additional time to make delivery, rather than accept cash compensation which does not allow the buyer to achieve its investment objectives.

[1] AFME-PwC report "Recapitalising EU businesses post Covid-19", January 2021. Available here.
[2] AFME paper "Optional buy-ins under CSDR – Delivering settlement discipline without prohibiting capital access for European corporates", July 2020. Available **here**.

Market Liquidity

In order to maintain liquidity across a wide spectrum of asset classes and execution sizes, and particularly across less liquid instruments, markets rely heavily on the liquidity provided by market-makers, who, in the absence of continuous, two-way, order-based prices, will provide bid-offer quotes to support the provision of immediate liquidity.

To provide continuous bid-offer quotes and market liquidity to buyers and sellers, it is necessary that dealers make markets in securities that they do not immediately hold in their inventory, by running a temporary short position to meet investor needs. As such, making offers without having the inventory at the point of trading represent a significant percentage, sometimes above 20%, of orders executed on fixed income credit trading desks, especially for less liquid instruments.

The introduction of a mandatory penalty and buy-in regime under CSDR removes the flexibility for market makers to offer prices without having the inventory. It is therefore an important consideration for a trader when determining whether to make a market in a particular security and at what price. For securities not held in inventory, or which cannot be readily sourced, the trader may understandably choose to increase the offer price to offset the potential cost of a buy-in, or in extreme cases not to offer a price at all. The impact of this could be the removal of liquidity from the market. This will disproportionately impact those sectors which already suffer from lower liquidity and higher costs of trading, including SME securities.

In relative terms, the buy-in regime targets a small proportion of the total volume of transactions but will necessitate an impact on the pricing and liquidity on a much larger percentage of overall transactions[3]. Allowing the purchasing party discretion to initiate a buy-in only when it is commercially and economically rational to do so would reduce the frequency of buy-ins and therefore reduce the impact on pricing and liquidity, whilst allowing market makers to maintain liquid markets and protecting end investors and companies.

Flexibility

Our proposal for a discretionary buy-in based on high-level principles set out in regulation, reduces the burden on regulatory authorities and creates greater flexibility for market-driven solutions. The prescriptive nature of current Level 1 and Level 2 regulation significantly constrains the industry's ability to develop practicable and effective market practices.

A simplification of the regulation, and the removal of the mandatory nature of the buy-in regime, would resolve many issues. For example, removing the obligation to initiate a buy-in on a particular date provides greater flexibility for trading parties to coordinate their actions to minimise the number of buy-ins taking place. The need for a precise and prescriptive scope for the buy-in regime is somewhat alleviated by a discretionary buy-in.

The scope of the buy-in regime and the exemptions applicable should be refined and clarified

AFME recommends that the buy-in provisions are modified to conclude with the legal and factual reality that custodians and settlement agents act solely on their client's instructions and are not parties to a trade. Any liability and non-payment of buy-in costs should sit solely with the delivering trading party. A buy-in is a trading event which can only be addressed by the trading parties and not by the settlement agents and custodians in the chain who are not principal to the trade.

Further to this, provisions relating to contractual arrangements and procedures, such as Article 25 of the RTS, should be amended to make clear that the trading parties responsible for the buy-in process (not custodians or settlement agents) are required to establish contractual arrangements with their counterparties to incorporate the buy-in process.

[3] Data shows that whilst the majority of targeted settlement fails are resolved before the end of the notional extension period that would apply under CSDR, those that remain outstanding are typically corporate bonds. Approximately 1.5% of corporate bonds in Euroclear Bank were still unsettled at ISD+7. These outstanding fails will therefore most likely be in less liquid instruments (in terms of trading liquidity, as expressed in bid-offer spreads), increasing the probability that the buy-in will not be successful due to an inability to source the necessary securities.

With respect to transaction types, as a general principle, transactions which can be deemed a 'trade' between a buyer and a seller but where a buy-in would serve no economic purpose or would not contribute towards improving the efficiency of securities settlement, should be removed from the scope of the buy-in regime. More generally, the text of the CSDR and the RTS need to be updated in key parts to reflect that they concern trades instead of settlements.

For products or transaction flows for which there are existing contractual mechanisms that achieve the same objective as a buy-in (i.e. provide a remedy/resolution to a settlement fail) an additional requirement to incorporate CSDR buy-in provisions into contracts would not serve any purpose or contribute the objectives of the Settlement Discipline Regime.

We strongly support a discretionary buy-in framework, in which the receiving trading party is not mandated to initiate a buy-in, on the basis that this would allow the buyer the flexibility to choose the appropriate "tool for the job". To explicitly remove certain products or transaction flows from the scope of CSDR buy-in rules would prevent unnecessary contractual repapering exercises and allow the industry to focus on products and transaction flows where the buy-in regime will be utilised.

A pass on mechanism should be introduced

The regulation should be updated to explicitly provide that the recipient of a buy-in notice should be permitted to:

- Pass-on a buy-in notice (and the consequences) to a counterparty with which it has an in-scope failing receipt.
- Reject a buy-in notice on the basis that a buy-in has already been initiated in the settlement chain or will be initiated by a CCP.
- Pass-on the result of a buy-in to a counterparty with which it has an in-scope failing delivery. This pass-on should be considered as equivalent to and complying with the regulatory obligation to execute a buy-in against the failing delivering party. This is intended to reduce the number of buy-ins required to remedy settlement fails, particularly where multiple settlements are contingent on a single (failing) settlement.

An effective pass-on mechanism is important to support market efficiency and stability. This is also consistent with buy-in practice and pass-on mechanisms widely used in the European securities markets today.

Furthermore, this should be accompanied by an amendment to the regulatory text to remove the current payment 'asymmetry'. The buy-in process should act as a mechanism to remediate a failing trade and restore all parties to the same economic position had the trade not failed. The establishment of symmetric payments of price differentials is essential to a workable pass-on mechanism and reduces market risk for all parties. This should be applicable for both the payment of the price difference (Art. 35 of the RTS) and the calculation of the cash compensation (Art. 32 of the RTS).

The requirement to appoint a buy-in agent should be removed

We recommend that the mandatory obligation to appoint a third-party buy-in agent is removed. Level 1 provisions should be amended to allow the receiving party to execute the buy-in themselves, supported by high-level principles to ensure fair and transparent treatment of both trading parties (i.e., best-execution, committed delivery, communication, and reporting).

The current rule places the regulatory and operational burden on the buyer, who is the injured party. The burden on smaller trading counterparties themselves is particularly onerous: those who do not have significant failed deliveries – who are more likely to be receiving counterparties – will be disproportionately affected.

The penalty rates should be the primary tool for improving settlement efficiency

We believe that it is necessary to include within the regulation an appropriate mechanism for dynamic recalibration of penalty rates to ensure appropriate incentives. We consider the penalty mechanism the primary tool that regulators and policymakers can utilise to achieve the policy objectives of the settlement discipline regime.

Firstly, it is necessary to ensure there is a suitable framework to measure the effect of penalties on settlement efficiency. We recommend the introduction of a mandate for ESMA to set target settlement efficiency rates, appropriately calibrated for each instrument type based on its liquidity. It should be understood that 100% settlement efficiency is not always an achievable objective. This is especially relevant for instruments which are inherently less liquid, for which, at the point of trade, the seller may not have the inventory, but is prepared to make an offer price to the buyer.

Appropriate cash penalties will serve as an adequate tool to improve settlement efficiency on a standalone basis, as they will penalise sellers while compensating buyers for late delivery. The penalty rates should be set at the right level, and with a view on the target settlement efficiency rates the regulators intend to achieve, which should be publicly defined.

If target rates are not reached, regulators can consider an adjustment to penalty rates, thereby providing a flexible yet effective tool to reach the objectives of CSDR, while avoiding the very negative consequences of mandatory buy-ins. We note that there should be a transparent framework for the recalibration of penalties rates, allowing sufficient time for market participants to prepare for any changes.

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