Targeted consultation on the review of the Directive on settlement finality in payment and securities settlement systems

1. Participation in systems governed by the law of a third country

The Settlement Finality Directive (SFD, Directive 98/26/EC) covers systems governed by the law of a Member State but not those governed by the law of a third-country. Credit institutions and investment firms may, however, participate in an SFD system even when their head office is in a third-country (third-country participant). The protections of the SFD apply fully and without discrimination in the event of the insolvency of a third-country participant in an SFD system. However, since the SFD does not cover third-country systems regardless of whether such systems are established inside or outside the EU, transactions and collateral posted by EU participants in such systems and related netting are not protected under the SFD.

Recital 7 of the SFD recalls that it is up to Member States to apply the provisions of the SFD to their domestic institutions, which participate directly in third country systems, and to collateral security provided in connection with participation in such systems.

During the legislative process for the BRRD 2 the European Parliament (EP) sought to extend the protections of the SFD to any third-country system where at least one (direct) participant had its head office in the EU. The EP's proposals were not adopted. Article 12a was added to the SFD requiring the Commission to report by 28 June 2021 on how Member States apply the SFD to their domestic institutions which participate directly in systems governed by the law of a third-country and to collateral security provided in connection with their participation. If appropriate, the Commission shall provide a proposal for revision of the SFD.

Question 1.1
Should EU institutions that participate in third-country systems be protected by the SFD?

- Yes
- No
- Don't know / no opinion / not relevant

Question 1.1.1
Please explain your answer to Question 1.1:

SFD gives primacy to the rules of a designated securities settlement system in the event of the insolvency of a participant in the system, in order to protect transfer orders from challenges resulting from insolvency proceedings. We agree that insolvency laws in the EU should not lead to different results when transfer orders are submitted by EU entities to non-EU systems. The extension of the SFD regime to third-country systems, where appropriate, will promote the integrity of the system and provide greater certainty to any EU institution who is a participant. This minimises the risk of Member State insolvency laws undermining the system's determination of settlement finality in case of the insolvency of an EU participant. In other words, an EU court could not be used to undermine the effect of transfer orders in third country systems in a way that could not be done if the system was in the EU.

We note that this is not intended to impact or alter the rules governing any third-country system or apply EU law extra-territorially.

Question 1.2
Please bring the following options in an order, attributing 1 to the option that you consider most suited and 4 to the option that you consider least suited:

- Criteria for protection should be set at EU level. Also, decisions to extend the protection should be taken at EU level. This ensures a level playing field in the EU and predictability for market participants. 1
- Criteria for protection should be set at EU level. However, decisions to extend the protection should be taken at national level. This ensures greater harmonization within the EU but gives the possibility to consider national market characteristics and laws. 2
- Criteria for protection should be set by each Member State. Also, decisions to extend the protection should be taken by each Member State. They know best their national market and possible implications and interactions with national laws. 3
- Other 4

Question 1.2.1
Please specify what is/are the other option(s) you refer to in question 1.2:

Question 1.3
In case the scope of the SFD was to be extended to EU institutions participating in third-country systems: How should this be done?

- The provisions of the SFD should apply directly to the third-country system in their entirety
- The SFD should defer to the protections conferred by the applicable third-country law
- Some SFD provisions should apply directly to the third-country system, whilst some provisions should defer to the protections conferred by the applicable third-country law
- Don't know / no opinion / not relevant

Question 1.3.1
Please explain your answer to Question 1.3:

It is important to distinguish between the protections granted by SFD and the requirements placed by SFD on third-country systems.

Once a third-country system has been designated under SFD, the protections offered by SFD with respect to EU insolvency procedures should apply directly with relation to activity in that system, and should apply in the same manner as they apply to activity in an SFD-designated EU system. The SFD should address the way that insolvency proceedings in a Member State treat transfer orders, with the aim of providing parity for those submitted to third country systems and those submitted to EU systems.

The SFD should not attempt to regulate the operation of third country systems. Deference to the rules of the system and to the applicable third country law is warranted.

The process for designation of third-country systems should include an assessment of rules of the third-country system and its governing law.

Question 1.4
Do you see the need to carry out an assessment whether the applicable third-country law provisions are comparable to the SFD's?

- An assessment to which extent the applicable third-country law provisions are comparable to the SFD's should be carried out
- There is no need for an assessment

- An assessment should be carried out only in certain cases (e.g. for certain systems or certain third-countries)
- An assessment to which extent its provisions are comparable to the SFD's should be carried out only for certain provisions
- Don't know / no opinion / not relevant

Question 1.4.1
Please explain why there is no need for an assessment:

Question 1.4.1
Please specify in which cases an assessment should be carried out:

As a matter of principle, we believe that there should be an assessment process before a third-country system is designated under the SFD. We believe that the purpose of the assessment is to ensure that the third-country system plays in its jurisdiction a role that is comparable to the role played by an SFD-designated system in the EU. This assessment process should be based largely on the question of whether the legal and contractual framework for the third-country system is consistent with the standards set out in the CPMI-IOSCO Principles for Financial Market Infrastructures. There should be no requirement for this process to assess whether the third-country legal and regulatory framework is equivalent to the framework in the EU.

Question 1.4.1
Please evaluate for which of the following provisions such an assessment should be carried out:

	1	2	3	4	5	Don't know
eligibility to participate in the third-country system directly					X	
eligibility to participate in the third-country system indirectly					X	
the moment of entry into the system, the moments of irrevocability and settlement finality within the system (notably whether such moments are left to the rules of the system or are mandated by the third country law governing the system)					x	
the settlement finality provisions (notably the extent to which transfer orders and collateral security as well as their netting are protected from being interfered with)					x	
the definition of a system					X	
provisions regarding interoperability of systems			x			
the application of the settlement finality provision without discrimination between domestic and foreign participants					X	

the compatibility of any provisions on conflict of laws					X	
Other						

Question 1.4.1.1
Please specify what is/are the other provision(s) you refer to in question 1.4.1:

Question 1.5
In case the SFD should provide criteria for the assessment for designation of a third-country system: What is your opinion regarding the following statements?

Question 1.5.a
SFD protection should only be extended to third-country systems, if the third country extends protections towards SFD systems.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Do you have comments/explanations on your opinion to proposal 1.5 a)? If so, please provide them here:

The first purpose of this proposal is to provide certainty with respect to EU institutions within the framework of insolvency laws in the EU. This should be applied on a unilateral basis without any requirement for reciprocity. If the determination is made on the basis of mutual reciprocity, there is a risk that the decision is impeded and delayed due to external considerations.

Question 1.5.b
Information about insolvency of a participant in the third-country system should be provided in a timely manner by the third-country system operator.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Do you have comments/explanations on your opinion to proposal 1.5 b)? If so, please provide them here:

As noted in Section 3.13.5 of the CPMI-IOSCO Principles for Financial Market Infrastructures, "timely communication with stakeholders, in particular with relevant authorities, is of critical importance. The FMI, to the extent permitted, should clearly convey to affected stakeholders information that would help them to manage their own risks." AFME members are fully supportive of this principle.

Question 1.5.c
Information about insolvency of a domestic participant should be provided in a timely manner by the third-country national authorities.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Do you have comments/explanations on your opinion to proposal 1.5 c)? If so, please provide them here:

All participants in a system should be made aware of the default of another participant as soon as possible. The distribution of this information is key – AFME favours alignment of the communication process as much as possible. This could be accomplished through memoranda of understanding with the competent authorities of the relevant third country, for example.

Question 1.5.d
Systemic importance of the third-country system should be prerequisite.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Do you have comments/explanations on your opinion to proposal 1.5 d)? If so, please provide them here:

The same principle should be applicable across all systems regardless of size. In practice, smaller systems may struggle to grow in size and importance if they are not first designated. Therefore, allowing for designation of smaller systems would be beneficial in supporting emerging systems.

Question 1.5.e
Adequacy of the rules of the system should be given.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Do you have comments/explanations on your opinion to proposal 1.5 e)? If so, please provide them here:

We agree that the rules of the system should be adequate. We believe that a high-level assessment of the rules can be effected by reviewing the compliance of the system with the CPMI_IOSCO Principles for Financial Market Infrastructures. We do not believe that it is necessary or appropriate to carry out a more detailed assessment of the adequacy of rules. In particular, we do

not believe that there is a need for any assessment of whether the rules of the system are equivalent to the rules of EU systems.

Question 1.5.f
Only systems that are as strict as the SFD regarding the provisions about (direct) participation should be eligible for designation.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Do you have comments/explanations on your opinion to proposal 1.5 f)? If so, please provide them here:

There should be minimum, objective criteria for participation in the third-country system. However, these should not necessarily be exactly the same as for SFD systems in every respect.

Question 1.5.g
Only systems that are as strict as the SFD regarding the provisions about indirect participation should be eligible for designation.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Do you have comments/explanations on your opinion to proposal 1.5 g)? If so, please provide them here:

There should be minimum, objective criteria for participation in the third-country system. However, these should not necessarily be exactly the same as for SFD systems in every respect.

Question 1.5.h
No discrimination between EU institutions and other institutions should be made by the third-country system.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Do you have comments/explanations on your opinion to proposal 1.5 h)? If so, please provide them here:

We agree that as a matter of principle there should be no discrimination in treatment based on the country of residence of the participant. We believe that the third-country system should comply with Principle 18 (on fair and open access) of the CPMI-IOSCO Principles. We do, however, note that from the perspective of the regulatory authorities in third country there may be a

difference in regulatory status between domestic and foreign institutions, and this may lead, for example, to some differences in specific requirements for participation.

Question 1.5.i
All participants have to be known to the system operator.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Do you have comments/explanations on your opinion to proposal 1.5 i)? If so, please provide them here:

We interpret this question as only relating to direct participants in the system. The identity of indirect participants may or may not be known to the system operator.

Full disclosure requirements exist today in SFD-designated systems for direct participants and should also be applicable for any designated third-country system.

Question 1.5.j
The country of establishment of the system operator should be considered.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Do you have comments/explanations on your opinion to proposal 1.5 j)? If so, please provide them here:

It should be considered whether the country of establishment of the system operator is a high-risk third country as assessed by the Financial Action Task Force, and whether there is a framework for cooperation in place between the competent authorities of that country and those of the Union.

Question 1.5.k
The country where the infrastructure is located, maintained and/or operated should be considered.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Do you have comments/explanations on your opinion to proposal 1.5 k)? If so, please provide them here:

We agree that the location of the infrastructure is a relevant factor, but we would see this factor as falling within the consideration of compliance of the system with Principle 17 (on operational risk) of the CPMI-IOSCO Principles.

Question 1.5.l
The third-country law governing the system should fulfill the assessment criteria as indicated in my response under question 1.4.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Do you have comments/explanations on your opinion to proposal 1.5 l)? If **so, please provide them here:**

The third country law governing the system need only be compatible with the proposed arrangements, rather than substantially similar to Union law.

Question 1.5.m
The volume and value of transactions either cleared, settled or otherwise executed through the third-country system in the three calendar years preceding this year should be considered.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Do you have comments/explanations on your opinion to proposal 1.5 m)? If so, please provide them here:

We see the consideration of volumes of activity processed in the third-country system as being a practical consideration. It is, of course, more important to designate under SFD third-country systems that have higher volumes than those that have lower volumes. But designation of third-country systems will deliver benefits to EU investors and intermediaries, so we do not see a rationale for any kind of minimum level of volume or value of transactions that would be necessary for designation.

Question 1.5.n
Cooperative oversight arrangements with the third country concerned should be prerequisite.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Do you have comments/explanations on your opinion to proposal 1.5 n)? If so, please provide them here:

Cooperative oversight arrangements would be valuable. Such cooperative arrangements should respect the domestic system of the third country, and should not be overly burdensome or likely to lead to the end of recognition due to procedural or administrative questions alone. The stability of recognition should be one of the priorities. As mentioned previously, designation of third country systems will deliver benefits to EU investors and intermediaries, so it would be anomalous to make such designation fully dependent on possibly unrelated actions by third-country actors.

Question 1.5.o
In the case of CCPs the recognition of the CCP concerned under Article 25 of EMIR should be prerequisite.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Do you have comments/explanations on your opinion to proposal 1.5 o)? If so, please provide them here:

The purpose of recognition under Article 25 of EMIR is different from the purpose of designation under the SFD. There is a rationale for higher requirements to be placed on a third country CCP for recognition under EMIR than for designation under SFD. Accordingly, it would be anomalous for recognition under EMIR to be a prerequisite for designation under SFD. However, it could be considered appropriate for designation under SFD to be a prerequisite for recognition under EMIR. This may, however, be a relatively theoretical point. In practice, there should be a high degree of concordance between the list of CCPs recognised under EMIR and the list of CCPs designated under SFD.

Question 1.5.p
In the case of CSDs the recognition of the CSD concerned under Article 25 of CSDR should be prerequisite.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Do you have comments/explanations on your opinion to proposal 1.5 p)? If **so, please provide them here:**

The logic set out in our answer to Question 1.5.o is even stronger for CSDs than it is for CCPs. Making recognition under CSDR a prerequisite for designation under SFD would be unnecessary and counterproductive.

We disagree that CSDs should only be eligible for designation under SFD if recognised under Article 25 CSDR. Recognition under Article 25 CSDR is required where a CSD establishes an EU branch or provides relevant services with respect to securities constituted under the laws of an EU Member State. Therefore, recognition under Article 25 CSDR is not needed for a third country CSD to have EU participants. In practice, many EU firms and EU CSDs are participants of unrecognised third country CSDs today – including in the context of CSD links, which form an essential part of a global post-trade settlement infrastructure that allows EU firms and investors to access global securities markets. It is important that this existing ecosystem is not disrupted, and that any extension of SFD designation to third country securities settlement systems is not undermined by imposing a condition of recognition under Article 25 CSDR, which will not be relevant to many third country CSDs. There are other conditions that could address potential concerns, as noted in the previous questions.

Question 1.5.q
The criteria should be the same for all third-country systems regardless by which third-country law they are governed.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Do you have comments/explanations on your opinion to proposal 1.5 q)? If so, please provide them here:

EU law should set out a common approach for the designation of third- country systems under SFD. The approach should be set at a high level, and should be able to take account of the different conditions in different countries. We believe that the EU should not take an extra-territorial approach, namely trying to impose EU rules and concepts on third-countries, and should not take a too detailed approach, as this creates the risk that designation, which would be of benefit for EU investors and intermediaries, would be refused on a technicality or a quirk of a non-EU legal or regulatory system. As set out in some of our other answers, we believe that the CPMI-IOSCO Principles for financial market infrastructure are a useful starting point for the assessment process.

Question 1.5.r
Other: please indicate other assessment criteria that you consider useful:

We would refer to the CPMI-IOSCO – Principles for financial market infrastructures – April 2012 ("PFMIs") and suggest that these are the criteria by which a third country system is assessed. The PFMIs are internationally recognised standards of good governance for FMIs. Therefore, given that designation under the SFD could be seen as giving an unofficial endorsement of the system in question (as designation amounts to taking positive action to facilitate EU firms' ability to

participate in such systems), it may be appropriate to reserve designation to systems that can demonstrate they comply with the PFMIs.

Principle 1: Legal basis – states that an FMI should have a well-founded, clear, transparent, and enforceable legal basis for each material aspect of its activities in all relevant jurisdictions.

Key considerations

1. The legal basis should provide a high degree of certainty for each material aspect of an FMI's activities in all relevant jurisdictions.

2. An FMI should have rules, procedures, and contracts that are clear, understandable, and consistent with relevant laws and regulations.

3. An FMI should be able to articulate the legal basis for its activities to relevant authorities, participants, and, where relevant, participants' customers, in a clear and understandable way.

4. An FMI should have rules, procedures, and contracts that are enforceable in all relevant jurisdictions. There should be a high degree of certainty that actions taken by the FMI under such rules and procedures will not be voided, reversed, or subject to stays.

5. An FMI conducting business in multiple jurisdictions should identify and mitigate the risks arising from any potential conflict of laws across jurisdictions.

Principle 8: Settlement finality

An FMI should provide clear and certain final settlement, at a minimum by the end of the value date. Where necessary or preferable, an FMI should provide final settlement intraday or in real time.

Key considerations

1. An FMI's rules and procedures should clearly define the point at which settlement is final.

2. An FMI should complete final settlement no later than the end of the value date, and preferably intraday or in real time, to reduce settlement risk. An LVPS or SSS should consider adopting RTGS or multiple-batch processing during the settlement day.

3. An FMI should clearly define the point after which unsettled payments, transfer instructions, or other obligations may not be revoked by a participant.

Question 1.6
In case the scope of the SFD was to be extended to EU institutions participating in third-country systems: Should the scope be extended to EU institutions participating in third-country payment and security settlement systems?

- Only to payment systems
- Only to security settlement systems
- To both, payment and security settlement systems
- Don't know / no opinion / not relevant

Question 1.6.1
Please explain your answer to question 1.6:

Question 1.7
Should the scope of the SFD be extended to all EU-institutions participating in third-country systems without discrimination?

- Yes
- No
- Don't know / no opinion / not relevant

Question 1.7.1
Please explain your answer to question 1.7:

This should include the EU institutions within the scope of the SFD as suggested in these reforms.

Question 1.7.2
If the scope of the SFD should only be extended to certain EU institutions: On which basis should a selection take place?

1 (Disagree) -> 5 (Fully Agree)

	1	2	3	4	5	Don't know
Size of the institution					X	
Systemic relevance for the financial market of the Member State in which the institution is located					X	
Amount that the institution is participating with in the system					X	
Type of participant (e.g. only banks, investment firms, ...)					X	
Other risk based criteria					X	
Other					X	

Please specify what are the other risk-based criteria you refer to in your response to question 1.7.2:

Please specify what is/are the other basis you refer to in your response to question 1.7.2:

Designation of a third-country system if the scope was to be extended

Question 1.8
Should the assessment for designation of a third-country system be done on a case-by-case basis?

- Yes. This is most appropriate as criteria which are specific to a certain system should be considered (see my answers to question 1.5 above).
- No. It is sufficient to assess the third-country law in general regarding comparability.
- Don't know / no opinion / not relevant

Question 1.9
Should a regular evaluation be required whether the requirements for a designation are still met?

- Yes
- No
- Don't know / no opinion / not relevant

Question 1.9.1
Please explain your answer to question 1.9:

Question 1.9.1
If your answer to question 1.9 is yes: In which frequency should an evaluation be required?

- Annually
- Every two years
- Every three years
- At the discretion of the designating authority
- Other
- Don't know / no opinion / not relevant

Please specify what is the other frequency you refer to in question 1.9.1:

Question 1.10
If you are a third-country national supervisory authority, do you grant protection to participants of payment systems and/or security settlement systems and/or collateral in one of these systems from national insolvency law in your country?

- Yes
- No
- Don't know / no opinion / not relevant

Question 1.10.1
Do you extent the protection to national institutions participating in other countries' systems?

- Yes
- No
- Don't know / no opinion / not relevant

Question 1.10.2
Please elaborate the conditions and assessment criteria. Please also elaborate whether you require reciprocity:

2. Participants in systems governed by the law of a Member State

The SFD lists the participants that are eligible to participate directly in an SFD system and benefit from the protection offered by the SFD. (Direct) participants are, among others, credit institutions, investment firms, public authorities, CCPs, system operators and clearing members of an EMIR authorized CCP.

Furthermore, the SFD gives Member States the option to decide that, for the purposes of the SFD, an 'indirect participant' may be considered a 'participant', if that is justified on the grounds of systemic risk. Only 'indirect participants' that fall under the categories eligible for direct participation, may be considered as (direct) 'participants' under this derogation.

Largely, the SFD does not mandate the legal form of eligible participants. Both natural and legal persons that come under the definitions are eligible to participate, except for CCPs which must be legal persons. Investment firms must be legal persons under MiFID 2 although Member States are allowed to authorise natural persons as investment firms subject to conditions.

E-money institutions under the E-Money Directive (EMD 2) and payment institutions under the Payment Services Directive (PSD 2) are not currently eligible participants under the SFD. In its Retail Payment Strategy, the Commission announced that it would consider, in its SFD review, extending the scope of the SFD to include e-money and payment institutions, subject to appropriate supervision and risk mitigation. In the absence of a harmonised SFD solution at EU level, some Member States have introduced national solutions that allow e-money and payment institutions either direct or indirect participation in payment systems, provided they fulfil certain criteria. This situation has led to level playing field issues between Member States, fragmentation of the European retail payment market and legal uncertainty regarding the cross-border recognition of settlement finality on SFD payment systems with wider national participation. It might be worth considering to add them to the list of eligible participants when they fulfil certain criteria to ensure a level playing field and provide legal certainty in a cross-border context. In the public consultation on the EU's retail payments strategy, nearly 43% of respondents thought that direct participation in SFD qualifying systems should be allowed, whilst nearly 32% thought that indirect participation through banks was sufficient .

Currently, the operator of a payment system that is not designated under the SFD is not an eligible type of SFD participant. Stakeholders raised the issue that this prevents these payment system operators from participating in TARGET2 (TARGET2 is the real-time gross settlement (RTGS) system owned and operated by the Eurosystem), where payment orders in euro are processed and settled in central bank money. They argue that (direct) participation of these payment system operators in TARGET2 (being SFD designated systems) would reduce the use of commercial bank money for settlement and the related credit and liquidity risk. Principle 9 of the principles for financial market infrastructures (PFMI) asks relevant (i.e. systemically important) financial market infrastructures to reduce credit and liquidity risks by conducting "its money settlements in central bank money where practical and available. If central bank money is not used, an FMI should minimise and strictly control the credit and liquidity risk arising from the use of commercial bank money." Adding them to the list of (direct) SFD participants would open up the possibility to allow their participation in TARGET2. While this could reduce credit and liquidity risk arising from settlement in commercial bank money, it has to be ensured at the same time that any risks arising for SFD systems are adequately mitigated.

Since the adoption of EMIR, CCPs have been added to the list of eligible (direct) SFD participants. However, CSDs as defined in Article 2(1)(1) of the CSDR are not explicitly included although their

participation is implicitly covered in their function as 'settlement agents' and 'system operators'. Yet, Article 39(1) of the CSDR, requires Member States to designate and notify securities settlement systems operated by CSDs in accordance with the SFD. Adding them to the list of (direct) participants would further clarify that they benefit from the SFD protection also in those cases, where they do participate in a system but not in the function of 'settlement agent' or 'system operator'.

Question 2.1
Should the list of currently eligible SFD participants be either limited or extended or otherwise modified? Please explain your reasons for each type of participant where relevant.

- No need for modifications
- Should be extended
- Should be limited. Some participants should no longer be eligible
- Should be otherwise modified
- Don't know / no opinion / not relevant

Question 2.1.1
Please specify how it should be extended:

The list of eligible SFD participants should be extended to include payment institutions and e-money institutions which have the capability and capacity to meet the requirements of the relevant settlement system.

SFD provides two different types of protection, namely (i) protection of the finality of a transfer order, and (ii) enforceability of collateral. Protection (i) (protection of the finality of a transfer order) should apply to all transfers executed within the system. Specifically, this means that all activity executed by an SFD-designated system (CCP, CSD or payment system) should be protected, so that all the direct participants in a CCP, CSD or payment system should be considered as falling within the scope of the protection, and thus, for protection (i), should fall within the SFD definition of a participant. In its current form, protection (ii) provides protection to collateral takers. Section 4 of this consultation paper suggests that SFD protection (ii) should be extended to collateral givers. We support this extension. The logic of this protection is that it should apply to all collateral givers, and to all collateral takers, in the intermediary chain between, and including, the market infrastructure and the trading party/order-giver, providing that there is a connection between the provision of collateral and the execution of the transfer order at the market infrastructure. The SFD definition of participant that is applicable to protection (ii) should be extended accordingly.

Please also see our answer to Question 7.2 for some more information on this approach.

Question 2.1.1
Please explain why it should be limited and list the participants that should no longer be eligible:

N/A

Question 2.1.1
Please specify how it should be otherwise modified:

N/A

Question 2.2
Should participation in an SFD system be limited to legal persons?

- Yes
- No
- Don't know / no opinion / not relevant

Question 2.2.1
Please explain your answer to question 2.2:

Our answer to Question 2.1.1 sets out our views as to which parties should benefit from SFD protections. Natural persons should benefit from SFD protection (i), if they are a direct participant in an SFD system; they should benefit from SFD protection (ii), if they have provided collateral in connection with the execution of a transfer in an SFD-designated system.

SFD should not impose restrictions of these protections, so that a natural person should be able to be a participant in an SFD system where they otherwise meet eligibility criteria.

It should be up to the relevant SFD system, in line with the specific rules applicable to the specific type of market infrastructure (such as EMIR and CSDR for, respectively, CCPs and CSDs), to assess the capability and capacity of a natural person to meet the requirements of the system, initially and on an ongoing basis.

We note that, in 2018, an incident occurred at Nasdaq Clearing involving a natural person, which naturally raised the question whether only legal persons should be eligible to take part in an SFD system. We believe that this event highlighted precisely the need for the SFD system to assess the capability and capability of a participant who is a natural person, but do not draw any conclusion that the participation of a natural person is necessarily problematic. For example, in direct holdings markets, a natural person is necessarily a member of a CSD. However, it is prudent that a participant who is a natural person should be sponsored by a regulated firm, such as a credit institution or an investment firm.

As noted in the introductory material for this section, Principle 9 of the principles for financial market infrastructures (PFMI) asks relevant (i.e. systemically important) financial market infrastructures to reduce credit and liquidity risks by conducting "its money settlements in central bank money where practical and available. If central bank money is not used, an FMI should minimise and strictly control the credit and liquidity risk arising from the use of commercial bank money." Adding them to the list of (direct) SFD participants would open up the possibility to allow their participation in TARGET2. While this could reduce credit and liquidity risk arising from settlement in commercial bank money, it has to be ensured at the same time that any risks arising for SFD systems are adequately mitigated.

Question 2.3
What is your opinion of the following (potential) participants? (options are exclusive)

You can select only one response for each type of institution.

	Payment institutions	E-money institutions
Should not be direct participants		
Should be direct participants (only)		

Should only be indirect participants who may be considered direct participants, if that is justified on the grounds of systemic risk		
Should be direct participants and indirect participants who may be considered direct participants, if that is justified on the grounds of systemic risk	X	X
Other		
Don't know / no opinion / not relevant		

Please specify what you mean by other in your response to question 2.3:

The approach set out in our answer to Question 2.2 with relation to natural persons should also apply to payment institutions and E-money institutions. Specifically, this would mean that SFD itself should not impose restrictions on the protections from which payment institutions and E-money institutions can benefit. However, it should be up to the relevant SFD system, in line with the specific rules applicable to the specific type of market infrastructure, to assess the capability and capacity of a payment institution or of an E-money institution to meet the requirements of the system, initially and on an ongoing basis.

Question 2.4
Please state your opinion on the following:

Question 2.4.a
If payment institutions and e-money institutions are added to the list of participants, they should be subject to a specific risk assessment.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Please provide some comments/explanations on your opinion to proposal 2.4 a):

In line with our answer to Question 2.3, we believe that direct access to an SFD-designated system should be granted by the system only after a risk assessment has taken place. There is no need for a specific risk assessment, but rather a need that equal risk mitigating requirements as well as financial crime prevention measures must be adhered to, as already imposed on existing participants. The risk assessment must include criteria to help mitigate the systemic risk the participant may introduce to the system as well as financial crime risk. Access should only be granted on the condition that these requirements are met.

Question 2.4.b
Payment institutions and e-money institutions should only be made eligible SFD participants if 'warranted on grounds of systemic risk'.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree

- 5 - Fully agree
- Don't know / no opinion / not relevant

Please provide some comments/explanations on your opinion to proposal 2.4 b):

Institutions which have sufficient capability and capacity to settle their obligations should be included, whether or not they are systemically important.

Question 2.4.c
If payment institutions and e-money institutions are added to the list of participants, no particular risk assessment is needed.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Please provide some comments/explanations on your opinion to proposal 2.4 c):

Please see our answer to Question 2.4.a

Question 2.5
Which risks should be considered in a specific risk assessment (mentioned in question 2.5.) for payment and e-money institutions?

How could such a risk assessment look like?

Please state your opinion on the following:

a) IT risks should be considered.
- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Please provide some comments/explanations on your opinion to proposal 2.5 a):

The risk assessment should be in line with existing relevant EU regulatory framework.

b) Operational risks (other than IT risks) should be considered.
- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Please provide some comments/explanations on your opinion to proposal 2.5 b):

The risk assessment should be in line with existing relevant EU regulatory framework.

c) Credit risk should be considered.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Please provide some comments/explanations on your opinion to proposal 2.5 c):

The risk assessment should be in line with existing relevant EU regulatory framework.

d) Liquidity risk should be considered.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Please provide some comments/explanations on your opinion to proposal 2.5 d):

The risk assessment should be in line with existing relevant EU regulatory framework.

e) Other, please specify

Whilst all of the identified risks are relevant to a risk assessment of a participant, the risk assessment should not be limited to these. The risks to be assessed should include all which are relevant to the ability of the participant to meet its obligations.

This may also include measures to prevent financial crime, in line with the relevant regulatory frameworks of the EU for sanctions screening, transaction surveillance and anti-money laundering measures.

It is important to combine the benefits of promoting more competition and innovation through opening up access with appropriate prudential controls and oversight arrangements.

We are supportive of allowing regulated/supervised non-banks access to payment systems. However, we believe this requires a careful configuration of access criteria to mitigate any potential financial, operational and reputational risks to other direct participants and to protect users' trust in payments. We have had experience in Norway where a participant was unable to fund its position, which led to significant clearing delays. In the UK we have seen the first non-bank payment service provider (PSP) given access to CHAPS, enter administration a year later.[1]

We note points made in the Committee on Payments and Market Infrastructures (CPMI) report to the G20 on enhancing cross-border payments - under building block 10 ('Improving (direct) access to payment systems by banks, non-banks and payment infrastructures') - which highlight

[1] https://www.fstech.co.uk/fst/Ipagoo_FinTech_Enters_Adminstation.php

the importance of having appropriate levels of oversight and supervision as well as the need to address any underlying legal obstacles.

Payment systems provide a vital component of the EU's infrastructure, which relies on a complex network of collaborative relationships. Inevitably, direct participation brings with it certain expectations and responsibilities, which are necessary to mitigate risks of failure in order to maintain mutual trust and financial stability.

While we are generally supportive of moves to open up access, we believe that the requirements for different types of firms permitted to participate directly in those payment systems should be on a par to avoid placing an increased or disproportionate risk on other firms. For example, all participants at a minimum should have to abide by the highest cyber and financial crime standards.

There needs to be recognition that for some providers direct participation may not be the ideal solution and they may prefer to participate indirectly. Therefore, support for such arrangements should continue. For example, for some clients, their main requirements of the system are to be able to settle money market, foreign exchange transactions and correspondent banking flows. Direct system access is not the only driver as payments may be a secondary, rather than a primary, consideration for such firms. In these circumstances, the focus is more service offering.

We welcome and encourage the build out of structured solutions for indirect access to payment schemes and strongly believe that it is to the benefit of all that these types of scheme frameworks exist in order to create both a level playing field for participants and members but also a robust control environment.

Question 2.6
In case a risk assessment is deemed useful: How often should risks be assessed?

- Annually (and ad hoc when necessary)
- Every two years (and ad hoc when necessary)
- As defined by a competent authority
- Don't know / no opinion / not relevant

Question 2.6.1
Please elaborate on your answer to question 2.6:

The risk assessment should be undertaken as frequently as determined by the competent authority, but both the elements of the risk assessment and the timing should be calibrated to the type of risk and the characteristics of the participant.

Question 2.7
Do you agree with adding CSDs to the list of participants covered by the SFD?

- Yes
- No
- Don't know / no opinion / not relevant

Question 2.7.1
Please explain your answer to question 2.7:

Please see our answer to Question 2.1.1 for some background on this answer.

Question 2.8
What do you think of adding operators of EU payment systems that are not designated under the SFD to the list of participants covered by the SFD?

- All payment system operators of EU systems that are not designated under the SFD should be eligible participants under the SFD if risks for SFD systems are adequately mitigated.
- Participation should only be possible based on the grounds of systemic risk.
- Even though credit and liquidity risk related to settlement in commercial bank money are reduced, other risks stemming from their participation in SFD systems increase. Therefore, only if they qualify as another type of SFD participant (e.g. a credit institution) they are good to participate.
- Other
- Don't know / no opinion / not relevant

Question 2.8.1
Please elaborate how this risk mitigation could look like in your opinion:

Please see our answers to Questions 2.1.1, 2.4.a and 2.5 for more information.

Question 2.8.1
Please elaborate on your answer to question 2.8:

Question 2.8.1
Please elaborate on the risks that prevent their participation in SFD systems in your opinion:

Question 2.8.1
Please explain your answer to question 2.8:

Question 2.9
What do you think of limiting the number of eligible SFD participants by replacing or complementing the current list of eligible participants by an approach that is based on a risk assessment for participants?

- This is a good idea, as it ensures that only entities which are really systemically important benefit from the SFD protection (in case of a purely risk based approach: notwithstanding their legal form (whether they are a bank, investment firm, payment institution, e-money institution etc.))
- This is too difficult from an operational point of view and will therefore jeopardize the aim of a risk based approach (as risks cannot be appropriately monitored and considered when they actually occur)
- Other
- Don't know / no opinion / not relevant

Please specify what you mean by 'other' in your answer to question 2.9:

A risk assessment is a good idea, but it should take into account the specific characteristics of the proposed participant. It should also not be the main or only condition for limiting the number of eligible SFD participants.

It is not only an operational challenge to undertake a risk assessment; it is a governance one, which should be tailored to the category of system. One way to address concerns about the changing risks that face any participant (such as credit risk) might to provide for sponsorship of SFD participants by credit institutions or investment firms.

3. SFD and technological innovation

The SFD is meant to be technologically neutral. Tech neutrality is primarily achieved by referring key requirements (e.g. the moments of entry into the system and irrevocability) to the rules of the SFD system, rather than mandating them in the SFD, itself. This approach, has largely allowed SFD systems to develop as needed, without major legislative change, so far.

The Commission has received input from various stakeholders who argue that some of the SFD's requirements create obstacles to the use of distributed ledger technology (DLT) and crypto-assets1 . Their main concerns refer to the application of the SFD in a decentralised permission-less DLT and in a context where multilateral as opposed to mainly bilateral relationships prevail. The most important issues for permission-less DLT are that there is no centralised operator, unidentified participants can enrol without restriction and functions can be attributed simultaneously to several participants. As the existence of a system operator defining the rules of a system and clear legal responsibility are important for the functioning of the SFD, this poses considerable challenges whether the SFD provisions can actually apply and if so under which conditions.

As there is not enough experience yet of the benefits and risks associated with the use of DLT, the Commission has adopted a proposal for a pilot regime on DLT market infrastructures (the pilot; COM/2020/594 final) using a sandbox approach to allow experimentation by derogating from certain EU financial markets provisions.

The pilot enables CSDs to operate 'DLT securities settlement systems' outside the scope of the SFD, but does not preclude CSDs from operating 'DLT securities settlement systems' within the SFD as stakeholder feedback suggests that this may well be possible for permissioned DLT under certain circumstances, where the system operator could design the system and its rules to be SFD compliant, possibly subject to some specification or clarification of the SFD to enhance legal certainty. Furthermore, the pilot does not apply to DLT payment systems. Hence, it could be useful to specify and clarify, in the current review, certain definitions and concepts in the SFD (e.g. system, transfer order, book-entry, settlement account and agent, conflict of laws, links with other financial market infrastructures). This could ensure they are tech neutral when applied to permissioned DLT based payment systems as well as DLT securities settlement systems that are not covered by the pilot. Feedback received so far by the Commission in this respect provided very mixed results and has not allowed for the full specification of those obstacles and potential solutions or proposals.

Stakeholders indicate further, that not only Member States transpose the existing SFD requirements differently but also national competent authorities (NCAs) interpret them differently, which might lead to legal uncertainty. Clarifying certain concepts and definitions in the SFD could hence help avoiding diverging national interpretations and transpositions and resulting legal uncertainty.

On 19 December 2019, Commission services launched a consultation on markets in crypto-assets. A part of the respondents gave replies to one or more SFD related questions (e.g. around 40% of overall respondents had an opinion on the application of SFD definitions). The responses were mixed and conflicting. Some thought that the SFD as it currently stands or with minor changes is sufficiently tech neutral to accommodate DLTs and crypto-assets, whilst others thought further clarification or specification was needed. The reasons for further changes and how to make them were not always clearly stated. See also ESMA's 'Advice - Initial Coin Offerings and Crypto-Assets', January 2019; '30 recommendation on regulation, innovation and finance' by the 'Expert Group on Regulatory Obstacles to Financial Innovation' (ROFIEG), December 2019 and 'The potential impact of DLTs on securities post-trading harmonisation and on the wider EU financial market integration' by the

'Advisory Group on Market Infrastructures for Securities and Collateral' (AMI-Seco), September 2017.

Question 3.1
Do you consider the SFD to be technologically neutral?

- Yes, everything is sufficiently clear no matter the technology used.
- No, I do not know how to apply certain concepts or definitions of the SFD for specific technologies which creates legal uncertainty (please explain under question 3.5.).
- Don't know / no opinion / not relevant

Question 3.2
Do you agree that the concepts of the SFD do not work in a permissionless DLT environment?

- Yes, important concepts of the SFD do not work in a permissionless DLT environment, especially as legal responsibilities might be unclear. It is indeed problematic that there is no centralised operator, unidentified participants can enroll without restriction and functions can be attributed simultaneously to several participants.
- No, I do not see any problem to apply the concepts of the SFD in a permissionless DLT environment. *(Please provide detailed information of how you think settlement finality under the SFD can be achieved despite the lack of a centralised operator, the fact that unidentified participants can enroll without restrictions and that functions can be attributed simultaneously to several participants.)*
- Don't know / no opinion / not relevant

Question 3.2.1
Please provide detailed information on your answer to question 3.2:

AFME members value the importance of a robust and transparent governance framework to ensure the safety and stability of a system, therefore the application of DLT for securities services has been premised on the need for control, legal certainty and clear allocation of roles and responsibilities.

There can be trade-offs for what is technically possible on different types of DLT networks (e.g. permissioned vs. permissionless, type of consensus mechanism, presence of a notary node). However, given the development of hybrid solutions and enhanced programmability, many projects in development today are overcoming challenges such as limiting access or permissions within the network. For example, while it is true that the design of a permissionless network may make it more challenging to identify participants and assign liabilities, it is feasible that permissioned applications can be built on to permissionless networks, to ensure that all participants are known to, and authorised by, a central authority or system operator.

Therefore, it may be too early to draw a permanent conclusion that a permissionless environment is incompatible with the principles of SFD while the technology is still evolving. For instance, we note that the proposed Pilot Regime programme may enable the development of many different DLT-based solutions. Taking this into consideration, we believe it is too simplistic to distinguish between permissionless and permissioned networks.

The concept of finality is based upon participants in a system agreeing to a set of minimum standards and binding rules that defines the moment of settlement finality (the irrevocability of the transfer order.) Whilst these rules have traditionally been defined by a central actor, it is conceivable that an alternative governance framework could be used. Most important is that

there is a clear definition of who (which actor for which instruction) declares finality, and based on what criteria.

Question 3.3
Do you agree that the scope of the current review of the SFD should be limited to considering the tech neutrality of the SFD in the context of permissioned DLTs where the system operator could design the system and its rules so as to be SFD compliant?

- Yes
- No
- Don't know / no opinion / not relevant

Question 3.3.1
Please explain your answer to question 3.3:

Please see our response to question 3.2.1

Question 3.4
Do you think that first experience with the pilot regime for market infrastructures based on DLT (COM/2020/594 final) should be gained before considering possible issues in the SFD?

- Yes, this will show problems resulting from the use of DLT that have to be considered in the SFD.
- No, there are already issues which have to be addressed for the use in a DLT environment as they currently create legal uncertainty.
- Don't know / no opinion / not relevant

Question 3.4.1
Please elaborate on your answer to question 3.4, if necessary:

There is a need for interpretive guidance to clarify that certain definitions in SFD can apply in a DLT context. We have outlined these definitions in our response to question 3.5 below. We believe this clarification does not need to wait until after the Pilot Regime is complete. It is important to provide regulatory clarity as soon as possible, where certain areas such as definitions have already been identified, to provide market participants the confidence to invest and innovate.

We note that there will likely be other issues which may be identified throughout the course of the Pilot Regime, as further DLT use-cases are developed, which is likely to require a further targeted review of the SFD as the Pilot Regime progresses.

Question 3.5
Should any of the definitions or concepts in the SFD be clarified or amended to apply explicitly in a permissioned DLT context?

3.5.1 Definition of a system

a) Should the definition of a system be clarified or amended to apply explicitly in a permissioned DLT context?

- Yes
- No
- Don't know / no opinion / not relevant

b) How should this ideally be done?

c) Is an amendment to the SFD required?

- Yes
- No
- Don't know / no opinion / not relevant

d) Please explain you answer to 3.5.1 c):

This answer relates specifically to the question of whether SFD should be changed in order for SFD to apply in a permissioned DLT context. This answer does not cover the question of elements of SFD should be changed in order for SFD concepts to be more aligned with the current business processes of different types of market infrastructure.

The definition of a "system" sets out when arrangements are meant to be caught by the SFD.

DLT is not itself a system, and can take many different forms. It is clear that not all DLT operated by all people should be brought within the scope of permissible system elements; nor should there be confusion about who is operating or responsible for the system.

e) Could this be dealt with by the system operator in the rules of the system?

- Yes
- No
- Don't know / no opinion / not relevant

f) Please explain you answer to 3.5.1 e):

3.5.2 Definition of a transfer order

a)Should the definition of transfer order be clarified or amended to apply explicitly in a permissioned DLT context?

- Yes
- No
- Don't know / no opinion / not relevant

b) How should this ideally be done?

c) Is an amendment to the SFD required?

- Yes
- No
- Don't know / no opinion / not relevant

d) Please explain you answer to 3.5.2 c):

This answer relates specifically to the question of whether SFD should be changed in order for SFD to apply in a permissioned DLT context. This answer does not cover the question of elements of SFD should be changed in order for SFD concepts to be more aligned with the current business processes of different types of market infrastructure.

The nature of settlement, for the purposes of the SFD, does not change by the use of a DLT or other form of ledger. The principal requirement is that an entry can be authenticated and is irrevocable.

We note that the definition of 'transfer order' includes more than one possible definition, which should offer sufficiently flexibility for system rules to be designed in such a way as to be compliant. Clarification may be required on certain terms used within the definition of 'transfer order' – please see our responses to 3.5.3 and 3.5.4.

Additionally, we note that many DLT-based systems assume an integration between trading and settlement. Further consideration should be given as to the implication of combining the 'trading order' and 'transfer order'.

We would welcome further clarification in the form of interpretive guidance.

e) Could this be dealt with by the system operator in the rules of the system?

- Yes
- No
- Don't know / no opinion / not relevant

f) Please explain you answer to 3.5.2 e):

The technological implementation of a DLT settlement system would need to be designed in such a way that the implementation of a transfer order in its register complies unequivocally with the above definition.

3.5.3 Concept of book-entry

a) Should the concept of book-entry be clarified or amended to apply explicitly in a permissioned DLT context?

- Yes
- No
- Don't know / no opinion / not relevant

b) How should this ideally be done?

In its 2019 report on ICOs and crypto-assets, ESMA[2] noted that "the legal nature of a securities account (i.e. statutory record, contractual construct or accounting device) and the legal nature and effects of book entries are still embedded in national law."

We note that some jurisdictions (e.g. France, Luxembourg) have amended their legal framework to explicitly recognise the recording of securities on a distributed ledger to be equivalent to (or having the same effect as) recording on an account in a book-entry form, in terms of transfer of ownership.

[2] https://www.esma.europa.eu/sites/default/files/library/esma50-157-1391_crypto_advice.pdf

It would be helpful for European authorities to provide interpretative guidance on this point, which may result in similar clarifications in national laws of member states.

c) Is an amendment to the SFD required?

- Yes
- No
- Don't know / no opinion / not relevant

d) Please explain you answer to 3.5.3 c):

e) Could this be dealt with by the system operator in the rules of the system?

- Yes
- No
- Don't know / no opinion / not relevant

f) Please explain you answer to 3.5.3 e):

3.5.4 Definition of settlement account

a)Should the definition of settlement account be clarified or amended to apply explicitly in a permissioned DLT context?

- Yes
- No
- Don't know / no opinion / not relevant

b) How should this ideally be done?

Please see our response to 3.5.3 (b)

c) Is an amendment to the SFD required?

- Yes
- No
- Don't know / no opinion / not relevant

d) Please explain you answer to 3.5.4 c):

e) Could this be dealt with by the system operator in the rules of the system?

- Yes
- No
- Don't know / no opinion / not relevant

f) Please explain you answer to 3.5.4 e):

3.5.5 Definition of settlement agent

a)Should the definition of settlement agent be clarified or amended to apply explicitly in a permissioned DLT context?

- Yes
- No

- Don't know / no opinion / not relevant

b) How should this ideally be done?

The use of DLT may introduce new actors and the role of intermediaries may change versus what is common today. If, as a result of the transition to a DLT environment, the concept of a settlement agent (participant) providing access to a SSS via the provision of a settlement account is changed (e.g. there are no settlement accounts any more, as per Q 3.5.4 above), then it will also be necessary to change the definition of settlement agent.

c) Is an amendment to the SFD required?

- Yes
- No
- Don't know / no opinion / not relevant

d) Please explain you answer to 3.5.5 c):

Please refer to our response to 3.5.5.b

e) Could this be dealt with by the system operator in the rules of the system?

- Yes
- No
- Don't know / no opinion / not relevant

f) Please explain you answer to 3.5.5 e):

Possibly yes, but this needs to be evaluated further in the context of all the technical, operational and legal arrangements of the new DLT-based system

3.5.6 Links with other financial market infrastructures and trading venues (traditional or DLT based)

a)Should the links with other financial market infrastructures and trading venues (traditional or DLT based) be clarified or amended to apply explicitly in a permissioned DLT context?

- Yes
- No
- Don't know / no opinion / not relevant

b) How should this ideally be done?

AFME members consistently advocate in favor of efficient interoperability arrangements for financial market infrastructures and platforms. For example, see "Technology and Innovation in Global Capital Markets", March 2019, page 17:

"There is a risk that the approach to how DLT is developed may reinforce existing systems and complexity, rather than create greater simplification. Similarly, a large number of bank-specific DLT solutions could further increase technology and operational fragmentation within the industry, illustrating the need for interoperable solutions. Cybersecurity concerns for DLT, such

as potential vulnerabilities in key management and access to systems, are also cited as a challenge."

In general terms, interoperability provides opportunities for cost reductions, service quality improvements, abatement of monopolistic positions and concentration risks in favor of user choice, innovation and flexibility.

With specific reference to DLT-based infrastructures, the key aspect to be considered in the context of SFD would be the definition of common rules and standards for SFD terminology as well as common legal & operational principles for crisis management activities (e.g. the simultaneous suspension or cancellation of pending instructions in case of the insolvency of a participant). An example of this is the collective agreement in T2S for a harmonized definition of the moments of enforceability and irrevocability of transfer orders.

Such interoperability arrangements should be created both across different DLT systems and between DLT-based systems and traditional ones, so as to ensure full interoperability and flexibility of services for end-users of all authorized platforms.

It should also be noted that in the case of CSD links outside of the T2S platform, securities settlements are possible but with ad-hoc protections (e.g. the conditional settlement procedures or other similar procedures), which frequently create delays and inefficiencies to the smooth completion of settlements.

c) Is an amendment to the SFD required?

- Yes
- No
- Don't know / no opinion / not relevant

d) Please explain you answer to 3.5.6 c):

Please refer to our response to 3.5.6.b

e) Could this be dealt with by the system operator in the rules of the system?

- Yes
- No
- Don't know / no opinion / not relevant

f) Please explain you answer to 3.5.6 e):

The rules of a system would be the best way of dealing with this requirement, provided that this is covered under an overarching prescription in the new settlement finality legislation supporting the interoperability principles.

3.5.7 Concept of conflict of laws

a)Should the concept of conflict of laws be clarified or amended to apply explicitly in a permissioned DLT context?

- Yes

- No
- Don't know / no opinion / not relevant

b) How should this ideally be done?

c) Is an amendment to the SFD required?

- Yes
- No
- Don't know / no opinion / not relevant

d) Please explain you answer to 3.5.7 c):

There is a need for a conflict of laws rules in SFD. This should be complemented by appropriate rules of the system. Please see our answer to question 3.5.7 f).

e) Could this be dealt with by the system operator in the rules of the system?

- Yes
- No
- Don't know / no opinion / not relevant

f) Please explain you answer to 3.5.7 e):

Commented [TP1]: To Be Updated

The SFD refers to rights "legally recorded on a register, account or centralised deposit system located in a Member State". Where the securities register is stored on a distributed ledger, however, the physical location of the technology holding that register is not a meaningful concept, as it could be stored on every node in the DLT network. We find that the governing law should be determined by the location of the central authority, such as a CSD, who operates the DLT network.

If there is no central operator, the governing law should be defined in the rules of the system.

Separately, we wish to highlight recommendation 8 of the 2019 report by the Expert Group on Regulatory Obstacles to Financial Innovation (ROFIEG), which concludes that: "In order to ensure market participants' rights and to guarantee a meaningful application of the commercial law concepts established in EU regulation (such as InsR, SFD, FCD, BWUD, BRRD) to crypto-assets which are held on a distributed financial network, the Commission, in co-operation with the ESAs and international standard-setting bodies and other relevant authorities, should:

a. legislate a relevant conflict-of-laws rule, ideally enshrined in a Regulation, and,

b. consider which further aspects of the commercial law regarding such networks and regarding the assets administered on them should be addressed at EU level."
It is necessary to ensure that there is legal certainty as to the ownership of assets held on a distributed ledger, in particular crypto-assets. As noted by the ROFIEG, this issue is of systemic importance given that "Risk management of financial institutions is built on the understanding that rights are enforceable in court."

3.5.8 Other

a)Is there any other definition or concept that should be clarified or amended to apply explicitly in a permissioned DLT context?

- Yes
- No
- Don't know / no opinion / not relevant

b)Please specify what other definition or concept should be clarified or amended to apply explicitly in a permissioned DLT context?

c) How should this ideally be done?

d)Is an amendment to the SFD required?

- Yes
- No
- Don't know / no opinion / not relevant

e) Please explain you answer to 3.5.8 d):

f)Could this be dealt with by the system operator in the rules of the system?

- Yes
- No
- Don't know / no opinion / not relevant

g) Please explain you answer to 3.5.8 f):

Question 3.6
Are there any other amendments to the SFD that should be considered to deal with opportunities and/or risks that are specific to a permissioned DLT based SFD system?

- Yes
- No
- Don't know / no opinion / not relevant

Question 3.6.1
Please explain the risks and how they might be mitigated in the SFD:

SFD protections should be harmonised across all EU SFD-designated systems. Similarly, operational processes linked to managing the insolvency of a market participant should be harmonised to the greatest extent possible. These are necessary elements of a Capital Markets Union. SFD should ensure that it permits such harmonised operational processes to the greatest extent possible, and that differences in national laws and national transpositions of SFD do not create discrepancies that hinder such harmonisation. One important step could be to convert SFD into a Regulation.

As recommended to the European Commission by the Expert Group on Regulatory Obstacles to Financial Innovation (ROFIEG)[1], in order to ensure market participants' rights and to guarantee

[1] *30 Recommendations on Regulation, Innovation and Finance - Final Report to the European Commission*, (December 2019) (the ROFIEG Report).

a meaningful application of the commercial law concepts established in EU law such as the SFD, a conflict-of-laws rule, ideally enshrined in regulation should be considered, and further aspects of the commercial law should be addressed considered as well.[2]

The ROFIEG in the report pointed to recent failures of certain intermediaries acting in the sphere of crypto-assets as illustrating that in the event of insolvency, in particular, the issue as to 'who owns what' will arise in relation to securities, cash or other financial assets.

Commercial law to a large extent remains a matter of Member States' national autonomous law. The ROFIEG expressed highest concern about the proprietary situation of client assets held on a ***distributed*** network. We assume this concern is less pronounced in a ***permissioned*** DLT based system in the context of SFD, as suggested in this Consultation Paper. However, we believe that it is still crucial to address potential conflicts among member state laws in order to ensure predictability and clarity regarding the jurisdiction of the operator of a network, the issuer's jurisdiction or a limited choice of law made by the participants of the network.

Beyond the above, we agree with the ROFIEG that the Commission and ESAs should assess whether a meaningful application of the remainder of commercial law, including property, corporate and insolvency law aspects, requires further targeted harmonisation. The ROFIEG points out that an important aspect of this relates to ownership of assets – in particular crypto-assets - held on a ***distributed*** financial network. We submit similar considerations arise in the context of a ***permissioned*** system. In both cases, the technology may suggest direct ownership of a particular crypto-asset, and it both cases a clear legal structure must still exist to confer rights onto the token holder, extending to the underlying real-world assets (if any) held through custodial structures.

As the ROFIEG points out, the clarification of commercial law relationships, including the conflict of laws question, is relevant beyond the issue of individual market participants' legal position. It has a wider regulatory, and even systemic importance. We agree with the ROFIEG that risk management of financial institutions is built on the understanding that rights are enforceable in court – this extends to the application of the SFD.

We therefore agree with the ROFIEG's recommendation that the application of commercial law to crypto-assets be clarified, at least so it is clear which aspects of Member State commercial law applies to which types of crypto assets that may be held over an SFD system.

We further suggest that focusing on MiFID – i.e., whether crypto assets are considered MiFID financial instruments or not – does nothing to address this concern. What would be meaningful is if – as part of the taxonomy exercise - assets are characterised as giving rise to rights in rem (property rights) or in rights in personam (contracts rights or personal claims), which is especially crucial in the context of insolvency. Understanding the nature of legal rights and obligations that arise with respect a particular asset type – and under which national law these rights and obligations arise – is a necessary precondition for the adoption of framework that operates safely and efficiently.

[2] See, Recommendation 8, ROFIEG Report.

4. Protections granted under the SFD vis-à-vis collateral security

The definition of 'collateral security' under the SFD covers 'all realisable assets', including financial collateral covered by the FCD. Such financial collateral includes cash, financial instruments and credit claims and is discussed in the targe-ted consultation on the FCD.

Article 9(1) of the SFD insulates collateral security given in connection with participation in an SFD system or in connection with monetary operations involving the national central banks of the Member States (NCBs) or the ECB from the effects of the insolvency of the collateral giver where the latter is a:

- *participant in a system or in an interoperable system*
- *system operator of an interoperable system that is not a participant counterparty to the NCBs or ECB*
- *third party that provided the collateral security*

However, Article 9(1) of the SFD does not protect collateral security provided by the client of a participant in an SFD system (e.g. a counterparty clearing its derivatives) from the effects of the opening of insolvency proceedings against the participant (e.g. a clearing member) or the system operator (e.g. a CCP) beyond any protection afforded by sectoral legislation (e.g. EMIR or CSDR).

Question 4.1
Should the protection in Article 9(1) of the SFD be extended to clients of participants in an SFD securities settlement system in the event of the insolvency of that participant?

- Yes
- Yes, but only for certain SFD securities settlement systems
- Yes, but only to certain clients of participants
- No
- Don't know / no opinion / not relevant

Question 4.1.1
Please explain your answer to question 4.1:

Where a client is required to place collateral with a participant of an SFD-designated system the collateral is not placed to protect the client against the insolvency of the participant such as a settlement agent but to protect the participant by, for example, securing a credit line granted to the client. The collateral placed must therefore be protected and an extension to the SFD would be warranted.

The rationale for this protection is strong, and widely-applicable. There is no rationale to limit this protection just to clients of direct participants in SSSs. This protection should apply to all collateral that is linked to the activity at the system and that is held by the intermediary, including collateral placed by the client with the intermediary, as well as collateral that the intermediary receives in the system through the execution of the client's transfer orders. A high degree of harmonisation of SFD protections across all EU Member States would have the benefit of legal certainty in all cross-border scenarios. These provisions are explicitly included in some national transposition laws of the SFD (for example, in Italy, D.Lgs. nr. 210 of 12/04/2001, Art. 6), but are not in other Member States. We would propose that these provisions should be fully harmonised across the EU, so as to ensure equal treatment and equal legal certainty for all participants and all their clients that are accessing an SFD-designated system.

Specifically, this protection should be extended to clients of all intermediaries that provide access services to all SFD-designated systems, no matter where those intermediaries are located in the chain of intermediaries.

Limiting this protection just to some type of activities creates both gaps in the protection, and operational complexity. For example, limiting the protection just to clients of direct participants would mean that an individual investor providing collateral relating to activity on a single securities account across multiple SFD-designated systems may be protected for part of that collateral, but not for all, given that the protections would depend on the different operational set-ups between the intermediary and the different SFD-designated systems.

Question 4.2
In case the protection in Article 9(1) of the SFD was extended to clients of participants in an SFD securities settlement system: How useful do you consider the following conditions?

a) The client should be known to the system operator.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Please explain why you provided that response to question 4.2 a):

There is no good reason why the protection given to the collateral giver should be dependent on the collateral giver being known to a third party (namely, the system operator). The protection is a matter for the collateral giver (the client), the collateral taker and the insolvency practitioner, and does not impact the system operator. An additional benefit would be that this would help facilitate harmonisation across EU Member States.

b) The client should have to fulfill criteria that are predefined by the system operator, e.g. regarding the client's credit/risk assessment.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Please explain why you provided that response to question 4.2 b):

The client's risk assessment and credibility should be determined by the intermediary. This should in no way contravene the relationship between the SFD-designated system and the participant which has its own risk assessment requirements / criteria. The system operator faces the participant, and should the system operator be required to conduct its own risk assessment it undermines the participant and its relationship with its client.

c) The client should have its own segregated account.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Please explain why you provided that response to question 4.2 c):

This requirement would be contradictory to Article 38 of CSDR and Article 39 EMIR, which ensure that the option of omnibus account segregation is available.

Clients already have the option of a segregated account. Mandating this will introduce cost and complexity.

d) The client should provide collateral security to secure transactions exceeding the threshold under EMIR (whereupon they are obliged to centrally clear their transactions).

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Please explain why you provided that response to question 4.2 d):

We don't fully understand the proposal set out in this question. Our answer is based on the core idea that the SFD protection for the collateral giver should relate to collateral provided as part of the process of transmitting transfer orders to the SFD-designated system. There is no justification for additional operational requirements that may be burdensome, and that may have the effect of reducing the protection.

e) Other, please specify and explain why:

Please see our answer to Question 4.2.d.

Question 4.3.1

As a client of a participant in an SFD system that is also an EMIR authorised CCP, please indicate the aggregated value of your clearing transactions entered into the system in 2020.

Note that the that the answers given to this question will be treated confidentially and will not be published.

Question 4.3.2

As a client of a participant in an SFD system that is also an EMIR authorised CCP, please indicate the aggregated value of related collateral security entered into the system in 2020.

Note that the that the answers given to this question will be treated confidentially and will not be published.

Question 4.3.1

As an EMIR authorised CCP: Of how many clients of clearing members are you aware?

Note that the that the answers given to this question will be treated confidentially and will not be published.

Question 4.3.2

Please explain your answer to question 4.3.1:

Note that the that the answers given to this question will be treated confidentially and will not be published.

5. Settlement finality under the SFD

The SFD bestows settlement finality on SFD systems. To determine what is covered and how it is covered, the SFD refers to two specific moments that must be defined in the rules of the system: entry into the system and irrevocability.

In this regard, stakeholders indicated what they consider shortcomings in the SFD. They state that the legal duty for an SFD system to specify the moments of entry into the system and irrevocability as well as where settlement is both enforceable and irrevocable, is not clearly stipulated in the SFD (see also EPTF Report, 15 May 2017). Furthermore, in their opinion, the settlement finality provisions of the SFD do not accommodate the specificities of clearing systems both under business-as-usual and market stress conditions (e.g. where commodities derivative contracts reached maturity or when a CCP's default management procedures kicked-in). Additionally, they raised the point that there was no provision in the SFD for ensuring that the moment of settlement finality is identical in relation to both the cash and securities legs of a transaction settled based on 'delivery-versus-payment'. Especially in the event of the insolvency of a participant in an SFD system, different finality timestamps in interoperable systems could cause problems. A transaction could be final, protected and executable in one system, while being neither final nor executable in another system (e.g. relevant in case of a CCP and a CSD of which one settles the cash leg and the other settles the securities leg of the transaction).

Question 5.1

Do you agree with the concerns raised regarding the settlement finality and notification about insolvency proceedings under the SFD?

a) The legal duty for an SFD system to specify the moments of entry into the system and irrevocability as well as where settlement is both enforceable and irrevocable should be clearly stipulated in the SFD.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Please explain your answer to question 5.1 a):

The issues raised in the EPTF Report remain relevant and should be priorities for reform. Stipulating this requirement in SFD itself will help promote harmonisation.

b) The settlement finality provisions of the SFD should accommodate the specificities of clearing systems both under business-as-usual and market stress conditions more clearly.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Please explain your answer to question 5.1 b):

A core concept of SFD is the concept of a "transfer order". This concept is not easily applicable to CCPs. It is important to ensure that activities executed by a CCP in the full lifecycle of a contract in a financial instrument benefit from SFD protections. The section in the EPTF report on EPTF Barrier 10 gives some explanations on this topic. We would see the provisions in a revised SFD as being equally applicable under business-as-usual conditions and under market stress conditions. It is not clear why there would be different requirements for market stress conditions, when that is when certainty of approach is most important.

c) A provision in the SFD for ensuring that the moment of settlement finality is identical in relation to both the cash and securities legs of a transaction settled on the basis of 'delivery-versus-payment' is needed.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Please explain your answer to question 5.1 c):

We agree with the conclusions of the EPTF Report which stated that "[t]he SFD should be revised in order to … ensure that the moment of settlement finality is identical in relation to both cash and securities transfer legs of a transaction which the parties intend to settle on a DvP basis. Linked payment and securities settlement systems may be required to define in their rules a moment at which the respective settlement occurs with finality, which may entail conditionality upon finality occurring in respect of the opposite leg in the corresponding system."

The EPTF Report notes that one of the challenges is the coexistence of different approaches to DvP. It might be more appropriate to provide through a regulation that the effect of different models that lead to the same result should be treated the same way, so that insolvency events do not lead to different situations.

d) The SFD needs to be amended to ensure that different times of finality do not cause problems in interoperable systems.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Please explain your answer to question 5.1 d):

e) The SFD should clearly stipulate, that a system operator should also be immediately notified about the opening of insolvency proceedings (in addition to an authority chosen by the Member State, the ESRB, ESMA and other Member States).

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral

- 4 - Rather agree
- 5 - Fully agree
- Don't know / no opinion / not relevant

Please explain your answer to question 5.1 e):

f) Other, please specify and explain your answer:

Question 5.2
Would your answer change if the SFD would be extended to cover third-country systems?

- Yes
- No
- Don't know / no opinion / not relevant

Question 5.2.1
Please explain why and how your answer would change if the SFD would be extended to cover third-country systems:

Our answers to the questions in section 5 relate to SFD as it applies to systems in the EU. As set out in our answers to the questions in Section 1, we do not believe that the assessment process for designation under SFD of third-country systems should mandate that third-country systems should comply fully with all the requirements of SFD as they apply to EU systems.

We support extending the SFD to provide for designation of third country systems, but in a way that does not impact or alter the rules governing any third-country system or apply EU law extra-territorially, as indicated in our response to question 1.1.

6. The SFD and other Regulations/Directives

The proper functioning of the SFD also requires clarity regarding its interaction with other relevant legislation, especially insolvency legislation. When the SFD was adopted, (pre-) insolvency and insolvency-like proceedings (e.g. regulatory moratoria) were governed by national law. Since then, the EU has adopted the BRRD, the Insolvency Regulation as well as the Second Chance Directive and the Framework for the recovery and resolution of central counterparties.

The Commission's services are interested in possible other legislation where provisions may not be sufficiently clear in their interaction with the SFD or vice versa.

Question 6.1
Is there any (insolvency or other) legislation where provisions are not sufficiently clear in terms of their interaction with the SFD or the other way round?

6.1.1 Insolvency Regulation (Regulation (EU) 2015/848)

- Yes
- No
- Don't know / no opinion / not relevant

Please explain why you think the provisions of the Insolvency Regulation (Regulation (EU) 2015/848) are not sufficiently clear in terms of their interaction with the SFD or the other way round.

Please also explain how this matter might be solved:

6.1.2 Second Chance Directive (Directive (EU) 2019/1023)

- Yes
- No
- Don't know / no opinion / not relevant

Please explain why you think the provisions of the Second Chance Directive (Directive (EU) 019/1023) are not sufficiently clear in terms of their interaction with the SFD or the other way round.

Please also explain how this matter might be solved:

6.1.3 BRRD (Directive (EU) 2014/59/EU)

- Yes
- No
- Don't know / no opinion / not relevant

Please explain why you think the provisions of the BRRD2 (Directive (EU) 2019/879) are not sufficiently clear in terms of their interaction with the SFD or the other way round.

Please also explain how this matter might be solved:

6.1.4 Framework for the recovery and resolution of central counterparties (Regulation (EU) 2021/23)

- Yes
- No
- Don't know / no opinion / not relevant

Please explain why you think the provisions of the Framework for the recovery and resolution of central counterparties (Regulation (EU) 2021/23) are not sufficiently clear in terms of their interaction with the SFD or the other way round.

Please also explain how this matter might be solved:

6.1.5 PSD2 (Directive (EU) 2015/2366)

- Yes
- No
- Don't know / no opinion / not relevant

Please explain why you think the provisions of the PSD2 (Directive (EU) 2015/2366) are not sufficiently clear in terms of their interaction with the SFD or the other way round.

Please also explain how this matter might be solved:

Question 6.1.6

If there is any (insolvency or other) other legislation where provisions are not sufficiently clear in terms of their interaction with the SFD or the other way round, please specify which ones, explain why, and explain how this matter might be solved:

7. Other Issues

The Commission's services are interested in possible other matters that stakeholders may have encountered in the context of the SFD that might be important for the review.

Question 7.1
To what extent have inconsistencies in the transposition of the SFD caused cross-border issues, which would merit further harmonisation?

Please provide examples of such instances:

The harmonisation of operational procedures in the event of an insolvency is an important objective. This is an integral part of a Capital Market Union, and should form part of Action 11 of the CMU Action Plan.

Achieving harmonisation of operational procedures is a complex endeavour, as an insolvent party may have activities in multiple jurisdictions, and may play multiple roles, and as an insolvency may raise complex and difficult questions.

SFD by itself will not achieve full harmonisation, as many relevant processes and factors are outside the scope of SFD. SFD can, however, make a contribution by ensuring that the SFD rules, approach and logic are applied in the same way across all member states and throughout the custody and intermediary chains.

Question 7.2
Is there anything else you would like to mention?

Principles

The need for reform of the SFD is well established. The specific parameters for reform need more work before they can be firmly concluded; particularly with respect to novel technologies, such as DLT. The extension of the SFD to new actors and technologies should proceed on the basis of a set of principles which recognise the value of settlement finality for the securities markets generally; and which avoid both the obstruction of technical innovations and the concentration of risks in ways that could impact financial market infrastructures.

We suggest that the following set of principles should be considered as part of the reform programme for the SFD:

1. Settlement finality should take priority over the effects of Member States' insolvency rules.
2. The settlement system should be able to specify, through its rules, the point at which a transfer order becomes irrevocable. Consistency of result is more important than consistency of timing or means.
3. Where a settlement system consists of a series of nodes rather than a single operator, then the contractual rules of the system may substitute for the rules of a system operator.
4. Payment and e-money institutions should be able to be recognised as participants in a settlement system for SFD purposes. Their eligibility to be a participant in any particular system should be subject to the conditions laid down by the system operator or in the contractual rules of the system, as appropriate; including any requirements for sponsorship by another participant which is an authorised firm.

5. Settlement systems in third countries should be eligible to be recognised for SFD purposes, subject to their ability to demonstrate compliance with the IOSCO Principles for Financial Market Infrastructures, and not on the basis of equivalence and reciprocity of the legal systems within which they operate.

Form of Legislation

We wish to note that, to achieve the aims of the legislation and ensure the primacy of the settlement finality rules over national insolvency regimes, it is suggested that it should take the form of a regulation.

DVP

We also highlight that SFD does not reflect the important role of delivery-versus-payment (DVP) in today's settlement systems. SFD treats the securities transfer and cash payment legs as separate, when in fact these are linked and dependent upon one another, as detailed in Barrier 10 of EPTF Report.

Indirect Participation and the Enforcement of Collateral

We recommend looking at harmonising the way markets in the EU deal with the insolvency of indirect participants within the framework of settlement finality and with respect to financial collateral. The challenge is that transfer orders may be transmitted to a settlement system for a client of a custodian which has become insolvent, and the treatment of the transfer orders as irrevocable could lead to the accumulation of risk at the custodian, i.e. in a participant of the settlement system providing settlement services for its clients.

In some EU markets, a transfer order cannot be withdrawn after it has been matched with the opposite transfer order. In the T2S system, for example, this could only happen with the agreement of each participant. Accordingly, the participant can be put in the position of paying for securities received for the account of its client, notwithstanding the insolvency of the client.

For transactions on a trading venue, a firm acting as a custodian will agree with the trading venue to be appointed as settlement and paying agent. The trading venue will transmit settlement instructions (i.e., transfer orders) without going through the custodian. So, in the case of T2S, transfer orders are sent quickly, and the custodian is subject to the irrevocable commitment to pay funds or deliver securities, based on what the trading venue participant has done.

The better situation would be that the custodian participant should be allowed to cancel transfer orders in the settlement system where there is notice of the insolvency of the indirect participant.

There should also be a self-help remedy available, so that the participant is able to realise as collateral any unpaid securities within its possession or control which are held for the account of the client/indirect participant. If the client/indirect participant is insolvent, then the participant should be able to act straight away, in order to address the risk that there may be a collapse in the value of the collateral.

The participant acting as a settlement agent should be able to suspend transfer orders or cancel them, depending on the system, so that transactions are not carried out for the account of indirect participants which are not capable of seeing them through directly.