Survey of Topics for the CSDR Review – AFME Response

10th July 2020

AFME welcomes the opportunity to provide input on the topics to be considered as part of the CSDR Review. As you will note, the majority of our feedback relates to the CSDR Settlement Discipline provisions under Article 7, reflecting the strength of AFME members' concerns regarding implementation of this regime as it currently stands.

AFME remains fully supportive of the aspiration to deliver increased settlement efficiency in European securities. 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. However, in order to measure the success of these new initiatives, we would support further empowerment of ESMA to set target settlement efficiency rates, and to periodically recalibrate the applicable penalty rates. These measures taken together would provide a robust, flexible and transparent regulatory framework to appropriately incentivise market participants.

This could be supplemented by a 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. **Our most critical recommendation is that initiation of the buy-in process must not be a mandatory obligation of the receiving party.** The currently proposed buy-in regime reduces optionality for end investors, raises transaction costs and severely damages market liquidity. This 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 – i.e. typically those issued by smaller companies.

Our proposal for an optional 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. There are a substantial number of open issues on which the industry is reliant on urgent clarification from ESMA and the European Commission, many of which are highlighted in our response. A simplification of the regulation, and the removal of the mandatory nature of the buy-in regime, would resolve many of these issues.

We note that the proposed legislative changes are significant in nature and would also require appropriate consultation across all stakeholders. AFME recommends therefore that the implementation of the settlement discipline regime is delayed to an appropriate later date, to allow sufficient time for any regulatory changes to be comprehensively discussed, agreed and written into law. We would support the sequencing of the penalties and buy-in requirements as appropriate. It is crucial that the mandatory buy-in regime as currently envisaged, is not implemented in February 2021, and that the penalties regime is also delayed until an appropriate later date, acknowledging concerns across the broader industry regarding readiness.

We would welcome further opportunity to discuss our feedback with you.

	Regulation (EU) No 909/2014 (CSDR)[1] – current provisions	Suggested Amendments	Justification including evidence and data
Article 1	Scope – Organisation and conduct of a CSD, and detailed rules on core service of a CSD (namely, the settlement service)	CSDR should set out some high-level principles and requirements for the two other core services of a CSD (notary service, and central maintenance service). One important principle that should be applied by CSDs with respect to these services is that the attribution of entitlements to a corporate event should be based on booked positions at the issuer CSD as of close of business on record date, and not on booked positions recorded on any other external register.	The lack of pan-European rules with respect to the provision of the notary service and the central maintenance services is a key reason why the CSDR objective of developing a competitive CSD market has failed, and why corporate actions and general meeting processing still represents a major barrier to cross-border investment.
Article 6	6.4 – "CSDs shall require participants to settle their transactions on the intended settlement date."	Removal of this sentence.	Article 5.1 already places an obligation on CSD participants to settle transactions on intended settlement date. This sentence places an obligation on CSDs, but it is unclear what this obligation is. The fact that this obligation is not mentioned in paragraph 5 suggests that CSDR itself recognises this obligation as inappropriate and unworkable. This obligation is potentially dangerous as CSDs are not in a position to require that their participants settle a transaction (given that a CSD participant may not be a trading party to the transaction, and the trading party may have insufficient resources of securities or cash for the transaction to settle). We note that Article 7.9 already provides that the CSD establishes procedures to deal with participants who fail on a systematic and continual basis.
Article 7	(a) All provisions	(a) As a general comment, AFME recommends a simplification of the Level 1 rules on penalties and buy-ins. We believe that the Level 1 text should only set out the high-level	(a) The current Level 1 text for penalties and buy-ins is highly prescriptive and significantly constrains the ability of the industry as a whole to develop practicable and effective market practices. On many specific points, there are

		principles of the regime, rather than covering details of the operational process.	inconsistencies or errors which require clarification or correction.
	(b) 7.14 – “The Commission shall be empowered to adopt delegated acts in accordance with Article 67 to specify parameters for the calculation of a deterrent and proportionate level of the cash penalties”	(b) Append the existing text to provide ESMA with a mandate to set specific settlement efficiency targets and an appropriate mechanism for dynamic recalibration of penalty rates to ensure appropriate incentives.	(b) AFME fully supports the overall objective of CSDR in terms of improving settlement efficiency and supports adequate measures to encourage the industry to achieve very high rates of settlement efficiency. At the same time, it should be understood that 100% settlement efficiency is not itself an achievable objective. This is especially relevant for instruments which are inherently less liquid (such as certain types of corporate bonds, ETFs), 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. In doing so, it needs to be considered that liquidity can vary substantially between different instrument types and is influenced by market circumstances, so target settlement efficiency rates need to be set and adjusted accordingly. 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 (see next recommendation). 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.
	(c) 7.3 – “where a failing participant does not deliver the financial	(c) Adjust the buy-in requirement from a mandatory obligation into to a	(c) The mandatory buy-in regime as it stands removes the ability for the buyer to decide when and whether to force delivery,

	instruments referred to in Article 5(1) to the receiving participant within 4 business days after the intended settlement date a buy-in process shall be initiated”	discretionary right for the buyer, for transactions not involving a CCP.	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 a cash settlement, 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. In addition, a rigid regime fails to acknowledge that that liquidity in some instruments may vary substantially. Imposing mandatory buy-ins may lead to sellers become more reluctant to make offer prices when they do not have ready access to inventory or increase bid-offer spreads, leading to increased risks and costs for investors (including asset managers, pension funds and insurance funds) and issuers. Adjusting the buy-in regime to a discretionary right, underpinned by a regulatory framework, as opposed to a mandatory obligation, in combination with penalties for late settlement (see above) will allow greater flexibility for the end investor whilst preserving the original policy objectives of enhancing settlement rates. This right should be enshrined into regulation as required. Where existing contractual remedies provide an effective means to resolve settlement fails in a timely manner that protects the purchasing party, it should be carefully considered if further provisions under CSDR are required. Allowing the purchasing party the discretion to initiate a buy-in only when it is commercially and economically rational to do so would reduce the expected negative impact on pricing and liquidity, while preserving the rights of buyers. In addition, discretionary buy-ins will enable simplification of the regulation, as there is no longer a need to prescribe detailed rules on timing and functioning of this mandatory process, allow for adjustment of the exceptions to buy-ins

			where they do not make economic sense, or correction of anomalies in the current CSDR regulation (e.g. on asymmetry).
	(d) 7.4 – Exemptions to buy-in process	(d) Expand on the list of exemptions to the buy-in process to provide greater clarity on the scope	(d) The objective of a buy-in is to enact the compulsory enforcement of an original agreement between two trading parties. The regulation should explicitly clarify that settlement instructions which do not represent a trade should not themselves be subject to a buy-in. Further exemptions should be made for other scenarios in which a buy-in would not serve any economic purpose – a non-exhaustive list of examples includes certain corporate action types, own account transfers, margin transfers, collateral movements, the ETF creation/redemption processes, and the delivery of in-scope instruments under physically settled derivative contracts. Further, a central database of in-scope securities and the relevant penalty rate and extension period maintained by ESMA would be helpful in reducing the likelihood of disputes. Again, a discretionary buy-in regime would make the regime much more flexible and mitigate this issue.
	(e) References to "participant" – e.g. 7.6, 7.7, 7.8, 7.10(c), 7.12	(e) Provide clear definitions of all actors within the settlement discipline regime - for example to distinguish between CSD participants and trading parties. The regulation should be reviewed to ensure correct and consistent use of each term throughout, identifying the appropriate obligor of each action.	(e) The level 1 text has used the term "participant" inconsistently through the text, where parties may interpret to mean a direct participant in the CSD (more properly considered as a settlement agent), or alternatively read in a broader sense as a participant in the trade (e.g. a trading party). This has resulted in a number of undesirable consequences, in particular in relation to buy-ins which all market participants are in agreement occurs at the level of the trading parties (given it is both an execution function and also a means of enforcement of obligations in a trading contract). The role of CSDs and CSD participants in the buy-in process should be limited to the provision of necessary settlement information.

			The language (in both level 1 and level 2) should be clarified to confirm: • Initiation and handling of the buy-in, are the responsibility of the Receiving Trading Party, and not of the settlement agent • Responsibility for payment of any costs relating to the buy-in, or of cash compensation, are the responsibility of the Failing Trading Party, who pays this directly to the Receiving Trading Party. • Settlement Agents are acting purely on their client's delivery instructions and are not in fact party to the terms of a trade. It is therefore the Delivering Trading party's responsibility to ensure that inventory is sourced in order to prevent the risk of buy-in. • In the event that a Failing Trading Party does not pay costs to the Receiving Trading Party, this is a dispute to be enforced under the trading contract between those parties. The settlement agent of the failing party would not be in a position to know if the reasons for non-payment were valid (e.g. buy-in had been executed on an out-of-scope transaction, best execution had not been applied etc) – the current language runs the risk of the settlement agent being asked therefore to adjudicate on a trading contract to which it is not a party, and which must clearly be a matter for the parties themselves or ultimately the courts.
	(f) No current provision	(f) Explicitly include provision for a pass-on mechanism	(f) The regulation should be updated to explicitly provide that where a receiving trading party has a failing settlement of the receipt of securities and a contingent ('linked') failing onward delivery of the same securities, the receiving trading party may 'pass-on' the buy-in notice to its failing delivering trading party. 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. This is consistent with Recital (19) of the Regulation and Recital (34) of the Regulatory Technical Standards. 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. Again, a discretionary buy-in regime would make the regime much more flexible and mitigate this issue.
	(g) 7.6 – "Without prejudice to the penalty mechanism referred to in paragraph 2, where the price of the shares agreed at the time of the trade is higher than the price paid for the execution of the buy-in, the corresponding difference shall be paid to the receiving participant by the failing participant"	(g) Replace Article 7.6 with a new provision allowing for symmetric settlement of the price difference or cash compensation.	(g) When the price that a buy-in is executed at is greater than the price of the original trade, the corresponding difference should be paid to the buyer by the original failing seller. Where the price that a buy-in executed at is less than the price of the original trade, the corresponding difference should be paid to the original failing seller by the buyer. 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).
	(h) 7.15 – ESMA shall develop regulatory technical standards.	(h) Specific changes are required to the RTS, as outlined: 1) Amendment to Article 25 2) Amendment to Article 32.1(a) 3) Removal of requirement for "buy-in agent"	(h) 1. Adjustment of article 25 (a) Article 25 imposes duties on intermediaries such as settlement agents to include clauses in their custody and settlement agreements to enforce the provisions of the CSDR settlement discipline regime upon their clients. Custodians and settlement agents are not parties to the trade, nor do they have any authority to or role in this respect to enforce the provision of a trading agreement to which they are not a party. It has been acknowledged that settlement participants are not acting in a principal

			capacity, and therefore they should also not be responsible for the enforcement of the buy-in. (b) Separately, as per Article 25.6 “The cash compensation referred to in Article 33 and the price difference referred to in Article 35(1) may only be considered as paid where the cash payment has been received by the receiving participants acting on behalf of the CCP, the receiving clearing members, trading venue members or trading parties.” There should be no requirement for this payment to go through the direct CSD participants. 2. Amendment of Article 32.1(a) “for settlement instructions against payment, the difference between the market value of the relevant financial instruments on the business day before the payment calculation of the cash compensation and the settlement amount included in the failed settlement instruction where that settlement amount is lower than that market value” The word “payment” should be replaced with “calculation”. The requirement to calculate the cash compensation amount on the business day before payment is not consistent with the Level 1 guidance that allows for payment to be made two business days after notification. 3. Review the requirement to appoint a Buy-in Agent AFME supports the principles of best execution and fair and transparent treatment of both the receiving and failing parties involved in the buy-in. Any buy-in framework should be based on these premises, with clearly defined parameters for the buy-in agent’s roles and responsibilities. The current lack of clarity is reflected in the extremely limited number of entities who have so far confirmed they will provide a buy-in agent service. We note that current offerings do not provide sufficient coverage to support all market participants.

	(i) 7.3 – "Where the transaction relates to a financial instrument traded on an SME growth market the extension period shall be 15 days unless the SME growth market decides to apply a shorter period." (j) 7.14 – "The Commission shall be empowered to adopt delegated acts in accordance with Article 67 to specify parameters for the calculation of a deterrent and proportionate level of the cash penalties" (k) 7.5 – "the exemptions referred to in paragraph 4 shall not apply in relation to transactions for shares where those transactions are cleared by a CCP."	(i) Apply 15-day extension period to all financial instruments registered for trading on an SME-Growth Market and clarify that this refers to 'business days' (j) The penalty regime should be simplified so that the same penalty rate applies to any individual security regardless of place of trade or type of transaction. (k) Removal of Article 7.5	(i) The determining factor of whether a transaction is subject to a 15-day extension period should be that the financial instrument is registered for trading on an SME Growth Market and not where the actual place of trade was. This ensures a consistent extension period is applied across a chain of linked transactions with on- and off-market legs. Additionally, it should be clarified that this means 15 business days, consistent with other extension periods. Again, a discretionary buy-in regime would make the regime much more flexible and mitigate this issue. (j) Similar to the above recommendation, a consistent penalty rate should apply across a chain of linked transactions in the same security. If for a single security the penalty rates vary by type of transaction, then this creates anomalies (increased risk, operational burden for correcting the anomalies) as it disrupts the netting effect for chains of (failing) transactions. There is no public policy justification for creating such anomalies. (k) Article 7.5 creates a different extension period for illiquid shares dependent on whether they are cleared via a CCP. This leads to scenarios where a clearing member may have a delivery instruction and receipt instruction with different extension periods, creating undue risk for a clearing member.
Article 23	23.3(e) – "where relevant, an assessment of the measures the CSD intends to take to allow its users to comply with the national law referred to in Article 49(1)."	Deletion of this sentence.	This requirement for an "assessment" is a major barrier for a CSD providing a notary service to an issuer established in another member state. Accordingly, this requirement is a major barrier to the cross-border provision of issuer services.
Article 32	No current provision	Article 32 should include requirements with respect to liability standards of CSDs with respect to all the services that they provide.	Please also see our response to the survey on the cross-border provision of services by CSDs.

Article 49	49.1 sub-para 2 – "Without prejudice to the issuer's right referred to in the first subparagraph, the corporate or similar law of the Member State under which the securities are constituted shall continue to apply."	Deletion of this sentence.	A competitive CSD market requires that CSDs can provide issuer services in a standardised manner no matter the member state of establishment of the issuer. This means that there should be pan-European rules on the provision of such services (see comments above on Article 1). Such pan-European rules shall still allow national corporate law to govern the internal organisation of issuers, and the relationship between issuers and shareholders. This sub-paragraph either simply makes this point, in which case it is redundant, or actively prevents CSDs from providing such a standardised service. In either case, the sub-paragraph should be deleted.
Article 76	76.5 "The settlement discipline measures referred to in Article 7(1) to (13) … shall apply from the date of entry into force of the delegated act adopted by the Commission pursuant to Article 7(15)."	The date of entry into force of the relevant delegated act (Article 42 of Commission Delegated Regulation 2018/1229) should be amended to an appropriate later date.	The currently proposed amendment to Article 42 of the Commission Delegated Regulation 2018/1229 states that the regulation shall enter into force on 1 February 2021. This does not allow sufficient time for any legislative changes to the regulation to be enacted prior to entry into force. In addition there is significant risk of market disruption, due to concerns regarding broader industry readiness. These concerns are reflected in the number of outstanding items requiring L3 guidance. AFME recommends that the date is amended to an appropriate later date to allow the implementation of any proposed legislative changes that are agreed in the CSDR Review.