EACH

European Association of CCP Clearing Houses

EACH Response - Targeted consultation on the review of Regulation on improving securities settlement in the European Union and on central securities depositories

February 2021

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Introduction

The European Association Clearing Houses (EACH) has represented the interests of Central Counterparties (CCPs) in Europe since 1992. CCPs are financial market infrastructures that significantly contribute to safer, more efficient and transparent global financial markets. EACH currently has 19 Members from 15 different European countries. EACH is registered in the European Union Transparency Register with number 36897011311-96.

EACH appreciates the opportunity to provide feedback to the European Commission targeted consultation on the review of 'Regulation on improving securities settlement in the European Union and on central securities depositories'[1] (CSDR). This consultation represents an excellent occasion to address some of the issues raised by the market to ensure that this piece of legislation, and from the EACH point of view its settlement discipline regime, is as robust and efficient as possible.

Our consultation response covers the following subjects related to a variety of parts of CSDR:

- The implementation timeline of CSDR Settlement Discipline Regime (SDR)
- The duplicative penalties system arising due to CSDR SDR RTS Article 19
- How to avoid duplicate penalties
- Netting
- SME Growth Markets
- Identification of Shares Instruments
- Penalty Rates for Bonds in the context of negative interest rates.
- Tri-party transactions

[1] Regulation: EU 909/2014

Question 33.2: If you answered "Other" to Question 33.1, please specify to which elements you are referring

1. Timeline

Legal Basis
CSDR SDR

Concern
The Settlement Discipline RTS were due to enter into force on 13 September 2020. There have since been several delays, the latest of which sets the date of entry into force to 1 February 2022. This consultation therefore takes place before CSDR's Settlement Discipline Regime is in force.

EACH is concerned that the market may be implementing a settlement discipline regime that may experience significant change due to this consultation, leading to sunk costs and the implementation of redundant technology. EACH would therefore appreciate clear guidance as soon as possible on whether to continue efforts in implementing the current CSDR Settlement Discipline regime or to halt efforts until the revised settlement discipline framework is finalised.

The potential changes to the legislation also raise concerns regarding the timeline: Should the settlement discipline regime not experience material change, EACH is currently of the opinion that CCPs can meet the current date of entry into force of 01 February 2022.

However, should this consultation lead to material changes based on input provided by market participants, EACH reiterates the concern previously raised that the current implementation date of 01 February 2022 does not give the market sufficient time to implement changes that are agreed as a result of this consultation.

CCPs are of the opinion that they would need 10 months to be able to go live with the current Settlement Discipline Regime by 01 February 2022. An indication on the extent of the changes and therefore the implementation timeline should therefore be given at the latest by end of March 2021.

EACH understands that certain market participants are advocating a delay only for buy-ins. If the European Commission should follow this recommendation, EACH asks the European Commission to consider keeping in place Article 15 of Regulation (EU) No 236/2012 on short selling in force until buy-ins can be implemented. We also advocate that any delays in the entry into force of CSDR SDR provisions are applied equally to the full market (i.e. both the cleared and uncleared space) to prevent an unlevel-playing field.

Recommendation
EACH recommends that the European Commission revises the date of entry into force of CSDR's settlement discipline regime depending on the size of the impact of the changes resulting from this consultation, giving market infrastructures and other market participants sufficient time to implement.

An indication on the extent of the changes and therefore the implementation timeline should be given at the latest by end of March 2021, so the market can comply with the settlement discipline regime by 01 February 2022, should the Commission decide not to make any material changes.

In the event that the European Commission decides to delay the implementation of buy-ins alone, EACH recommends a deletion of Recital 78 CSDR, so the current Article 15 Regulation (EU) No 236/2012 on short selling remains in force. We also advocate that any delays in the entry into force of the CSDR SDR provisions are applied equally to the full market (i.e. both the cleared and uncleared space) to prevent an unlevel-playing field.

2. Netting

Legal basis
CSDR RTS Articles 5(3) and 5(4), (a), (b), (c) and (e)

Concern
The ability of CCPs to multilaterally net transactions for settlement significantly improves settlement efficiency. This netting may involve transactions with parameters containing different values that otherwise are required by the Regulation to be specified on settlement instructions. Such parameters include trade date, transaction type and place of trade.

Recommendation
We request that it is made clear that CCPs can continue to net to the full extent possible and can provide a suitable value of a parameter of their choice on a settlement instruction where the constituents may not all contain the same value.

The consent for CCPs to do this is not clear in the Regulation. We would welcome either in the Regulation or by a separate formal confirmation that this is the case.

3. Identification of 'Shares' Instruments

Legal Basis
ESMA document 'FIRDS CFI validations' [Reference ESMA70-145-1090], available at https://www.esma.europa.eu/document/firds-cfi-validations.

Concern

A clear practical way to ensure consistency of the definition of 'Shares' is required by the market. In line with ECSDA's proposals for use in penalty calculations, EACH suggests that 'Shares' are identified as those instruments classified as 'equities' with CFI codes starting with an 'E', as defined in the ESMA document 'FIRDS CFI validations' [Reference ESMA70-145-1090], available at https://www.esma.europa.eu/document/firds-cfi-validations." As such, ETFs, for example, are not shares.

Recommendation

EACH would suggest the following statement: "'Shares' are those instruments classified as 'equities' with CFI codes starting with an 'E', as defined on the ESMA document 'FIRDS CFI validations' [Reference ESMA70-145-1090], available at https://www.esma.europa.eu/document/firds-cfi-validations."

4. SME Growth Markets

Legal Basis

CSDR SDR RTS Article 7(3) second paragraph

Concern

Regarding the identification of SME Growth Markets, we believe the current CSDR text (level 1 and level 2) rightly identifies that the instruments traded on SME markets have special needs, but the exiting text in CSDR is ambiguous. The existing text in Article 7 (3) is formulated:

"Where the transaction relates to a financial instrument traded on an SME growth market the extension period shall be 15 days unless the SME growth market decides to apply a shorter period."

This text can be interpreted in different ways, but there are two main interpretations for when the 15 days should be applied:

i) That a transaction relates to a trade which has been executed on a trading venue qualitied as a 'SME growth market' [SME market].
ii) The Financial instrument is traded, implying listing, on a trading venue qualitied as a 'SME growth market [SME market]'

When referring to the 15-day period, it should also be clear that these are 15 ***business*** Days.

Recommendation

EACH suggests that Article 7(3) is clarified to ensure the right interpretation.

5. Triparty Transactions

Legal Basis
CSDR SDR RTS Article 13(1)(d)

Concern
EACH believes that the processes which are used by triparty system operators for the settlement of triparty obligations are in many ways significantly different from standard DVP/FOP settlements instructions executed by a CSD. The principal transaction agreed between the parties refer to a general obligation to be collateralised through a delivery of securities appertaining to a pre-agreed basket, and therefore, it does not contain the actual settlement instructions that will be generated subsequently by the triparty agent (TPA). It is the TPA who will generate the settlement instructions that will be sent to the CSD for settlement. Settlement discipline measures should not be applicable to the principal transactions, as these refer to a basket and a general obligation and do not contain specific collateral delivery transactions that can generate penalties or buy-in obligations. The settlement discipline regime (penalties and buy-ins) should apply to each specific settlement instructions generated by the TPA where a concrete ISIN is delivered free or versus payment between the two counterparties.

Recommendation
A CCP's CSDR obligation in respect of triparty transaction buy in should be limited solely to CSD settlement instructions generated by the triparty operator where the instruction has not been cancelled by the business day following the expiry of the extension period of that CSD settlement instruction.

Question 34: The Commission has received input from various stakeholders concerning the settlement discipline framework. Please indicate whether you agree (rating from 1 to 5) with the statement below

	1 (disagree)	2 (rather disagree)	3 (neutral)	4 (rather agree)	5 (fully agree)	No opinion
Buy-ins should be mandatory				X		
Buy-ins should be voluntary			X			
Rules on buy-ins should be differentiated, taking into account different markets, instruments and transaction types					X	
A pass on mechanism should be introduced[2]						X
The rules on the use of buy-in agents should be amended				X		
The scope of the buy-in regime and the exemptions applicable should be clarified					X	
The asymmetry in the reimbursement for changes in market prices should be eliminated			X			
The CSDR penalties framework can have procyclical effects	X					
The penalty rates should be revised					X	

The penalty regime should not apply to certain types of transactions (e.g. market claims in cash)					X	

Question 34.1 Please explain your answers to question 34, providing where possible quantitative evidence and concrete examples

6. 'Rules on buy-ins should be differentiated, taking into account different markets, instruments and transaction types'

EACH's view is that trades in subscription rights/rights issues or voluntary Corporate Action events should be fully exempt from buy-ins, due to their limited life span (typically between 10 and 20 days), small market value, and lack of value after they have lapsed. Furthermore, as buyer protection procedures may apply to these transactions, buy-ins would unreasonably interfere with these buyer protection procedures increasing market risk.

Recommendation
We suggest adding a new subparagraph c) to Article 7.4 of CSDR as follows: 7.4.(c) (new) "for failing transactions on securities which are rights or are impacted by buyer protection, the buy-in process referred to in paragraph 3 shall not apply where due to the short life span of the security the buy-in process would be ineffective."

7. 'A pass on mechanism should be introduced'

CCPs have already had penalty frameworks in place for years. No adverse effects have been shown during this time.

8. 'The rules on the use of buy-in agents should be amended'

EACH aligns with the market view that the current rules are too restrictive. In order to ensure a level playing field between the cleared and uncleared space and avoid unduly de-

incentivising central clearing, the buy-in time frames should be the same for cleared and non-cleared transactions, whether that be Liquid, Illiquid or SME.

Fixed income -. Fixed income has been identified as a higher risk for the market as no buy in process is in place today but for equities, CCPs believe this can be achieved and reduce buy in risk in the market. In line with our suggestion in the previous paragraph, EACH suggests that the same buy in regime is applied for the cleared and uncleared parts of the market, i.e. either both parts are subject to the buy in regime or they are not.

Equity - Many buy ins today result from non-cleared trades failing for an extended period in the chain. In the Equity space, CCP's currently have a successful buy-in model in place, and the EACH preference would be that the uncleared space aligns with this, to ensure that any cleared activity is not disadvantaged from a lack of buy-in regime in the uncleared part of the market. If this is not possible for cash equities, our preference is that the mandatory buy-in regime for cash equities remains in place for cleared transactions.

Recommendation
In the case of fixed income instruments, EACH recommends that Article 7(5) clarifies that the same regime is applied for the cleared and uncleared part of the market, i.e. either both parts are subject to the buy in regime or they are not.
In the case of equity instruments, EACH recommends that to ensure a level playing field in the Equity space, Article 7(5) of CSDR is modified to prescribe that buy-ins are applied for uncleared equities.

9. 'The asymmetry in the reimbursement for changes in market prices should be eliminated'

EACH is neutral on this point. However, in the event that due to the decreased market value of the financial instruments, the receiving Clearing Member faces a net debit against the CCP, CCPs may address the CCP's short position in the following two ways:

1. Option 1 - To require receiving Clearing Member to pay the cash amount to the CCP without applying the exclusion, on the basis that the exclusion is not intended to apply where the CCP is the failing party (Article 7(11) CSDR).

2. Option 2 - Charge the failing delivering Clearing Member the net debit. Since the receiving Clearing Member is not the cause of the failed delivery of securities, it should not have to carry the loss in market value incurred due to the lack of delivery.

10. 'The CSDR penalties framework can have procyclical effects'

CCPs already have had penalty frameworks in place for years. No adverse effects have shown during this time.

Question 36: Which suggestions do you have for the improvement of the settlement discipline framework in CSDR?

11. CSDR SDR RTS Article 19

Legal Basis
CSDR Article 7.11, CSDR SDR RTS Article 19 in combination with CSDR SDR Article 17

Concern
The CSDR Settlement Discipline Regime provides for two separate processes for the collection and distribution of cash penalties depending on whether one of the participants is a CCP (Article 19 SDR) or not (Article 17 SDR). This duality in the SDR RTS text leads to contradictions and unnecessary complications with regard to cash penalties involving CCPs.

In our opinion, the verbatim implementation of SDR RTS Article 19 would be complex, costly, inefficient and unnecessarily duplicative for CCPs, CSDs and the members and participants of both. The coexistence of CSDR RTS Article 17 and Article 19 effectively result in the existence of two parallel, non-perfectly synchronised systems for the collection and distribution of penalties for failed settlements that CSDs, CCPs and their users would have to subscribe to when a single standardised system would achieve the same result in a much simpler and more efficient manner.

The implementation of SDR RTS Article 19 would neither contribute to nor achieve the objective described in Chapter 4.1.2 of the Impact Assessment (Annex IV to the Final Report on draft SDR RTS dated 01 February 2016), namely 'to maintain the appropriate outcome for the penalty mechanism, ensuring that no undue risk is placed on the CCP.'

EACH would like to stress that we are not aware of any market participant who is against this simplification. It is clearly supported here by EACH and we understand is explicitly supported by CSDs and users in their responses to the consultation.

Succinctly, the deletion of SDR RTS Article 19 would resolve many issues of operational risk, legal risk and development cost, as we have presented to you above and in more detail in previous submissions, which have been attached to our response for further reference.

EACH therefore makes the below proposals to resolve the unnecessary complexity in the collection and distribution of cash penalties.

The below charts demonstrate the systems as currently provisioned under CSDR SDR, as well as a far simpler option where CSDR SDR RTS Article 19 is removed, and all penalties are collected and distributed under CSDR SDR RTS Article 17. Further to this, we have included a suggestions on how this can be achieved.

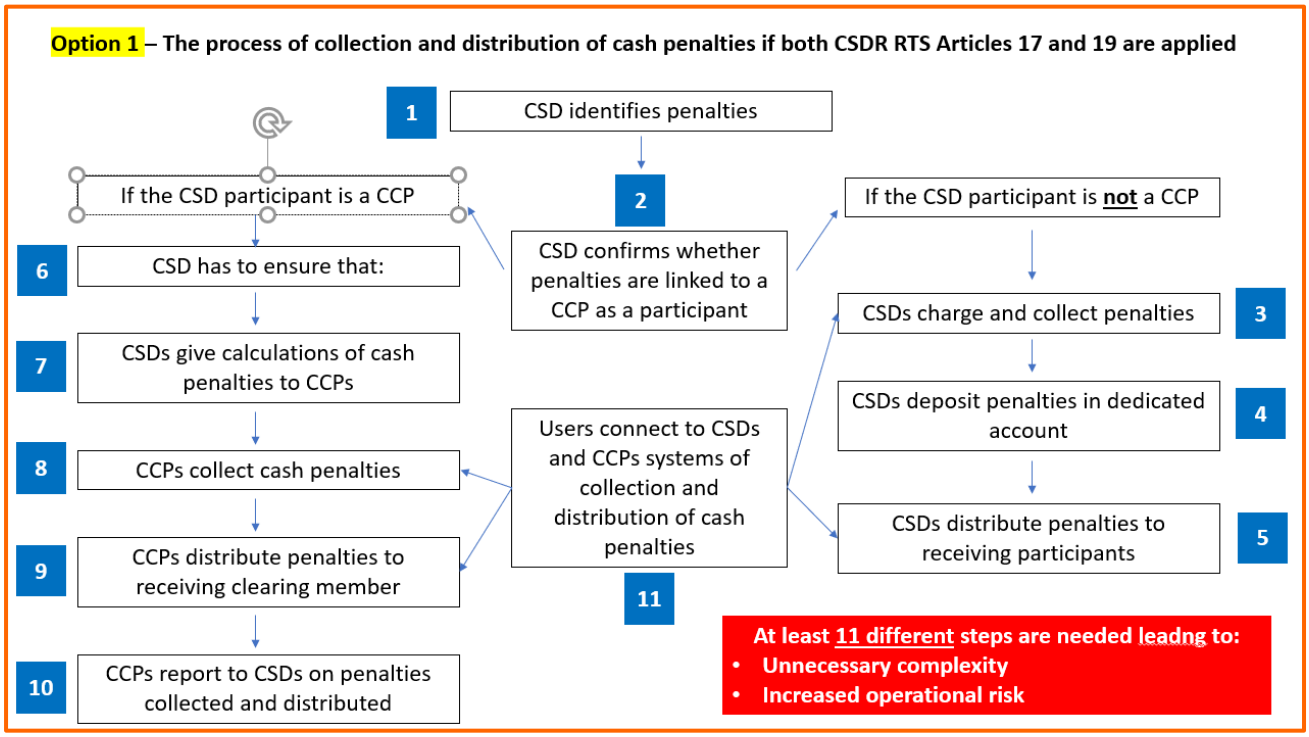

Figure 1 – Penalties process with the application of both CSDR SDR RTS Articles 17 and 19

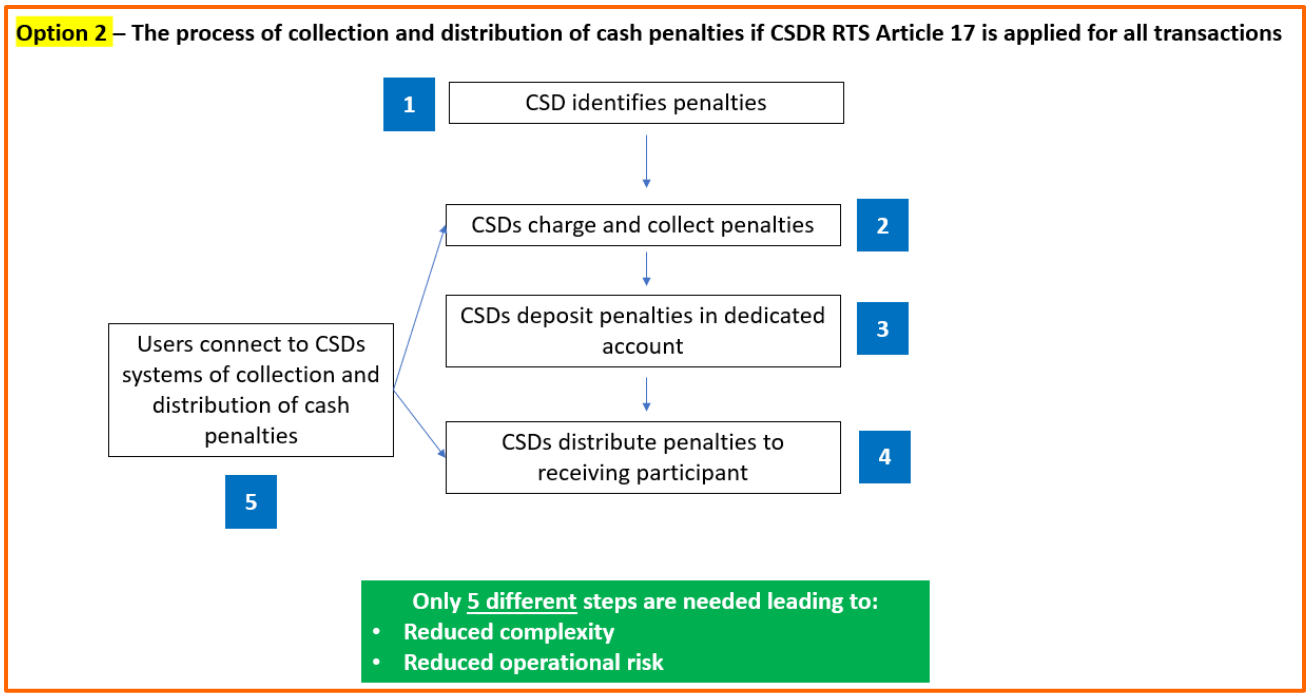

Figure 2 – Penalties process with the application of only CSDR SDR RTS Article 17

How can Option 2 in the diagram above be implemented?

Figure 3 below describes with an example how the collection and distribution of penalties can be done in line with CSDR SDR Art 17 for all transactions, rather than differentiating among transactions and applying CSDR SDR Art 17 and Art 19. This would happen as follows:

- When the clearing member is the CSD participant, the CSD will be charging directly the CSD participant.
- When the clearing member is using a settlement agent, the CSD will charge the CSD participant (i.e. the settlement agent) who will charge (pass-on) the penalty to their client (i.e. the clearing member) as follows:
    - If the clearing member is acting on their proprietary account this would be the end of the chain
    - If the clearing member is acting on behalf of a client of theirs, the CM will pass-on the penalty to their client.

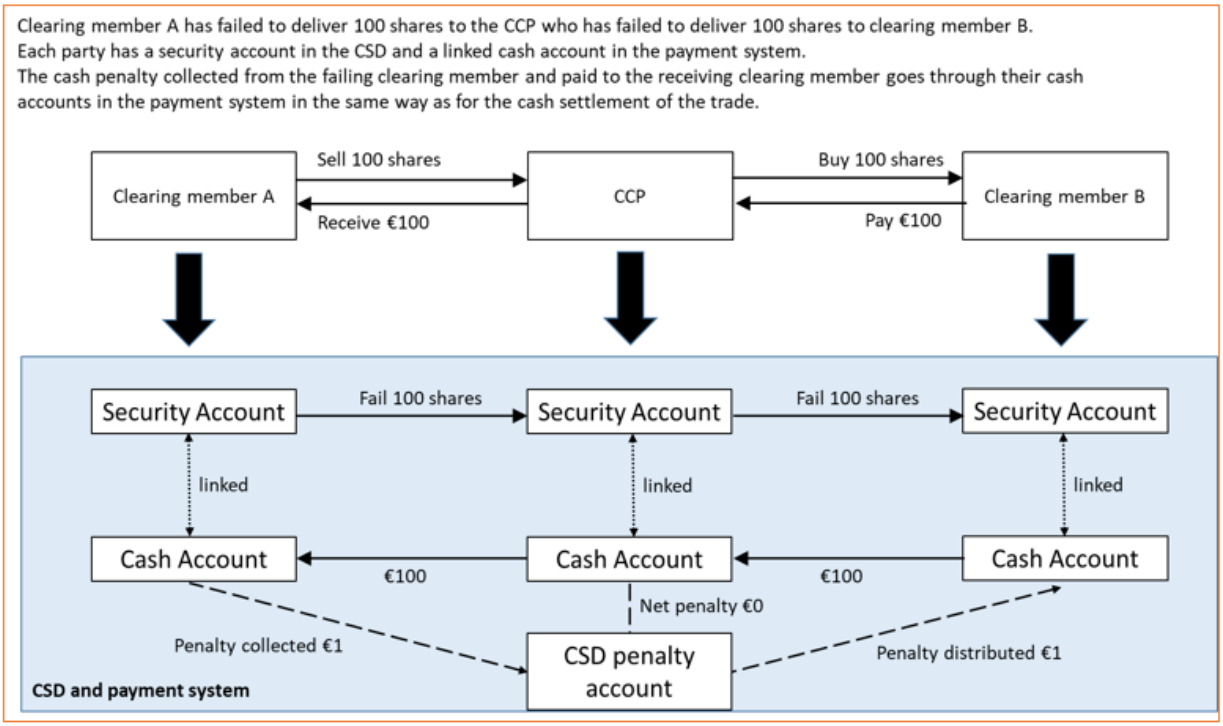

Figure 3 – Implementation of the penalties collection system under CSDR SDR RTS article 17

Recommendation

- **Removal of Article 19 of the SDR RTS** - All penalties can therefore be collected and distributed by the CSDs on a single consistent basis with their participants. This resolves many issues of operational risk, legal risk and development cost, several of which have been presented previously. We are not repeating the arguments here as the key point we would like to stress is that we are not aware of any market infrastructure or market participant who is against this simplifying proposal. It is clearly supported here by EACH and we understand is explicitly supported by CSDs and users in their responses to the consultation. We therefore recommend this change on this basis.

- **Avoiding an unjustified net loss for CCPs** - There is the potential for the result of the penalty process to leave a CCP with a net loss at no fault of either the CCP or any specific member. EACH therefore recommends adding a new paragraph 11b to Article 7.11 stating: **11b (new)** – ***'CCPs shall not incur losses from the application of the second subparagraph of Article 7 paragraph 2. If CCPs incur losses from the application of the second subparagraph of Article 7 paragraph 2, the CCP can establish a mechanism to recover losses.'***

12. CCP as Receiving Party

Legal Basis
CSDR SDR RTS Article 7(11)

Concern
The CCP is by definition interposed between the receiving clearing member and the delivering clearing member. A clearing member can fail to deliver to a CCP as the receiving party and this may result in the CCP executing a buy-in. No linkage exists between a specific fail to a CCP and any specific delivery or deliveries from a CCP. The buy-in does not change the outstanding delivery obligations of the CCP to its receiving clearing members. Once a CCP has received securities through a buy-in they will be delivered to waiting receiving clearing members through the normal settlement process. Therefore, receiving clearing members need not and should not be referenced in Articles describing a CCP buying-in a failing delivering clearing member.

As the graphic below illustrates, the CCP becomes the receiving party for all delivery obligations, and the delivering party for all receiving obligations. Furthermore, when considering that settlement instructions remain open for varying lengths of time, the relationship between delivering and receiving Clearing Members breaks down even further. Thus, as no receiving Clearing Member can be reliably identified, EACH considers Article 27 SDR fulfilled when CCPs notify the failing counterparty of the impending buy-in.

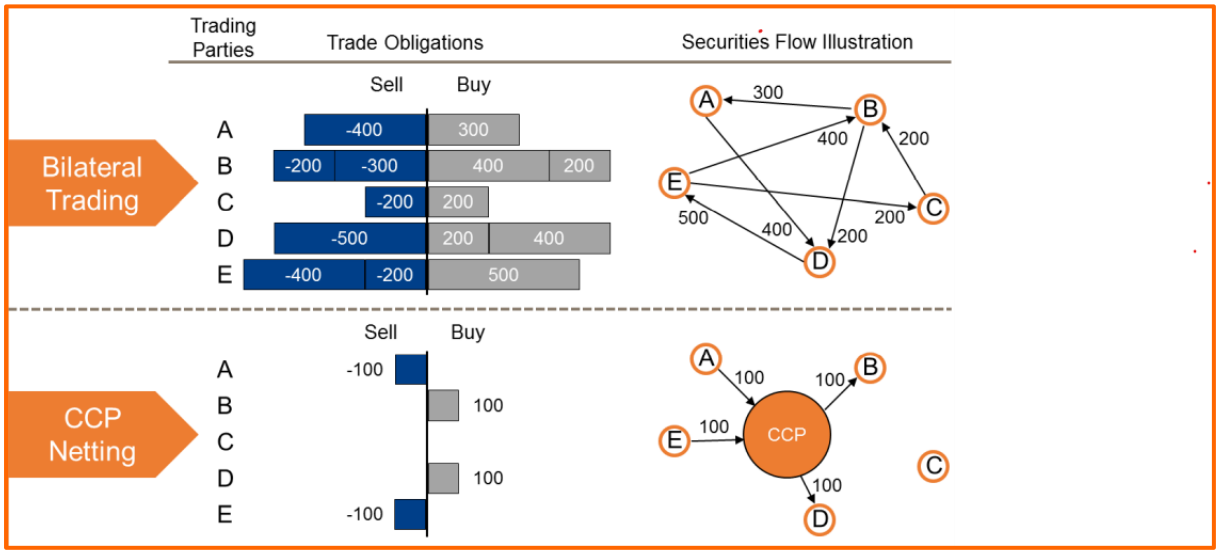

Figure 4 - Bilateral trading versus CCP netting

Recommendation
All references to receiving clearing member in respect of the buy-ins in the RTS should be removed - i.e. RTS 27.1, 27.7, 27.10(a) and the whole second paragraph of 35.1. It should be noted that a literal interpretation of the second paragraph of RTS 35.1 guarantees a loss to a CCP and an unwarranted gain to one or more random receiving clearing members.

13. Avoiding duplicate penalties

Legal Basis
Commission Delegated Regulation (EU) 2018/1229 – RTS Article 16

Concern
Penalties should not be paid more than once for the same failed obligation. This would be the case if a fail has been charged penalties and that fail is then deleted and replaced by new settlement instructions which represent the same failed obligation. This point is recognised in RTS Article 16(3) paragraph 3 sub-paragraph 2 for partial buy-ins where the reinstructed unbought-in fail is only charged penalty from the date the instruction is entered and not from the intended settlement date. This same situation can arise in other cases, such as splitting a fail into two shapes such that different corporate action elections can be applied to each shape. Equally, manual splitting to achieve partial settlement is the same. Therefore, we recommend that RTS Article 16(3) paragraph 3 sub-paragraph 2 is extended to cover the more general case.

Recommendation
Modify Article 16.3 with the additional sentence added below (in bold and italics).

3. Where a settlement instruction has been entered into the securities settlement system or has been matched after the intended settlement date, cash penalties shall be calculated and applied as from the intended settlement date.

Where new settlement instructions are entered into the securities settlement system for any non-delivered financial instruments in accordance with Article 27(10), Article 29(11) or Article 31(11), cash penalties shall apply to the new settlement instructions from the day those instructions are entered into the securities settlement system. ***Similarly, for other circumstances where a fail on which penalties have already been calculated is deleted and replaced by new equivalent settlement instructions, cash penalties shall apply to the new settlement instructions from the day those instructions are entered into the securities settlement system.***

Where settlement instructions have been matched after the intended settlement date, cash penalties for the period between the intended settlement date and the business day prior to the day on which matching has taken place shall be paid by the last participant who has entered or modified the relevant settlement instruction in the securities settlement system.

14. Penalty rates for Bonds in the context of negative interest rates

Legal Basis
CSDR Article 7(14)

Concern

Current penalty rates for bonds (0.1 basis points for sovereign debt) are not properly considering the context of negative interest rates. If we annualise and compare this rate with the negative rate applied by the Eurosystem or other EU central banks in the overnight deposits facility, this is clearly insufficient to act as a deterrent or to compensate the receiving counterparty in a repo transaction. In addition, if transactions fail over a weekend, the penalties will apply for just one day while the receiving party will be facing the negative interest for the cash they couldn't deliver for three days.

Negative interest rates are in their own a burden to the repo market, and the risk of facing a settlement fail is an additional load that is causing repo buyers to question the convenience of entering into such transaction. Therefore, we propose to include a provision in the Regulation in order to ensure the adequacy of penalty rates for bonds which are mainly used as collateral for financing transactions.

Recommendation

We suggest amending Article 7(14) of CSDR as follows "The Commission shall be empowered to adopt delegated acts in accordance with Article 67 to specify parameters for the calculation of a deterrent and proportionate level of the cash penalties referred to in the third subparagraph of paragraph 2 based on asset type and liquidity of the financial instrument, ~~**and**~~ the type of transaction **and the effect that in a context of negative interest rates fails could have on the affected counterparties** that shall ensure a high degree of settlement discipline and the smooth and orderly functioning of the financial markets concerned."

- END -