ICMA
International Capital Market Association

ICMA Feedback on the European Commission Proposal Revising CSDR

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Overview

1. This paper outlines ICMA's formal feedback on the European Commission's proposal amending the CSD Regulation (Regulation (EU) No 909/2104).

2. ICMA and its members broadly welcome the proposed revisions to the CSDR, in particular those relating to the mandatory buy-in framework. Members believe that the "two-step approach", in principle, takes into account the potential disruptive market impacts of applying a mandatory buy-in requirement, as well as allowing for more proportionate and targeted initiatives to improve settlement efficiency rates (including the CSDR penalty regime) to be implemented first. ICMA further welcomes the proposed revisions to the buy-in process, such as providing for symmetrical payments of the buy-in and cash compensation differential and the ability to facilitate pass-ons.

3. ICMA and its members would like to use the opportunity of this call for feedback to provide some further constructive recommendations and considerations. These are intended to refine the proposed revisions for the settlement discipline framework and to enhance the robustness of the "two-step approach" for mandatory buy-ins.

4. The feedback is organized into three sections. The first section focuses on the proposed revisions to the mandatory buy-in (MBI) framework. The second section focuses on the penalty regime (mainly from a secondary market perspective). The third section raises a specific point with respect to the application of settlement discipline from a primary market perspective.

5. Sections one and two are based on feedback from ICMA's CSDR Settlement Discipline Working Group, which constitutes broad representation from sell-side and buy-side members, as well as financial market infrastructures, including traders (bonds and repo), operations experts, market structure specialists, and legal and compliance.

6. Section three has been prepared by ICMA's Primary Market Practices Committee (PMPC), which gathers the heads and senior members of the syndicate desks of member firms active in lead-managing cross-border syndicated bond issues in the EMEA region.

Section 1: Mandatory Buy-ins

7. This Section focuses on the mandatory buy-in framework and provides three key recommendations: (a) more flexibility in the assessment considerations for the two-step approach; (b) exempting securities financing transactions from the scope of MBIs; and (c) using a different regulatory tool to implement MBIs (in the event that they may be warranted).

(a) The "two-step approach"

8. The two-step approach provides that an implementing act can be used to apply MBIs to a particular financial instrument or transaction type *"where the Commission considers that those measures constitute a proportionate means to address the level of settlement fails in the Union and that, based on the number and volume of settlement fails, any of… [three outlined] …conditions is met"*.

9. While ICMA is broadly supportive of the approach, it raises a number of issues of concern that the revised regulation may wish to address.

Conditions

10. ICMA would propose that the three outlined conditions for assessing whether MBIs are a proportionate means to address settlement fails should be considered in combination, rather than as independent criteria. A more holistic assessment of the impact, and cause, of settlement fails would seem to be a more robust, and even flexible, approach than relying on a single (potentially objective) benchmark.

Assessment methodology

11. There is the potential for ambiguity as to the underlying assessment that may be used to inform any ultimate decision to apply MBIs to a particular instrument or transaction type. ICMA does not believe that it would be helpful or meaningful to propose a particular methodology for assessing whether MBIs may be warranted for a particular underlying instrument or transaction type, nor in suggesting specific targets for acceptable levels of settlement efficiency across different asset classes or markets. However, it would like to stress the importance of full transparency with respect to any methodology (or targets) applied.

12. Such methodology should also take into consideration underlying market structures, liquidity conditions (noting that these are variable), possible frictions related to the interdependencies of multiple market infrastructures, as well as existing contractual frameworks or market initiatives for resolving settlement fails. Data integrity will also be key in any analysis used to determine trends in settlement efficiency rates, as will identifying and accounting for any data and methodology inconsistencies in any comparison with other jurisdictions. The work of the ECB's TARGET2-Securities on market settlement efficiency[1] also helps to highlight the challenges in establishing reliable and consistent metrics for measuring settlement fails.

[1] See: https://www.ecb.europa.eu/paym/intro/publications/html/ecb.targetsecar202205.en.html

13. In addition, ICMA would recommend that any analysis on settlement rates focus on the number of fails at the end of the prescribed extension periods for MBIs (ie 'aged fails'), since it is only this population of fails that MBIs would be intended to address.

Industry adoption

14. As communicated by the industry previously, implementing a mandatory buy-in regime is extremely resource and time consuming, requiring operational system builds to manage the buy-in process, as well as extensive, multi-jurisdictional contractual outreach. This is made even more complex by both the fact that the mandatory buy-in framework is starkly different to established, contractual buy-in processes, and that MBIs would effectively be enforced through a regulation that does not apply directly to the entities impacted by the requirement.

15. It would seem disproportionately onerous to expect firms to prepare in advance for the possibility of MBIs being applied to a particular instrument or transaction type, given that proportionality is one of the considerations underlying the "two-step approach". Therefore, it would seem reasonable that any eventual decision to apply MBIs should also allow for an appropriate timescale ahead of implementation for the relevant affected entities (many of whom will not even be involved in the buy-in process) to prepare.

Recalibration of penalties

16. As the Commission seems to anticipate in its proposal, there remains a question mark over whether the current calibration of the penalty mechanism, with respect to the fees applied, are appropriate, particularly in light of a very low or negative interest rate environment. As we move to a higher (positive) interest rate environment this may help, and this may even be more impactful than penalties. But ICMA would recommend periodic assessments of the impact of penalties on settlement efficiency rates for different asset classes, and to consider a recalibration of the relevant fees, where appropriate, rather than moving directly to MBIs.

17. Similarly, ICMA would also recommend the ongoing monitoring on the impact of penalties on market liquidity across different asset classes to ensure that they are not detrimental, particularly as market interest rates increase.

Other measures to improve settlement efficiency

18. As well as considering the impacts of recalibrating the penalty rates where settlement efficiency targets are not met, ICMA would urge the Commission also to consider other potential measures to improve settlement efficiency as part of the two-step approach. This could include (but not be limited to) delegated regulatory interventions in support of current market initiatives to establish market best practice around shaping, partialing, and the use of auto-borrow/lending programs.

19. A helpful point of reference initiatives to improve settlement efficiency is the work recently undertaken by ICMA's work on *Optimising Settlement Efficiency*,[2] and related best practice recommendations (originally for the EU repo market but now being extended to international bond markets).

[2] See: https://www.icmagroup.org/assets/Uploads/ERCC-discussion-paper-on-settlement-efficiency.pdf?vid=2&showiframe=true

20. ICMA would also propose that the two-step approach can be applied both ways, and that in the event of MBIs being introduced for a particular security or transaction type, the assessment process be utilized to determine whether MBIs should be disapplied at some point.

21. Based on these important considerations, ICMA would propose the following revisions to the proposed drafting:

> Article 7(2)
> (b) the following paragraph 2a is inserted:
>
> '2a. Without prejudice to the penalty mechanism referred to in paragraph 2 of this Article and the right to bilaterally cancel the transaction, the Commission may, by means of an implementing act, decide to which of the financial instruments referred to in Article 5(1) or categories of transactions in those financial instruments the settlement discipline measures referred to in paragraphs 3 to 8 of this Article are to be applied where the Commission considers that those measures constitute a proportionate means to address the level of settlement fails in the Union and that, based on the number and volume of settlement fails, ~~any~~ of the following conditions ~~is~~ are met:
>
> (a) the application of the cash penalty mechanism referred to in paragraph 2 has not resulted in a long-term, continuous reduction of settlement fails in the Union, even following a recalibration of the applicable penalty fee(s) and/or other interventions to improve settlement efficiency;
> (b) settlement efficiency in the Union has not reached appropriate levels considering the situation in third-country capital markets that are comparable in terms of size, liquidity as well as instruments traded and types of transactions executed on such markets, while taking into account differences in market structure and methodologies for recording settlement fails;
> (c) the level of settlement fails in the Union has or is likely to have a negative effect on the financial stability of the Union.
>
> The implementing act shall be adopted in accordance with the examination procedure referred to in Article 68(2).', with full transparency of the assessment process and sufficient time to allow for market adoption;

(b) The buy-in design

Securities Financing Transactions

22. ICMA is pleased to see some enhancements to the MBI design in the proposal, in particular the provisions for symmetrical payments of the buy-in and cash compensation differential and for a pass-on mechanism.[3] ICMA looks forward to engaging with ESMA in the process of revising the Level 2 to accommodate both of these, as well as in addressing a number of other design challenges, including: (i) the conditions for not requiring a buy-in agent; (ii)

[3] ICMA would note that a pass-on mechanism will not necessarily work in the case where a CCP is part of the transaction chain and that this will also need to be considered in the pass-on design and application.

establishing an effective cash compensation process where there is no reference price; and (iii) guaranteeing certainty of the buy-in at the point of execution (not settlement).

23. However, one key area of concern that remains in the Level 1 text relates to the potential application of MBIs to securities financing transactions (SFTs). This relates specifically to Article 7(4)(b) in the Regulation, which remains in the proposal: *"for operations composed of several transactions including securities repurchase or lending agreements, the buy-in process referred to in paragraph 3 shall not apply where the timeframe of those operations is sufficiently short and renders the buy-in process ineffective".*

24. ICMA would strongly disagree with the inclusion of SFTs in an MBI regime. Firstly, SFTs are not independent outright sales or purchases of securities: they are the short-term loan of securities. Particularly in the case of a failing start-leg, neither a buy-in nor cash compensation would make economic sense from the perspective of both parties, and certainly would not restore either to the position they would have been in had the original SFT settled.

25. Secondly, SFTs are broadly executed under established contractual arrangements (such as a GMRA or GMSLA) that include specific provisions designed to protect the non-failing party in the case of a settlement fail (on either leg). Imposing an MBI regime on such "documented" SFTs would undermine the integrity of these contractual, transaction specific remedies.

26. Thirdly, documented SFTs are subject to daily (and even intra-day) margining. Thus, the credit exposure for a failed-to party is significantly less than that of a failing cash transaction.

27. Finally, SFTs are frequently used to help resolve settlement fails. In other words, they are a fundamental tool for improving settlement efficiency. Brining SFTs into scope of a highly disproportionate MBI regime would be a disincentive to lending securities, and would therefore be counterproductive to the objectives of settlement discipline.

28. ICMA would therefore recommend that the proposal be revised to provide an explicit exception for SFTs.

Article 7(4)
(e) paragraph 4 is replaced by the following:

(a) based on asset type and liquidity of the financial instruments concerned, the extension period may be increased from 4 business days up to a maximum of 7 business days where a shorter extension period would affect the smooth and orderly functioning of the financial markets concerned;
(b) for operations composed of several transactions ~~including securities repurchase or lending agreements,~~ the buy-in process referred to in paragraph 3 shall not apply where the timeframe of those operations is sufficiently short and renders the buy-in process ineffective;
(c) for settlement fails that occurred for reasons not attributable to the participants, the buy-in process referred to in paragraph 3 shall not apply;
(d) for transactions that do not involve two trading parties the buy-in process referred to in paragraph 3 shall not apply;
(e) for documented securities financing transactions, the buy-in process referred to in paragraph 3 shall not apply;

Addressing the payment asymmetry

29. While the revisions to the MBI framework aim to address the issue of asymmetrical payments of the buy-in or cash compensation differential (as described in Recital (7) of the proposal), there remains a potential ambiguity in the proposed revised text with respect to cash compensation. The proposed revision to Article 7, paragraph 6 is very clear in facilitating symmetrical payments in the case of buy-ins. However, there is no revision to Article 7, paragraph 7, which implies an asymmetrical treatment in the case of the cash compensation differential.

30. Furthermore, ICMA would recommend not referring the buy-in failing in the Level 1 text as a condition for cash compensation, since the risk involved in the buy-in process can be significantly reduced by completing the buy-in on successful execution, rather than successful settlement: a consideration that could be better addressed in the Level 2.

31. ICMA would therefore recommend a revision to Article 7(7) be introduced:

Article 7

7. If the buy-in fails or is not possible, the receiving participant can choose to be paid cash compensation or to defer the execution of the buy-in to an appropriate later date ('deferral period'). If the relevant financial instruments are not delivered to the receiving participant at the end of the deferral period, cash compensation shall be paid.

Cash compensation shall be paid to the receiving participant no later than on the second business day after the end of either the buy-in process referred to in paragraph 3 or the deferral period, where the deferral period was chosen.

Be replaced by the following:

7. If the buy-in is not possible, the receiving participant can choose an alternative of cash compensation or to defer the execution of the buy-in to an appropriate later date ('deferral period'). If the relevant financial instruments are not delivered to the receiving participant at the end of the deferral period, cash compensation shall be paid.

Where the price of the financial instruments agreed at the time of the trade is different from the price used to determine cash compensation, the corresponding difference shall be paid by the participant benefitting from such price difference to the other participant no later than on the second business day after the end of either the buy-in process referred to in paragraph 3 or the deferral period, where the deferral period was chosen.

32. An additional consideration is whether "cash compensation" is the appropriate term for the process being described. ICMA would recommend replacing this with the term "cash settlement", since this is what it effectively is.

Level 2 revisions

33. A number of potential challenges in the existing Regulatory Technical Standards will need to be addressed in the revised Level 2, including the conditions for not requiring the appointment of a buy-in agent, determining when a buy-in is completed (i.e. successful execution as opposed to successful settlement), and how to determine cash compensation when a reference price is not available.

34. However, ICMA would also recommend that more aspects of the MBI framework be outlined and calibrated in the Level 2, noting that many of the challenges with the existing provisions stem from an overly prescriptive Level 1 (exemplified by the significant number of outstanding 'Q&A' requests). This should include the determination of appropriate extension periods, the process for pass-ons, as well as identifying scope and exceptions.

(c) Market regulation

35. As ICMA has suggested previously, many of the implementation (and enforceability) challenges related to the CSDR MBI framework stem from the fact that any legal requirements covering a buy-in transaction would be better achieved through market regulation, not post-trade regulation. Buy-ins are not a post-trade process. They are market transactions, executed between trading parties, with associated market risk. In most cases these will not be the CSD "participants" referred to in the Regulation. In other words, what the CSDR MBI framework effectively attempts to do is to impose a requirement for a trading entity to enter into a market transaction through a regulation that does not directly apply to them. In many cases that trading entity will not even be an EU regulated entity.

36. In the event that the Commission determines that an MBI requirement is appropriate for a particular instrument or transaction type in the EU, ICMA would strongly recommend that it apply this through market regulation, targeted at the relevant, regulated trading entities. This would be far more effective, and significantly less complex, than trying to apply the law through contractual arrangements "along the transaction chain".

Section 2: Cash Penalties

37. ICMA and its members are broadly supportive, in principle, of a cash penalty regime for settlement fails on EU (I)CSDs. In combination with other initiatives to improve settlement efficiency (such as shaping, partialing, auto-borrow and lending programs), cash penalties can provide an additional incentive to settle transactions on a timely basis, as illustrated by the implementation of the TMPG fails charge in the US Treasury market.[4]

38. ICMA and its members have reflected on both (i) the scope and (ii) design of the CSDR penalty mechanism and provide the following recommendations in response to the proposed revisions:

(i) *Scope*

39. ICMA does not agree with the exception outlined in the proposed amendment to Article 7 paragraph 2 relating to transactions between wo trading parties.: *"The penalty mechanism referred to in the first subparagraph shall include cash penalties for participants that cause settlement fails ('failing participants') except where those settlement fails are caused by factors not attributable to the participants to the transaction or for operations that do not involve two trading parties."*

40. ICMA would agree that in the case of MBIs (or any buy-in), this should only apply in the case of outright purchases or sales between trading parties. This is because buy-ins are market transactions, executed by trading desks, with associated market risk, and are not a post-trade process. However, penalties are a post-trade mechanism and can apply to a broader universe of transactions. It is also important to recognize that transactions that do not involve two trading parties can have impacts through the settlement chain on transactions that do, including outright purchases and sales. Therefore, penalties could be an effective tool for preventing such fails chains if more broadly applied.

41. As noted in the Recital (4) of the Commission's proposal, ICMA recognizes that there are specific cases where the application of penalties between two trading parties might not be warranted, such as certain primary market transactions[5] (*see also Section 3 of this feedback*). However, ICMA agrees that such additional exceptions to the application of the penalty regime not referred to in Recital (4) should be further clarified in the delegated act.

(ii) Design

42. While ICMA believes that the penalty system could have been more dynamically designed, based on variable rate and applied using calendar days rather than business days (more akin to the US TMPG fails charges framework), to institute such structural changes at this stage would likely require significant cross-industry investment and development. Therefore, ICMA does not believe that this could be justified from a cost-benefit perspective.

43. ICMA members raise more pressing concerns about the current application of the penalty mechanism, and challenges related to underlying data quality as well as inconsistencies and

[4] See: https://www.newyorkfed.org/medialibrary/media/research/epr/10v16n2/1010garb.pdf

[5] While beyond the direct scope of ICMA's remit, the creation and redemption of fund units is another example

anomalies in application and reconciliation. ICMA is therefore supportive of the introduction of a single database (a so-called “golden source” for reference data), created and maintained by ESMA. This would help to underpin consistency and accuracy in the application of the penalty mechanism across the market, as making the reconciliation process far more efficient.

Section 3: Primary market alleviation from SD

44. ICMA notes the Commission Proposal (COM(2022) 120 final) provides that:

    - exclusions from the cash penalty and mandatory buy-in mechanisms should cover in particular settlement fails not attributable to the transaction participants or regarding transactions involving non-trading parties, where penalties would be impracticable or detrimental – *"such as certain transactions from the primary market"* (Proposal Recital 4);
    - settlement fails not attributable to the transaction participants or regarding transactions involving non-trading parties are excluded from the cash penalty and mandatory buy-in mechanisms (respectively CSDR Articles 7.2#3 and 7.4(c)/(d) pursuant to Proposal Article 1(2)(a)/(e)); and
    - the commission is empowered to adopt in this respect delegated acts specifying (i) the reasons for settlement fails to be considered as not attributable to the transaction participants and (ii) the transactions not to be considered to involve two trading parties (CSDR Article 7.14a pursuant to Proposal Article 1(2)(e)).

45. ICMA has historically not requested a specific exclusion relating to the new bond issuance primary market, as scenarios for delayed primary market settlement seemed either outside the scope of the settlement discipline mechanisms (e.g. a primary issuance being delayed or cancelled) and otherwise highly unlikely to occur in practice and/or to be manageable. However, a further scenario has been recently brought to light where there may be frequent settlement fails that are not attributable to the transaction participants and/or regarding transactions involving non-trading parties.

46. This further scenario is where a new bond issue is initially delivered by the issuer into DTCC in the United States, for the new issue underwriters (the delivering trading parties) to settle with the initial primary market investors (the receiving trading parties) in the two international CSDs (ICSDs / Euroclear and Clearstream) in Europe. Such initial delivery by the issuer occurs in the morning in the United States but also then in the afternoon in Europe, due to time zone differences. So onward transfer from DTCC into the ICSDs by the underwriters quite commonly misses the ICSDs' intra-day cut off times for same-day ('daylight') settlement. This has been a long running situation that has never been perceived as problematic, since the ICSDs back-value next-day ('overnight') settlement receipt by the initial primary market investors (enabling timely payment of the issue proceeds to the issuer). In this respect the initial same-day settlement failure typically relates to the delivery from a new issue underwriter's DTCC account to another new issue underwriter's ICSD account (as a preliminary to delivery to primary market investors' ICSD accounts) and is thus both (i) not attributable to the transaction participants (being due to initial issuer delivery in a United States time zone) and (ii) typically regarding transactions involving non-trading parties (as involving just new issue underwriter accounts rather than new issue underwriter accounts and primary market investor accounts).

47. In this respect it has been anecdotally reported to ICMA that primary market investors are now being asked in some cases to accept their initial allocation in their DTCC accounts. Primary market investors can then, if they wish, transfer their bonds from their DTCC accounts to their ICSD accounts as a secondary delivery – with any fails etc being internal to each primary market investor and less impacted by the ICSDs' cut-off times. It has also been suggested, as an alternative, that initial delivery by the issuer occurs directly into the ICSDs –

though the likelihood of practical traction with issuers used to delivery into DTCC (in terms of adopting a new procedure in a different time zone) remains to be seen.

48. Consequently, ICMA supports the fact that the Commissions' intention to alleviate fails from the SD regime includes certain transactions from the primary market. A potential approach in this respect might be to allow one day's grace to all new bond transactions that are due to settle on that bond's new issue closing date, whether in the primary market or in the secondary market (this would avoid secondary market on-sales from being penalized due to a primary market delay). ICMA looks forward to assisting the Commission in elaborating its delegated acts in this respect.

About ICMA

For over 50 years the International Capital Market Association and its members have worked together to promote the development of the international capital and securities markets, pioneering the rules, principles and recommendations which have laid the foundations for their successful operation.

In pursuit of its objectives, ICMA brings together members through regional and sectoral committees focusing on a comprehensive range of market practice and regulatory issues, prioritising sustainable finance and three core fixed income market areas: primary; secondary; repo and collateral.

ICMA currently has around 600 members active in all segments of international debt capital markets in 64 jurisdictions globally. Among our members are private and public sector issuers, banks and securities dealers, asset and fund managers, insurance companies, law firms, capital market infrastructure providers and central banks.

ICMA is a not-for-profit association (Verein) under the Swiss Civil Code. The Association is headquartered in Zurich, with offices in London, Paris, Brussels and Hong Kong and registered in the Zurich Commercial Register.

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