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European Commission
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CC: Sean Berrigan, Acting Director-General, DG FISMA; Patrick Pearson, Head of Financial Market Infrastructures and Derivatives, DG FISMA; Tatyana Panova, Head of Capital Markets Union, DG FISMA; Thomas Wieser, Chair, High-Level Forum on Capital Markets Union

Via email.

22nd January 2020

Joint Trade Association Letter regarding Implementation of the CSDR Settlement Discipline Regime

Dear Executive Vice-President Dombrovskis and Mr Maijoor,

We write to you regarding the implementation of Regulation (EU) No 909/2014 [“CSDR”] and the Commission Delegated Regulation (EU) 2018/1229 [“SDR RTS”]. CSDR and the accompanying RTS on Settlement Discipline sets out an objective to improve efficiency and safety in European capital markets. This aspiration is shared by members of the Joint Associations[1]. We believe that CSDR can be a driver of greater settlement efficiency and improved operational processes, for the ultimate benefit of the end investor.

Settlement Discipline consists of three main features: rules for the trade allocation and confirmation process, cash penalties on failed transactions, and mandatory buy-ins. Improved allocation and confirmation processes, and the introduction of cash penalties to incentivise timely settlement, are important and necessary measures that should lead to a significant improvement in settlement rates. That CSDs will be required to facilitate hold and release and partial settlement functionality[2] is also expected to contribute to improved settlement efficiency.

The success of the Settlement Discipline Regime will be determined by the resultant impact on settlement efficiency in European capital markets. The Regulation should not have negative consequences beyond its post-trade policy objective.

However, the consensus view amongst buy- and sell-side market practitioners, is that the mandatory buy-in regime will have very significant negative implications from a trading and liquidity perspective, across many asset classes.

It will negatively impact the efficiency of European capital markets, leading to greater costs and barriers to investing in European securities. Mandatory buy-ins are expected to lead to wider bid-offer spreads in the cash markets, reduce market efficiency and remove incentives to lend securities in the securities lending and repo markets, and may ultimately favour the settlement in non-EU CSDs of less liquid securities.

This would conflict with wider CMU objectives of developing EU capital markets, especially to provide efficient financing to smaller corporate clients, whose securities will have lower inherent liquidity and therefore would be disproportionately affected.

Executive Summary

We support the imposition of a penalty regime under CSDR as an important step towards improving settlement efficiency in European capital markets. However, we continue to be concerned that the impact of a mandatory buy-in regime will have negative consequences that are damaging to market liquidity and efficiency and restrict the growth of capital markets in Europe.

We respectfully request the authorities to consider a cautious, phased-in approach to ensure the successful implementation of the cash penalty regime and reconsider the mandatory nature of the buy in.

1. Introduce cash penalties once market infrastructures, banks and their clients have built and tested the required new messaging and technology.

2. Deferral of the mandatory buy-in regime until the effects of penalties and other measures (e.g. prompt allocation/confirmation processes) to promote settlement efficiency are implemented. An in-depth impact

[1] The Joint Associations are AFME, AFTI, AGC European Focus Committee, AIMA, AMAFI, Assogestioni, ASSOSIM, BVI, DACSI, EBF, EDMA Europe, ICMA, ISLA, and the IA. More information about each organisation is included in the Annex.
[2] Articles 8 and 10 of the SDR RTS

analysis should be undertaken by the Commission during this period on the potential impact of introducing a mandatory buy-in.

3. Implement monitoring processes to measure the impact of the penalty regime on settlement efficiency.

4. Replace the mandatory nature of the buy-in with an optional right of the receiving party, underpinned by law, to allow a buy-in of a non-delivering counterparty. Address the asymmetrical issues relating to buy in costs. The topic of cash compensation should be thoroughly reassessed.

Mandatory Buy-ins: Impact to Market Liquidity and End Investors

Market-makers perform a critical intermediation function, based on their ability to source and to sell securities, as well as to borrow and lend securities. Market-makers monitor the size of their inventories in order to lessen risk in their operations, reduce associated capital and balance sheet costs, and ultimately minimise costs for end investors. In the vast majority of cases, liquidity providers are able to locate sellers or lenders to fill the purchase order of their client or counterparty. However, in certain cases market-makers provide liquidity on securities, based upon the availability of inventory or their reasonable expectation of sourcing such securities. In other cases, market events can also lead to unexpected and prolonged contractions in liquidity. This is particularly apparent in less liquid instruments, such as corporate bonds, small- and mid-cap equities, and ETFs.

It is important to note that the trading parties assume economic exposure to the purchased securities at the point of trade, not settlement, and monitor credit exposure versus their counterparties on an ongoing basis. The concept of buy-ins exists today in European markets and is effective as a tool for concluding settlement fails. The key element that underpins this effectiveness is that the buy-in is discretionary rather than mandatory. Also of importance is the widespread utilisation of pass-on mechanisms to limit the disruptive nature of multiple buy-ins along a single chain of transactions. Most investors today have the contractual right to exercise buy-ins against failing counterparties, and they choose to use this in circumstances in which they deem it appropriate. The vast majority of cash equities executed on exchange are already subject to a mandatory buy in by a central counterparty (CCP). However, the imposition of a mandatory buy-in on OTC transactions would be a new and untested process. We note that the potential "indirect cost" of reduced liquidity was anticipated in the ESMA Impact Assessment[3] published in 2016. Crucially, however, this assessment did not attempt to quantify the size and scale of the impact.

With respect to bond markets, the 2019 ICMA Impact Study[4] indicates that 100% of sell-side responders and 80% of buy-side responders expect that mandatory buy-ins will negatively impact overall efficiency and liquidity. Market makers expect to widen bid-ask spreads by at least 100%, with a greater impact expected on illiquid asset classes, and full withdrawal from market making in some instances. Traditional lenders are expected to hold more buffers, or even withdraw inventory, thus limiting liquidity for short covers. Sell-side practitioners state that "there will be no choice but to widen pricing in the High Yield and illiquid spaces to the detriment of investors."

Recital 19 of CSDR and Recital 34 of the SDR RTS suggest "minimising the number of buy-ins" where possible, but there is no market-wide framework for the management of buy-ins. CSDR and the SDR RTS portray a single, discrete transaction between two parties, whereas in reality the settlement landscape is a complex network of interlinked transactions involving a multitude of market participants, in which a single settlement fail can cause the failure of an entire chain of settlement instructions. There is a high probability that multiple parties will each be obligated to execute a buy-in for what is ultimately a single settlement fail. The impact of this will be a shortage of liquidity leading to a potential distortion in prices and an artificial increase in the cost of the security.

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[3] https://www.esma.europa.eu/sites/default/files/library/2016-174-annex_iv_-_impact_assessment_on_csdr_rts_on_settlement_discipline.pdf

[4] https://www.icmagroup.org/assets/documents/Regulatory/Secondary-markets/CSDR-Settlement-Regulation/Mandatory-buy-ins-under-CSDR-and-the-European-bond-markets-Impact-Study-271119.pdf

As has been well documented, this situation is further aggravated by the asymmetric treatment in the payment of the differential between the original transaction price and the buy-in price.[5] This exposes all market participants to significant risk, creates irregular and unpredictable trading outcomes, and acts as a further deterrent to liquidity provision and principal intermediation, as well as securities lending. Fundamentally, the result of a successful buy-in should be that both parties are in the economic position in which they would have been if the original trade had not failed, notwithstanding the penalties imposed on the failing party.

A significant area of concern for the industry is the provision for cash compensation in the case of unsuccessful buy-ins. Feedback from buy-side firms is that this is an inappropriate and inadequate resolution mechanism. The regulation effectively prescribes that a traded position in a security may be cancelled and replaced by a cash amount, twelve or more business days after trade date, due to circumstances beyond the control of the receiving party. This cash amount is not an equivalent substitute for the traded securities, which were purchased as part of an investment strategy. This also has implications for contingent trades, such as FX, swaps or other hedging activity, which will need to be unwound. In addition, there is an open question as to the method for price determination in such cases, where there is no liquid market and thus no recent reliable market price on which to base the cash compensation amount.

We would also note that where the transaction is executed on a trading venue but not cleared[6], the legislation does not currently recognise that a trading venue member may be acting entirely for the accounts of one or more underlying trading parties (as defined in the SDR RTS).

Due to these risks, we support a cautious and incremental approach to the implementation of the settlement discipline regime. The introduction of cash penalties, in conjunction with improved allocation and confirmation processes, and improved CSD functionalities, may prove a sufficient and proportionate measure to address regulatory concerns about current settlement rates. Therefore, we support the implementation of the cash penalty regime, with the buy-in regime deferred until such a time as the impact on the market can be suitably measured. A data-driven review should be undertaken on the effectiveness of the penalty's regime, and other measures, plus an impact analysis on the potential effects of a mandatory buy-in.

The regulation enshrines into law a harmonised framework for the buy-in process, strengthening the rights of the receiving party. However, the mandatory nature of the regime removes the receiving party's right to determine if initiating a buy-in is their preferred course of action. We would support the introduction of a buy-in regime in which the receiving party retains optionality.

Cash Penalties: Implementation Timeline

Members are keenly engaged in understanding, designing and building the requisite technology and operational processes to ensure they can comply with CSDR Settlement Discipline. As the entity responsible for the calculation, reporting, collection and distribution of penalties, and the entity responsible for monitoring the results of the buy-in process, each CSD has a crucial role in enabling its clients to ensure compliance. These processes must then propagate through the settlement chain from direct CSD participants to end investors. In order to ensure compliance with the CSDR penalty regime, all market participants have a dependency on clear and consistent processes across all European CSDs, which can be replicated throughout the settlement chain. The CSDs themselves also have a requirement for regulatory clarity on how to implement CSDR in order to estimate build requirements and service offerings to their participants.

Acknowledging the efforts of ECSDA to provide for a harmonised approach of all CSDs via its Penalties Framework[7], our members, as direct and indirect users of CSD services, are concerned that the level of detail required will not be available in sufficient time to make the necessary technology and operational changes, and to undertake thorough testing, to comply with the regulation when it enters into force. A project of this scale and

[5] Article 35(2) of the SDR RTS

[6] Articles 28 and 29 of the SDR RTS

[7] https://ecsda.eu/wp-content/uploads/2019/11/2019_11_Framework_Settlement.pdf

complexity typically requires 12-18 months to implement, from finalisation of the technical and operational requirements to completion of all necessary testing. To date, there is a lack of detailed technical specifications available to market participants to allow firms to make significant progress towards implementation of the new measures. Below we highlight some of the key outstanding issues on which the industry is awaiting clarification:

- Lack of a harmonised concept of 'party' at which penalties will be applied. For entities active in multiple CSDs, this creates significant additional build complexities.
- Uncertainty how development and ongoing costs of the penalty mechanism will be allocated. This prevents direct CSD participants, and thus all parties in the settlement chain, from understanding their costs and developing operating models accordingly.
- Uncertainty on the process by which penalties will be collected and redistributed for penalties relating to CCP-cleared transactions.
- Lack of a harmonised "golden source" database of in scope instruments, as well as clarity on the types of instruction in scope.
- Undefined exception handling processes.

We understand that a delay may be agreed to allow for the implementation of the penalty regime to follow the launch of the T2S Penalty Mechanism and the SWIFT Release in November 2020. Subject to clarification on the outstanding issues, we would urge policymakers to consider an alternative activation date that ensures a safe, orderly and successful transition to the penalty regime and avoids significant market disruption. This timeline should be based on the provision of fully scoped technical requirements from market infrastructures, and allowing sufficient time for market participants to build and test new technology and operational processes. A 'parallel testing' period prior to the implementation, in which penalties are calculated and reported but not charged to participants yet, should be considered to ensure that systems and processes are well calibrated ahead of the effective implementation of penalties.

Conclusion

Prior to implementing the post trade transparency framework in MiFID, ESMA undertook an extensive consultation process and market engagement which resulted in a cautious, phased-in approach to ensure minimal risk of disruption to market functioning, stability, and liquidity. We support this approach and would welcome the following:

1. Cash penalties to be introduced once market infrastructures, banks and their clients have built the technology required to process the fines, and not before the market has had an opportunity to test the required new messaging and technology. A 'live testing' period, in which penalties are calculated and reported but not charged to participants, should be considered to ensure a successful implementation of the penalty regime.

2. Deferral of the mandatory buy-in regime until the effects of penalties and other measures to promote settlement efficiency are implemented, and in-depth impact analysis is undertaken on the potential effects of a mandatory buy-in.

3. Implement monitoring processes to measure the impact of the penalty regime on settlement efficiency.

4. The mandatory nature of the buy-in should be amended to become an optional right of the receiving trading party, underpinned by law, to allow a buy-in of a non-delivering counterparty. Additionally, the asymmetrical issues relating to buy in costs should be amended so that each party is restored to its original position. The topic of cash compensation should be thoroughly reassessed.

In conclusion, the Joint Associations support the imposition of a penalty regime under CSDR as an important step towards improving settlement efficiency in European capital markets, once the infrastructure to facilitate this has been properly tested. However, we are extremely concerned that if the buy-in regime is implemented as it stands, there will be a significant negative impact on market liquidity, operational processes, and ultimately, end investors.

Yours sincerely,

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Chairman, AFME

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President, AFTI

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Galina Dimitrova
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Annex 1 – Information about Signatory Organisations

About AFME:

The Association for Financial Markets in Europe (AFME) is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues. We represent the leading global and European banks and other significant capital market players. We advocate for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society. We aim to act as a bridge between market participants and policy makers across Europe, drawing on our strong and long-standing relationships, our technical knowledge and fact-based work.

About AFTI:

The Association Française des Professionnels des Titres (AFTI), is the leading association representing post-trade businesses in France and Europe. AFTI has over 80 members covering a wide range of activities, including market infrastructures, custodians, account holders and depositaries, issuer services providers, as well as reporting and data providers.

About AGC:

Established in 1996, the Association of Global Custodians (the "Association") is a group of 12 global financial institutions that each provides securities custody and asset-servicing functions primarily to institutional cross-border investors worldwide. As a non-partisan advocacy organization, the Association represents members' common interests on regulatory matters and market structure. The member banks are competitors, and the Association does not involve itself in member commercial activities or take positions concerning how members should conduct their custody and related businesses.

The Association has long engaged extensively with government and regulatory authorities throughout the world to support their work to better understand our industry and ensure the safe and efficient provision of securities custody services for the benefit of investors and the financial system as a whole. The Association continues to support these efforts and stands ready to provide assistance and information – within the boundaries of competition and antitrust constraints - as authorities request.

About AIMA:

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,000 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in hedge fund and private credit assets.

About AMAFI:

Association française des marchés financiers (AMAFI) is the trade organisation working at national, European and international levels to represent financial market participants in France. It mainly acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI has more than 150 members operating for their own account or for clients in equities, fixed-income, structured products and derivatives. Nearly one-third of its members are subsidiaries or branches of non-French institutions.

About Assogestioni:

Assogestioni is the Italian investment management association. Our members include UCITS managers, AIFs, portfolio managers and open-ended pension schemes. We represent the interest of all Italian investment managers and the majority of foreign investment managers operating in Italy, consisting in more than 80 investment groups managing assets in excess of 2.2 billion Euro. The mission of Assogestioni is to promote growth and innovation in the asset management industry through the development of efficient regulation and market conditions and the promotion of high standards of investor protection. Since 1984 Assogestioni has been representing the interests of the industry towards institutions and market authorities, actively contributing to the debate on regulation at the domestic and European level. Assogestioni's ID number in the EU Transparency Register is 89046007765-76. For more information, please visit www.assogestioni.it.

About ASSOSIM:

Assosim represents the interests of the intermediaries active on the Italian financial markets, namely Italian investment firms, investment banks and subsidiaries of foreign investment services providers. Its members account for nearly the entire amount of the transactions carried out on the Italian stock markets as from Italy, and more than 80% when considering cross border transactions. In addition to advocacy activities, the association advises its members on legal and organisational matters pertaining to the full range of services and activities they provide, including trading and post-trading activities, portfolio management, financial advice and placement.

About BVI:

BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Asset Managers act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's 111 members manage assets more than 3 trillion euros for retail investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 22%, Germany represents the largest fund market in the EU. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

About DACSI:

DACSI is the principal trade association in The Netherlands for the securities industry. Our aim is to promote and improve the smooth functioning of "securities post-trade": we strive for an efficient and effective infrastructure for the securities and derivatives markets. We do so by coordinating between providers and users of the securities infrastructure and by advocating the Dutch interests with relevant institutions, including the domestic and European legislators and supervisors.

About EBF:

The European Banking Federation is the voice of the European banking sector, bringing together national banking associations from 45 countries. The EBF is committed to a thriving European economy that is underpinned by a stable, secure and inclusive financial ecosystem, and to a flourishing society where financing is available to fund the dreams of citizens, businesses and innovators everywhere.

About EDMA Europe:

Electronic Debt Markets Association represents the interests of companies whose primary business is the operation of regulated electronic fixed income multilateral trading facilities in Europe (regulated markets and/or trading venues) and act as a source of consultation between the members in their roles as operators of such venues in order to project collective views on regulatory, compliance and market structure topics for the benefit of the electronic fixed income markets.

About ICMA:

ICMA is the trade association for the international capital market with over 580 member firms from 63 countries, including issuers, banks, asset managers, central banks, infrastructure providers and law firms. It performs a crucial central role in the market by providing industry-driven standards and recommendations for issuance, trading and settlement in international fixed income and related instruments. ICMA liaises closely with regulatory and governmental authorities, both at the national and supranational level, to help to ensure that financial regulation promotes the efficiency and cost effectiveness of the capital market.
www.icmagroup.org / @ICMAgroup

About ISLA:

International Securities Lending Association (ISLA) is a leading industry association, representing the common interests of securities lending and financing market participants across Europe, Middle East and Africa. Its geographically diverse membership of over 160 firms, includes institutional investors, asset managers, custodial banks, prime brokers and service providers. Working closely with the global industry as well as regulators and policymakers, ISLA advocates the importance of securities lending to the broader financial services industry. ISLA supports the development of a safe and efficient framework for the industry, by playing a pivotal role in promoting market best practice, amongst other things. ISLA sponsors the Global Market Securities Lending Agreement (GMSLA) and the annual enforceability review in over 20 jurisdictions globally. Through member working groups, industry guidance, consultations and first-class events and education, ISLA helps to steer the direction of the industry and is one of its most influential voices on the European and global stage.

About The IA:

The Investment Association is the trade body that represents UK investment managers, whose 250 members collectively manage over £7.7 trillion on behalf of clients. Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks & shares ISAs. The UK is the second largest investment management centre in the world and manages 37% of European assets. More information can be viewed on our website.