AFME Response to European Commission CSDR Refit Proposals

26 May 2022

1. Opening Remarks

AFME welcomes that the European Commission proposes that Mandatory Buy-ins (MBI) will not be immediately implemented. As acknowledged in the Commission's impact assessment, the **implementation of a MBI Regime could have a disproportionately negative impact on the liquidity and competitiveness of EU capital markets**.

We note that the Refit proposals address several of the open questions and concerns raised by AFME and other industry participants, and we welcome this intention.

However, AFME continues to believe that other policy tools are more appropriate for achieving the shared objective of improving settlement efficiency. AFME is supportive of other measures, both regulatory and industry-driven, targeted at **prevention of settlement fails**. We note that this is a growing area of focus for both individual organisations and across industry forums. From a regulatory perspective, we specifically support further measures to **improve and harmonise CSD functionality**.

If the above actions do not result in a sufficient reduction in settlement fails, then **penalty rates should be recalibrated** accordingly.

If MBI provisions are to remain part of the Settlement Discipline Regime, the application of MBI should be as targeted as possible and considered only as a last resort, after other policy options have been exhausted. AFME believes considerable revision to Level 1 and Level 2 MBI provisions is necessary.

2. High-level Reaction to Proposals

2.1. Proposed amendments to Cash Penalties

We are generally supportive of measures to refine the scope of the cash penalties regime. A key principle of the penalties mechanism should be that market participants do not suffer economic loss for settlement fails outside of their control.

In this respect, we welcome the proposed amendment to Article 7.2 to remove from scope "settlement fails…caused by factors not attributable to the participants to the transaction".

We note that any refinement must be workable for CSDs based on the information that is populated on the settlement instruction. Application of the penalties rules must be consistent across all in-scope CSDs and apply to both credits and debits.

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2.2. Proposed scope of Settlement Discipline Regime

AFME welcomes the objective to narrow the scope of transactions subject to both penalties and mandatory buy-ins (should they become applicable). However, we consider that penalties and buy-ins should each have their own scope of application, rather than being identical. It is important that 'Level 1' CSDR officially considers this, with the specific details to be determined in 'Level 2' Regulatory Technical Standards (RTS).

AFME considers that the proposal to exempt transactions that do not involve "two trading parties" to be inappropriate for penalties, and may not fully capture all necessary exemptions for mandatory buy-ins. There are further examples of transactions concluded between two "trading parties" (with a caveat on the definition of "trading party", see below) for which a buy-in would serve no economic purpose or would not contribute towards improving the efficiency of securities settlement (for example: subscription/redemption, voluntary corporate actions, margin/collateral movements the buy-in itself).

2.3. The definition of trading parties

As the CSDR Refit proposals introduce the term 'trading party'[1], which was previously defined in the RTS. AFME recommends therefore that the definition of 'trading party' is incorporated into CSDR Level 1, and that it is used consistently throughout the mandatory buy-in provisions (instead of using the notion of "participants").

Moreover, this definition should not be the one currently in the RTS, which corresponds solely to pure OTC transactions, that are neither cleared nor executed on a Trading Venue.

Any definition should ensure that retail investors are not defined as trading party.

2.4. Proposed conditional application of Mandatory Buy-ins

We are supportive in principle that the mandatory buy-in (MBI) rules will not be immediately introduced. We continue to believe that MBIs are not an appropriate or proportionate tool for delivering settlement efficiency objectives.

As noted in the European Commission's Impact Assessment[2], the costs of applying the MBI rules "could outweigh their benefits" and "give rise to unintended consequences for the competitiveness of the EU capital markets".

We strongly recommend that, prior to any consideration of a mandatory buy-in regime, should any of the conditions of Article 7.2(a) be met, the Commission should in the first instance pursue other more appropriate measures to improve settlement efficiency.

This could include regulatory requirements for the facilitation and usage of partial settlement functionalities, or targeted amendments to trading level requirements, such as the SSR

Further consideration should be given to a recalibration of the penalty rates for specific asset classes as an intermediate step to be taken before the introduction of MBIs.

[1] See Articles 7.2, 7.4(d), 7.14(a)

[2] https://ec.europa.eu/finance/docs/law/220316-csdr-review-impact-assessment_en.pdf

We also recommend that the conditions of Article 7.2(a) should be considered cumulatively – i.e. all three conditions should be met before the application of MBI provisions. We note that the proposed objective of a "long-term ***continuous*** reduction" in settlement fails could imply an ultimate aspiration for a zero-fail environment. AFME does not consider this a realistic outcome and therefore welcomes clarification on this point.

Should it be determined to retain a mandatory buy-in provision in CSDR, we encourage further clarity on the process by which it will be determined if the conditions of Article 7.2(a) have been met, and the sequential next steps in such scenarios. There are a number of key open questions, which are explored further in Sections 4.1 and 4.2.

AFME requests clarification that requirements for contractual incorporation of MBI provisions would only be applicable in the event that MBIs are reintroduced through a separate delegated act. We recommend that CSDR sets out an appropriate transition period between adoption of the delegated act and enforcement of MBIs, to allow sufficient time for legal, technical and operational preparation.

2.5. Proposed amendments to MBI rules

Notwithstanding our abovementioned views on the appropriateness of mandatory buy-ins as a settlement discipline tool, we are supportive of the European Commission's aspiration to improve the functioning of the MBI process itself.

We believe that the targeted amendments proposed in the CSDR Refit go some way to achieving this objective. However, AFME strongly believes that further, more substantive amendments to CSDR and a full revision to the accompanying RTS is required, and for responses to the outstanding industry Q&As to be incorporated to the regulation as appropriate.

As a general principle, we believe that the 'Level 1' CSDR text should be simplified, and that more granular details on the actual mechanics of the buy-in process (e.g. extension periods, exemptions, pass-on mechanisms) should be defined in the 'Level 2' RTS.

2.6. Provision of Banking-type Ancillary Services

AFME does not support the proposal to allow CSDs authorised to provide banking-type ancillary services to provide such services to CSDs that have not obtained this authorisation. We recommend that the proposed amendments to Article 54 of CSDR are removed.

We believe that the CSDs' critical role as central market infrastructures for core functions should remain adequately protected from any additional risks, such as credit risks or market risks, that are normally associated with the provision of banking services.

Increasing the interdependency of CSDs would increase contagion risk, and could negatively impact market stability, in particular in times of market stress. This increases risks for all types of institution with a direct or indirect connection to the CSD – not only settlement participants, but also issuers and by extension, investors, regardless of their domicile.

We note that in its July 2021 report on the provision of Banking-type Ancillary services of July 2021[3], ESMA noted that "at this stage there does not seem to be a need for more flexibility around the definition of banking-type ancillary services that can be provided by CSDs" and that "the potential additional risks for the core CSD

[3] https://www.esma.europa.eu/sites/default/files/library/esma70-156-4582_report_to_the_ec_-_csdr_banking_services.pdf

activity that these services might bring should be carefully considered" (see para 44). AFME strongly agrees with these statements.

Capital requirements applicable to any financial institution must be applicable to the activities that the financial institution conducts. Should a CSD expand the scope of the services it provides, this should be reflected in the applicable capital requirements, which should necessarily aim at maintaining a high degree of reliability and safety of the CSD, for the benefit of all direct and indirect users of its services.

Further to this, we question whether a policy measure that increases CSDs' access to commercial bank money would be consistent with the broader principle of encouraging settlement in central bank money wherever possible. We consider that priority attention should be given to the simplification of procedures for CSDs to access central bank money in the required foreign currencies (or alternatively the definition of less stringent requirements for CSDs without a banking license to provide settlements in foreign currencies), rather than to a riskier relaxation of rules for commercial bank money services.

With regards to the proposals for more flexibility in the provision of banking services by commercial banks, we would certainly welcome the benefits that might derive from access to professional risk management and banking prudential discipline that are currently used in the banking sector. However, we would remain cautious about the objective complexities that might be encountered in the definition of appropriate thresholds, that would both suit the CSD needs and at the same time still guarantee a level playing field, as well as in the definition of ad-hoc new conditions and criteria for granting access to commercial bank money while at the same time maintaining supervisory convergence across NCAs.

Finally, with reference to the broadening of banking-type services in support of the development of innovative technologies, we believe that the current L1 and L2 rules already provide sufficient flexibility for CSDs to develop services based on innovative technologies. Furthermore, we would advise to avoid any duplication of rules between CSDR and the DLT Pilot Regime. In any case, it would be necessary to ensure that any such measures in CSDR should be specifically limited to the requirements in the DLT Pilot Regime legislation. Considering that this legislation is still in discussion, it is difficult to provide more detailed comments on how this could be achieved.

In principle, AFME does not oppose the proposed introduction of a mandate for the EBA to develop regulatory technical standards to determine the appropriate threshold below which banking-type services can be provided by credit institutions. However, we strongly encourage that broad stakeholder input is sought by the EBA in order to determine on what basis this determination should be made.

3. Specific Recommendations

3.1. Recommendations relating to prevention of settlement fails

a) Standardisation of CSD functionality

Article 12 of the RTS should be removed. This provides an exemption for certain CSDs from requirements to provide a 'hold and release' mechanism and to allow partial settlement.

Further to this, a new provision should be introduced, requiring CSDs to facilitate 'partial release' of settlement instructions. This functionality is currently offered by many, but not all, large EU CSDs, and is essential for maximising settlement opportunity for positions held in omnibus account structures. This is a particular limitation for buy-side market participants with respect to their transactions with the sell-side.

b) Measures to improve usage of CSD functionality

Further consideration should be given to introducing market standards for receiving parties to accept partial deliveries offered by the delivering party, taking into consideration certain parameters. In such cases, the delivering party will be able to maximise its settlement obligation and help reduce risk in the settlement chain. AFME would welcome broad industry collaboration from all stakeholders, including supervisors, on developing appropriate principles, and detailed market standards, to fully utilise partial settlement functionality.

3.2. Recommendations relating to cash penalty provisions

a) Golden Source Database

AFME notes that many of the issues experienced by the industry in relation to the penalties regime are caused by data quality issues. Currently, reference data must be sourced from multiple locations, including three ESMA databases. This requires significant efforts by CSDs and T2S, and limits market participants' ability to effectively monitor and reconcile their exposure to penalties. We strongly support the introduction of a Level 1 mandate for ESMA to create and maintain a central 'golden source' database, containing all information necessary to calculate cash penalty amounts.

This should include: whether the instrument is in- or out-of-scope; instrument classification and applicable penalty rate; and daily reference price.

The lack of a common source of reference price data prevents CSDs' adherence to Recital 4 of Commission Delegated Regulation (EU) 2017/389 which states that the "same reference price should be used by CSDs on a given day for calculating cash penalties for settlement fails concerning identical financial instruments".

An alternative option for public provision of reference price data could be within the future Consolidated Tape, or within ESAP.

b) Penalty rates should be derived at instrument-level

AFME recommends that CSDR is amended to remove anomalies which result in different penalty rates applying to the same instrument, depending on trading location. Ensuring a consistent penalty rate applies to any individual security allows for greater simplification and transparency across market participants.

Specifically, the penalty rates referred to for "instruments traded on SME growth markets" should be applicable to any instrument that qualifies as an SME as per the MiFID II definition.

The current ESMA interpretation is that these penalty rates apply only to transactions executed on the SME venue, not any off-venue leg. Transactions executed on a market, even when cleared by a CCP, can still result in several settlement instructions before the securities reach the account of the end investor. Thus, limiting the dedicated penalty rate to market legs only creates significant market risk for an intermediary, such as a broker-dealer, with an offsetting failing buy (on SME-venue) and sell (off SME-venue). This also creates additional complexity for cleared transactions, as CCPs have to create separate netted instructions.

c) Scope of cash penalties

We welcome the proposed clarification to Article 7.2 of CSDR to exempt "settlement fails … caused by factors not attributable to the participants to the transaction" from the scope of the penalties regime.

A practical example of this would be the exclusion of CSD-generated instructions from 'late matching' penalties. Where the instruction is created by the CSD itself with a back-dated intended settlement date, it is clearly outside the control of the participants. Neither participant can be fairly penalised for the failure to settle on intended settlement date.

We recommend that this is clarified by amending the first paragraph of Article 16.3 of the RTS accordingly:

> Where a settlement instruction has been entered into the securities settlement system or has been matched after the intended settlement date, cash penalties shall be calculated and applied as from the intended settlement date. **If the settlement instruction was entered into the securities settlement system by the CSD, cash penalties shall be calculated and applied only once the settlement instruction is matched.**

The proposed amendment to Article 7.2 of CSDR also suggests exempting "operations that do not involve two trading parties" from the scope of the penalties mechanism. AFME agrees with the objective of exempting from the scope of penalties "certain transactions from the primary market, corporate actions, reorganisations, creation and redemption of fund units and realignments", as outlined in Recital 4.

However, "operations that do not involve two trading parties" could prove to be too broad. Cash penalties generally should apply to as many transaction types and should encourage timely settlement, regardless of the underlying nature of the settlement instruction.

Chains of failing instructions are likely to involve a combination of different types of transaction (e.g. an outright purchase/sale, plus a recall of borrowed securities, or an exercise/assignment.) Exempting certain failing instructions could undermine the immunisation principle outlined in ESMA's Final Report on CSDR Settlement Discipline[4] and result in scenarios where a party has a failing delivery in-scope of penalties, but the offsetting receipt is out-of-scope, resulting in an uncontrollable economic loss.

A broad descoping of settlement instructions relating to all "operations that do not involve two trading parties" could also be problematic for CSDs to determine from the information available on the settlement instruction, increasing the complexity of the requirements.

d) Provision to suspend the cash penalty regime

We welcome the addition of paragraph 13a which permits ESMA to recommend a suspension of paragraphs 3-8, however, a similar provision should be considered for cash penalties to protect against procyclicality and the operations of FMIs and participants who will be under pressure during market turmoil.

Further, there is no reference in CSDR or the RTS of any grounds to suspend the application of cash penalties in the event of a technical outage at the CSD. Any downtime in the CSD's operation will impede participants ability to settle transactions. A provision for a Delegated Act should be considered to address this.

[4] "whereby in case of chain of transactions, the penalty would be paid and collected so the entities suffering and causing the fail would net the two amounts"- https://www.esma.europa.eu/sites/default/files/library/2016-174_-_final_report_on_csdr_rts_on_settlement_discipline_0.pdf

e) CSDs' obligations

CSDR does currently not provide any requirement for or, by default, consequence for CSDs' operation of the cash penalty regime. For example, there is no concept of "finality" in the current provisions – i.e. by when the monthly cash penalty process must be considered as completed. This effectively leads to CSD participants having an 'open wallet' to the CSDs who can report late and levy cash penalties indefinitely. This undermines the integrity of the cash penalties process and creates undue operational and financial repercussions for all parties in the custody chain from CSD participants to end investors.

We therefore recommend the inclusion of a new article:

A CSD shall take appropriate measures to identify, calculate and report cash penalty calculations on a daily basis and to reconcile, report and distribute on a monthly basis. Finality of the cash penalty process should be achieved by the end of the following month.

f) Entity responsible for collection and redistribution of penalties

AFME proposes the removal of Article 19 of Level 2, to establish that CSDs are is responsible for collection and distribution of penalties relating to CCP-cleared transactions.

This could be prefaced by an amendment to the third paragraph of Article 7.2 of CSDR:

Cash penalties shall be calculated on a daily basis for each business day that a transaction fails to be settled after its intended settlement date until the end of a buy-in process referred to in paragraph 3, but no longer than the actual settlement day**. The cash penalties shall be collected and distributed by the CSD.** The cash penalties shall not be configured as a revenue source for the CSD.

3.3. Recommendations relating to mandatory buy-in provisions

a) Scope of MBI provisions

AFME is supportive of the proposed amendment to Article 7.4 to specify that in situations where a settlement fail is caused by factors not attributable to the participants to the transaction or where a transaction does not involve two trading parties, such settlement fail is not subject to the mandatory buy-in mechanism.

AFME would be supportive of explicit exemptions for certain transaction flows for which a mandatory buy-in obligation would not contribute towards the objective of improving settlement efficiency, and for which established contractual mechanisms already exist to protect the non-failing party in the case of a settlement fail.

Namely, AFME recommends that margin or collateral transfers and documented securities financing transactions are explicitly removed from the scope of mandatory buy-ins.

b) Extension Periods should be determined by instrument, in Level 2 provisions

The proposed amendment to Article 7.3 suggests that the extension period for SME-Growth Market transactions will be 15 calendar days.

We recommend firstly that Extension Periods should be determined in the Regulatory Technical Standards.

To ensure a consistent application of the buy-in process, we recommend that the extension period is defined by type of instrument rather than place of trading, and should be measured in ***business*** days rather than ***calendar*** days.

> Where the transaction relates to a financial instrument **for which the issuer qualifies as an SME as per Article 1.1(13)[5] of Directive 2014/65/EU**, the extension period shall be 15 **business** days ~~unless the SME growth market decides to apply a shorter period.~~

c) Include details of the pass-on mechanism in RTS

AFME welcomes the proposal from the European Commission to include a new Article 7.3(a), designed to enable intermediate receiving participants to pass-on the costs and obligations of a buy-in to their corresponding delivering participant, where applicable

We further welcome the introduction of symmetrical payments, guaranteeing that the economic positions of both participants are reflective of their positions had the original transaction settled. This represents a key precondition for a workable pass-on mechanism.

This approach should be extended to cash compensation also. We therefore propose an amendment to Article 7.7 of CSDR:

> If the buy-in fails or is not possible, the receiving participant can choose to be paid cash compensation or to defer the execution of the buy-in to an appropriate later date ('deferral period'). If the relevant financial instruments are not delivered to the receiving participant at the end of the deferral period, cash compensation shall be paid.
>
> ~~Cash compensation shall be paid to the receiving participant~~ **Where the price of the financial instruments agreed at the time of the trade is different from the price used to determine cash compensation, the corresponding difference shall be paid by the participant benefitting from such price difference to the other participant** no later than on the second business day after the end of either the buy-in process referred to in paragraph 3 or the deferral period, where the deferral period was chosen.

However, the proposed language, in both measures, places the obligation at the level of the participant rather than the trading party. The CSD participant is not always the party to the trade – see (d) below.

Directionally, the pass-on obligations are placed towards the 'end receiving participant', thus placing the burden on the investor rather than towards the failing delivering trading party.

Given the complexity, we believe that the details of such a pass-on mechanism would be better defined within the Level 2 provisions, following public consultation. It would be sufficient within the Level 1 text to state that a pass-on mechanism is permissible, to be further defined by delegated act.

[5] 'small and medium-sized enterprises' for the purposes of this Directive, means companies that had an average market capitalisation of less than EUR 200 000 000 on the basis of end-year quotes for the previous three calendar years;

d) Review use of term 'participant' in MBI provisions

As noted, the mandatory buy-in is a trading-level event, which the receiving trading party is obliged to initiate, and which the failing trading party is liable for the consequences thereof. As such, AFME believes it is critical that the CSDR Level 1 and accompanying RTS are amended to reflect this. The current text assigns responsibility for the contractual enforcement of the MBI to CSDs and CSD participants, imposing undue risks on intermediaries who are not responsible for the trading, and consequently buy-in, process.

We also recommend that Recital 12 of CSDR is revised to differentiate between a trading party who will be buying or selling financial instruments and a 'participant' who will be facilitating settlement:

In order to ensure the safety of settlement, **any participant in a securities settlement system** ~~buying or selling certain financial instruments~~, ……..should settle its obligation on the intended settlement date.

Further, we believe that only professional regulated entities should be required to initiate and manage buy-ins, which should take an upstream approach towards the party that has caused the fail (trading party or CCP) not downstream towards the investor. AFME recommends that the definition of 'trading party' is amended, so that 'retail client' as per point (11) of Article 4(1) of Directive 2014/65/EU, is out of scope of the definition 'trading party'.

e) Remove requirement for enforcement of mandatory buy-ins through CSD rulebook

In line with the above recommendation, Article 7.10(c) should also be amended to remove the obligation for CSDs to incorporate mandatory buy-in provisions into their internal rules. For transactions not cleared by a CCP nor executed on a trading venue, buy-in provisions (if applicable) should be incorporated by relevant trading parties in their respective terms of business. See suggested wording below.

For transactions not cleared by a CCP or executed on a trading venue, trading parties shall include in their terms of business (or equivalent client documentation) an obligation to apply the measures referred to in paragraphs 3 to 8.

AFME recommends that this is followed by an amendment or removal of Article 25 of the RTS, to clarify that a CSD participant is not required to amend its contracts to ensure the enforceability of mandatory buy-ins on its clients.

f) Clarification on contractual repapering requirements

AFME would welcome explicit clarification that financial market participants would only be required to contractually incorporate the mandatory buy-in provisions should an implementing act be published. In the absence of an implementing act, specifying the date of entry into force of MBI for specific asset classes or transaction types, there is no requirement to update contractual arrangements to incorporate MBI provisions.

We emphasise that an appropriate transition period should be incorporated into the regulation, to ensure that global market participants have sufficient time to prepare for the application of MBI rules.

g) Remove requirement to appoint a Buy-in Agent

CSDR should be amended to allow the receiving party to execute the buy-in themselves, without the obligation to engage a buy-in agent but rather selecting any adequate counterparty, 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. Those who do not have significant failed deliveries – who are more likely to be receiving counterparties, with lower trading volumes– will be disproportionately affected.

3.4. Recommendations relating to other aspects of Settlement Discipline

a) Suspension Rules

AFME proposes an amendment to Article 39 of Level 2, to clarify that a CSD participant will be subject to a suspension under Article 7(9) CSDR only where the CSD participant itself (as opposed to its clients) meets the criteria for failure to consistently and systemically deliver securities.

When the CSD participant is an intermediary in the settlement chain, it cannot influence the trading patterns of its clients and necessarily prevent settlement fails. Therefore, the CSD participant cannot be held responsible for settlement failures due its clients' trading or settlement practices.

We therefore recommend that accounts identified as 'client' accounts should be exempt from Article 7.9 and Article 39 of the RTS.

a) Exclude 3rd country instruments

AFME notes that Article 7.13 remains unchanged, whereby only shares have a third-country exemption when the principal venue is located in a third country. There is no similar exemption for any debt instruments. This creates an uneven application of the scope based on asset class, and creates additional complexities for cross-border fail chains in third-country instruments which could unduly penalise European investors who are transacting across jurisdiction.

As a principle, only debt and equity instruments issued in the EU itself should be in scope of an EU regime and only settlement instructions to or from EU (I)CSDs should be in scope of the SDR.

3.5. Recommendations relating to other aspects of CSDR

a) Provision of cross-border CSD services

AFME remains supportive of further expansion of T2S – both in terms of the number of participating CSDs and the number of settlement currencies offered. We welcome the plans of Euroclear Finland and Euroclear Bank to join T2S in the coming years. We are also supportive of recent discussions regarding the path forward for the Swedish securities market, and Riksbank's directional decision in favour of T2S.

We also welcome the important first steps taken by the ECB and several national Central Banks to begin exploring the use of wholesale CBDC (w-CBDC) to facilitate DvP settlement. Widespread adoption of interoperable w-CBDCs could offer "the opportunity to overhaul radically the functioning of cross-border payments to make them frictionless and more efficient."

Although access to cross-border CSD services has historically focused largely on settlement services, we believe that improving cross-border access to other core CSD functions – specifically, maintenance and notary services – is also of critical importance.

As noted, addressing these barriers will require legislative intervention beyond the scope of CSDR.

These obstacles include national-level divergences in the following areas:

- Issuance processes and requirements
- Corporate law requirements
- Processes for the attribution of corporate action entitlements
- Different tax regimes

On this last point, we note that many national processes for the attribution of corporate action entitlement are, prima facie, inconsistent with Article 3 of CSDR.

To make significant improvements in these areas will require, inter alia, that the proposals of the European Commission's Action Plan on Capital Markets Union are put into effect. Most relevant are Actions 10 (promoting a standardised system for withholding tax relief at source) and 12 (a harmonised EU-definition of 'shareholder', and further clarification and harmonisation of corporate action processing.

In addition to legislative changes, AFME believes there is scope for further development of pan-European market practices. In this context, the work of European Central Bank groups, such as the Debt Issuance Market Contact Group (DIMCG) and Corporate Events Group (CEG), can be important drivers of the creation and monitoring of market standards.

4. Additional Comments / Background Information

4.1. Measuring Settlement Efficiency

The proposed new Article 7.2(a) sets out the conditions which may result in the application of mandatory buy-ins. In broad terms, these are:

a. Assessment of whether penalties result in a long-term continuous reduction in settlement fail rates
b. Comparison of EU settlement fail rates versus other jurisdictions
c. Assessment of whether current settlement fail rates pose any financial stability risk

Given the widely acknowledged potential impacts of MBI, it is essential that such an important policy decision is grounded as much as possible on relevant, complete and accurate data.

In this section, we outline a number of specific considerations, which we believe must be taken into account.

Firstly, there is no 'baseline' measurement, as a full-scale granular assessment on the extent of, and reasons for, settlement fails was not conducted prior to the introduction of cash penalties.

AFME notes anecdotal evidence from member firms that targeted enhancements to internal practices were made in anticipation of the introduction of CSDR cash penalties on 1 February 2022. It is therefore reasonable to assume that there may have been a reduction in settlement fails directly attributable to CSDR cash penalties which will not be captured if settlement efficiency is only measured from 1 February 2022.

Secondly, we believe it is critical that short-term spikes in settlement fails attributable to external events are given due consideration, and do not result in the application of MBI provisions. For example, we note that rising market volatility in February/March 2022 may have resulted in a temporary increase in

settlement fails during this period. As previously noted by AFME[6], the negative impact of mandatory buy-ins on market liquidity is likely to be exacerbated in periods of market stress. These periods would therefore be an inappropriate to introduce MBI requirements.

As a consequence, we would recommend that any assessment of the settlement efficiency rates should be focused on measurable trends of improvement over a given time period, rather than on an absolute number to be reached as a static target level of settlement efficiency. We also encourage more detailed analysis of the most appropriate definition of the settlement efficiency rate, to ensure full clarity about what is counted as the total number of settlement instructions that are ready for settlement and the total number of failing transactions for a given time period.

Thirdly, we note that mandatory buy-ins only address settlement fails still outstanding after 4 or 7 business days. Settlement instructions that fail on ISD but settle before ISD+4 (for liquid equities) or ISD+7 (for other instruments) would not be resolved any quicker by the introduction of mandatory buy-ins. Therefore, it is critical that any policy decision related to the application of MBI is based on data relating to settlement fails still outstanding after 4 or 7 business days and not settlement fails measured on ISD.[7]

Finally, we urge that regulators proceed with caution when assessing EU settlement fail rates against other jurisdictions. As well as the inherent structural differences outlined in Section 4.3, it should also be noted that direct comparison may be difficult, if not impossible, due to a lack of publicly available granular information in other jurisdictions, differences in methodology or differences in how settlements are processed.

4.2. Considerations for Implementation of Mandatory Buy-ins

AFME believes that further clarity is required on the sequencing and mechanics by which MBIs may enter into force.

We emphasise that a substantial lead-time will be required between an announcement that MBI will become applicable, and the actual entry into force of MBI requirements. The length of this transition period should be specified in the regulation itself. This is necessary to allow sufficient time for the industry to prepare for implementation, including the repapering of relevant contracts, and operational/technology readiness - including the development of systems, processes and resourcing. Not only are these prerequisites time-sensitive, but also cost-sensitive and will require planning and budgetary provision, not just within the EU but externally, for any entity transacting in EU capital markets. It should be contemplated that in the time it takes to implement mandatory buy-ins, the fail rate may have sufficiently improved resulting in disproportionate and redundant cost.

We recommend that the following sequence would be required prior to any introduction of the MBI:

- Step 1: Comprehensive quantitative and qualitative fails analysis
- Step 2: Identification of specific asset classes / transaction types where settlement efficiency has not reached suitable levels
- Step 3: Identification and implementation of additional measures to prevent settlement fails – including possible recalibration of penalty rates

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7 As noted in the European Commission's impact assessment, "*there is some evidence that these costs could be born to potentially address a less significant problem, as the majority of fails seem to be resolved between one and five days after the intended settlement date, meaning they would not enter buy-in.*"

- Step 4: Repeat of fails analysis
- Step 5: Announcement of specific asset classes / transaction types for which MBI would apply
- Step 6: Imposition of revised RTS on MBI, outlining scope and transition period

Should a mandatory buy-in regime be imposed for a specific asset class or instrument type, it is unclear whether or not this would be a permanent requirement. AFME believes that this should be on a time-limited or conditional basis – in other words, if settlement fails subsequently are reduced to acceptable levels, for example, settlement fails subsequently are reduced to "acceptable" levels or the negative effects on the financial stability of the EU that may derive from an "excessive" level of settlement fails are neutralised, then MBIs will be disapplied.

Considering the above, AFME strongly believes that a cash penalty regime whereby rates can be adjusted on a more dynamic and flexible basis, is a superior policy tool for penalising settlement fails, without the negative cost and market consequences of a mandatory buy-in

4.3. Structural Differences between EU and other markets

AFME considers that comparisons of settlement efficiency between EU and third countries must take due consideration of the marked differences in the EU's market structure versus any other capital market. In its Impact Assessment, the European Commission comments on the 'ongoing inefficiencies in the EU settlement market' through two lenses: barriers to cross-border settlement; and disproportionate compliance costs. While both are undoubtedly impactful, the issues in EU securities markets run much deeper, which challenges any comparison to a third country:

Market structure: EU markets remain characterised by significant complexity with respect to the number of market infrastructures and legal frameworks.

- T2S
- 33 CSDs
- 14 CCPs
- 27 tax regimes
- 27 legal frameworks

Settlement discipline regime: there is no capital market outside the EU that has a comparable settlement discipline regime, as recognised by the European Commission in its Impact Assessment. Notably, there is no jurisdiction that has implemented a mandatory buy-in regime for OTC transactions. The introduction of an MBI cannot therefore be considered as a proven route to delivering improved settlement efficiency.[8]

Barriers to cross-border settlement: The Commission's impact assessment notes that CSDs "find providing cross-border services difficult." We note that these difficulties also impact other market participants. AFME considers that barriers to cross-border settlement services have a material negative impact on overall settlement efficiency.

[8] The absence of a comparable settlement discipline regime is acknowledged by the Commission as a reason why the costs of applying the MBI rules could outweigh the benefits. In this respect, AFME agrees with the Commission's assessment that the EU MBI rules may create additional costs and risks for EU-settled securities that could disadvantage EU companies. Moreover, the application of these rules could lead i) to a loss of counterparties and ii) to a reduction of liquidity. In the final analysis, the attractiveness of EU capital markets risks being diminished, thereby contradicting the overarching objective.

There is an urgent need for public and private sector organisations to collectively identify and tackle structural issues.

4.4. Industry measures to improve settlement efficiency

Against the backdrop of CSDR settlement discipline rules, there has, in recent years, been a significant increase in focus across the industry on improving settlement efficiency. AFME notes the publication of best practices by different industry associations, including AFME[9] and ICMA[10], focused largely on encouraging greater use of tools such as shaping, auto-partial, partial release, and auto-borrow.

This topic has also been discussed extensively within ECB stakeholder groups, notably the AMI-SeCo and the CSD Steering Group.

Further consideration should be given to introducing market standards for receiving parties to accept partial deliveries offered by the delivering party, within certain parameters. AFME would welcome broad industry collaboration from all stakeholders, including supervisors, on developing appropriate principles, and detailed market standards, to fully utilise partial settlement functionality.

AFME believes it is essential that relevant data is collected and shared publicly in order to support these discussions.

4.5. Impact of cash penalties so far

AFME notes that some anecdotal evidence suggests that there are "positive signs" that cash penalties are leading to an improvement in settlement efficiency. Analysis[11] by one EU-based market-maker estimates that settlement fail rates on OTC transactions fell by 40% between 1 September 2021 and 16 March 2022.

We welcome further, broader assessment of settlement fail data.

Figure 1

[9] https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20Recommendations%20for%20Partial%20Settlement.pdf
[10] https://www.icmagroup.org/assets/Uploads/ERCC-discussion-paper-on-settlement-efficiency.pdf?vid=2&showiframe=true
[11] https://www.optiver.com/insights/blog/csdr-promising-signs-from-the-new-settlement-discipline-regime/

4.6. Overview of settlement lifecycle and roles of market actors

As noted in our response, a core problem with the mandatory buy-in regime is that it attempts to enforce a trading-level action through the settlement-level actors. As illustrated in the Figure 2, a transaction (trading-level) is distinct from a settlement instruction (settlement-level). Multiple settlement instructions can result from a single transaction.

From a mandatory buy-in perspective, this is problematic because each settlement instruction 'triggers' an obligation to initiate a buy-in. Further complexity arises from the number of different market actors involved in the settlement lifecycle, multiplying the scale of both the initial contractual repapering exercise, and the ongoing operational management of any buy-in process, unless targeted amendments are made as recommended in Section 3.3

Note that other trading and settlement models are possible. For example, pure OTC transactions would not involve Trading Venues, CCPs or Clearing Members.

For more detailed analysis of the settlement lifecycle, please refer to the following resources:

- EPTF Report – Detailed Analysis of the European Post Trade Landscape (2017)
- AFME – Post Trade Explained (2015)

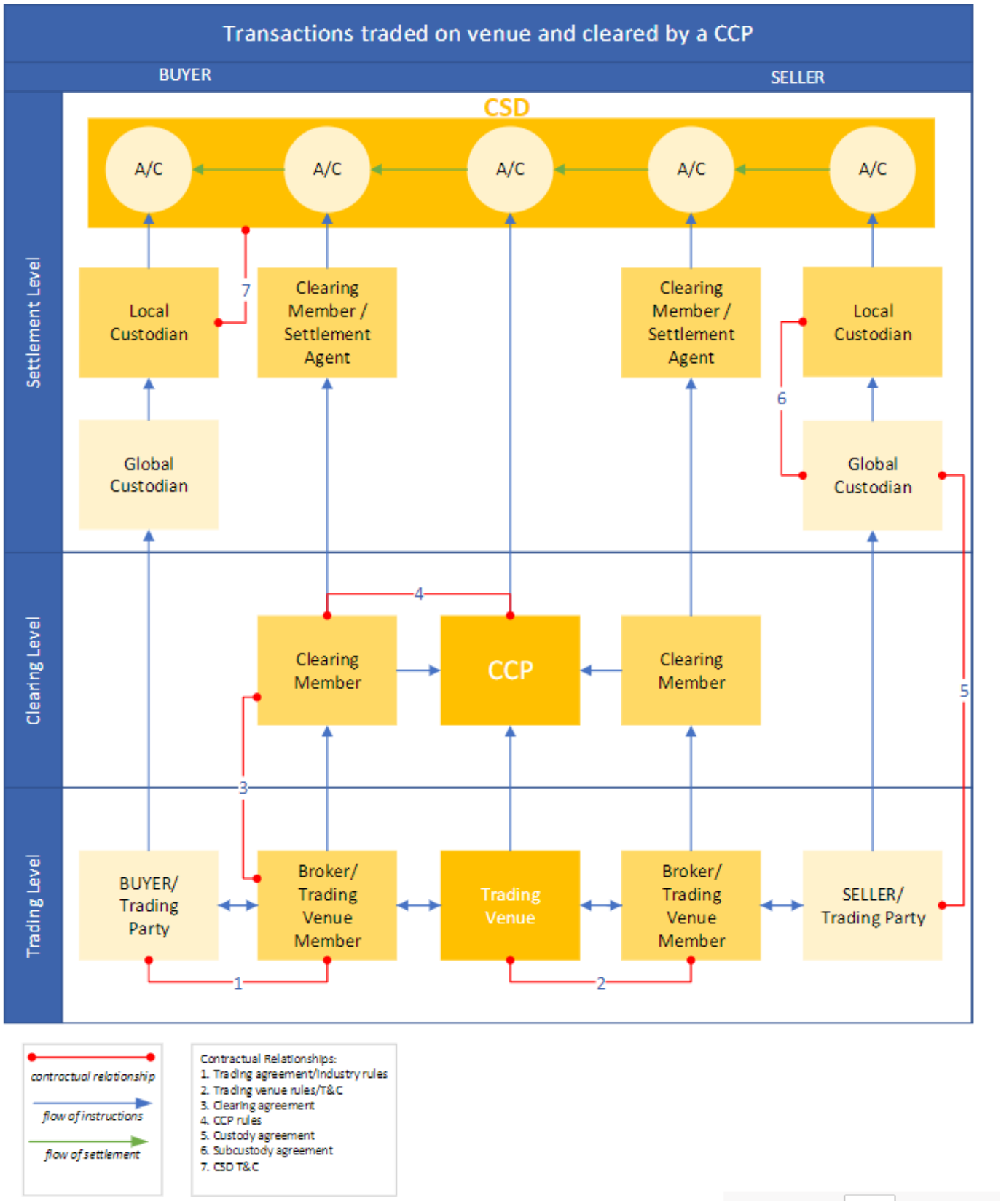
Transactions traded on venue and cleared by a CCP
BUYER
SELLER
CSD
A/C
A/C
A/C
A/C
A/C
Settlement Level
Local Custodian
Clearing Member / Settlement Agent
Clearing Member / Settlement Agent
Local Custodian
Global Custodian
Global Custodian
7
6
4
5
3
Clearing Level
Clearing Member
CCP
Clearing Member
Trading Level
BUYER/ Trading Party
Broker/ Trading Venue Member
Trading Venue
Broker/ Trading Venue Member
SELLER/ Trading Party
1
2
contractual relationship
flow of instructions
flow of settlement
Contractual Relationships:
1. Trading agreement/Industry rules
2. Trading venue rules/T&C
3. Clearing agreement
4. CCP rules
5. Custody agreement
6. Subcustody agreement
7. CSD T&C

Figure 2

4.7. ETF creation and redemption process

Two separate ETF transactions take place in the Primary Market:

i) Trading and settlement of underlying securities, and

ii) ETF order creation/redemption (ETF Leg)

Whilst the trading and settlement of the underlying securities should clearly be in scope for mandatory buy-in rules, to apply a MBI on the ETF Leg would serve no economic purpose.

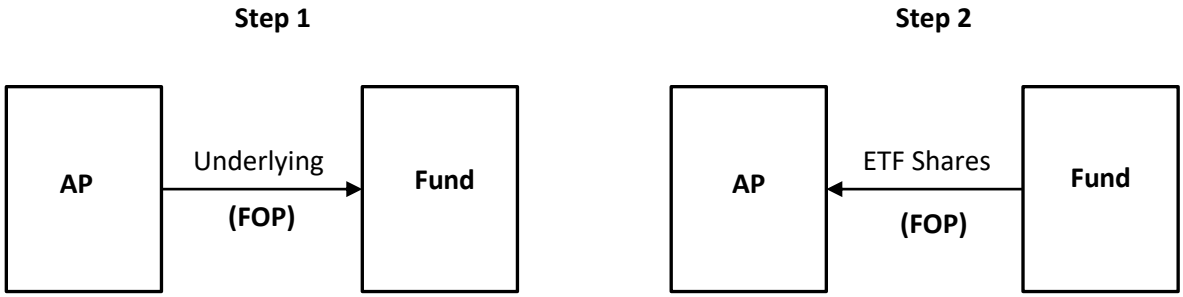

Figure 3

- Underlying securities settle T + 2 (ISD), this transaction completes first
- ETF Leg settles T + 2 (ISD), this transaction completes once the above leg is complete
- The AP will deliver underlying securities on T + 2
  - The AP sources the underlying in the market or from inventory
  - On the ISD, the AP receives any instruments they have sourced in the market and delivers those, plus anything from inventory, to the fund free of payment. Only then, will the ETF shares be delivered to the AP, again free of payment.
- If the AP fails to deliver all underlying securities on T + 2, the ETF shares delivery will also be delayed, until that leg has completed
- As the ISD of the ETF is now delayed (due to the failure of the AP to deliver the underlying securities), the fund will incur late settlement penalties on the full value of the ETF shares
- If the AP continues to fail to deliver securities, a buy-in scenario will occur on the fund, where the BIA secures delivery of the ETF shares to the failing AP and the fund incurs the cost of the buy in. This is detrimental to the fund.
- In addition, the fund has already created the said amount of ETF shares, the failing AP will now have double the amount they initially created, which may need to be sold back to the fund in the Primary Market.
- This example relates to 'in-kind' creations and redemptions, but the same principles are applicable to 'cash' creations and redemptions as well.

4.8. Functioning of the Pass-on Mechanism

We support an update to the Level 2 provisions to explicitly detail the functioning of a pass-on mechanism. Such a mechanism should allow the receiving trading party to (i) pass-on to its failing delivering trading party the consequences of a buy-in instead of triggering a buy-in against the latter and (ii) to reject a buy-in on the basis a buy-in has been / shall be initiated (for example where a CCP is involved in the settlement chain) and instead pass-on the results of the buy-in.

Where a settlement chain involves a CCP, clear information should be provided to the clearing member to which the CCP fails to deliver. When the CCP informs the receiving clearing member that a buy-in has been initiated, this information could be used by the receiving clearing member to defer a buy-in relating to its failing onward delivery. This is all the more important given the central role of CCPs in market settlement and would allow a solution for the fact that CCPs cannot be bought in or a buy-in cannot be passed onto them, exposing the receiving clearing member.