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CSDS AND THE REFORM OF THE SETTLEMENT PROCESS

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ABSTRACT

The post-trade activities in securities has again raised considerable attention and discussions: recent public consultations of European Commission have resulted in a very active debate concentrating on three issues: new regime for settlement finality, with specific attention to the Buy-in process, the consequences of possible introduction of distributed ledger technology in the securities settlement process, and finality the widespread use of internalisation as a replacement to the CSDs. Overall, these discussions also result in a debate about the supervisory system. The debates on these topics are still open and are likely to keep us busy for quite some time. Therefore, this status questionis may be useful.

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The final version of this paper will be published elsewhere.

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Introduction

The structure and functioning of the post-trade activities in securities has again raised considerable attention and discussions. Several aspects of the settlement process have been the object of recent proposals aimed at changing the applicable legislation , which are the result of a critical analysis by the Commission, and several public consultations on Commission proposed actions[1], resulting in a very active debate concentrating on three issues: settlement finality, with specific attention to the Buy-in process, the consequences of introducing distributed ledger technology in the securities settlement process, and finality the widespread use of internalisation as a replacement to the CSDs. Overall, these discussions also result in a debate about the supervisory system. The debates on these topics are still open and are likely to keep us busy for quite some time. Therefore, a status questionis may be useful.

1. The CSD LANDSCAPE in Europe[2]

Table 1

	B	C	D	D/C
CSDs and SSS	**Value in account millions EUR**	**Instructions thousands**	**Value of transactions billion €**	**Average** value in billion €
Belgium	15890156	119584	556689	4,65
Germany	9595761	65218	68366	1,05
Estonia	9172	174	8	0,05
Cyprus	167730	36	0	
Greece	3438	112	5321	47,51
Spain	2367049	9394	32235	3,43
France	7322430	29214	112464	3,85
Italy	3363527	25662	97731	3,81
Latvia	3807	36	5	0,14
Lithuania	12680	54	5	0,1
Luxembourg	8037812	66540	220250	3,31
Malta	15538	35	2	0,06
Netherlands	1101287	6588	5619	0,85
Austria	586891	1321	640	0,49
Portugal	350960	930	172	0,18
Slovenia	35744	52	18	0,35
Slovakia	54508	32	34	1,06
Finland	389959	9576	1557	0,16
Bulgaria	14398	46	14	0,3
Czech Republic	274773	1467	7353	5,01
Denmark	1246284	59144	40128	0,68
Hungary	123021	556	856	1,54
Poland	337479	6707	13816	2,06
Romania	66086	664	122	0,18
Sweden	1641980	13768	13311	0,97
			1176716	
UK - ireland	6406141	63019	357184	5,67

[1] See Commission, TARGETED CONSULTATION DOCUMENT REVIEW OF REGULATION ON IMPROVING SECURITIES SETTLEMENT IN THE EUROPEAN UNION AND ON CENTRAL SECURITIES DEPOSITORIES, 2 February 2021

[2] Source: ECB Securities Settlement Statistics, 2019, https://sdw.ecb.europa.eu/reports.do?node=1000001581

These figures illustrate the considerable differences between the national CSDs, with the main CSD groups concentrating the highest number in terms assets on their accounts, and as a consequence, a high concentration in terms of value per transaction and number of transactions. In some states, the average value is much higher, due a lower number of transactions but a relatively high value per transaction. In terms of relative concentration, Euroclear group totals 239280 billion euro - and including EUI 596464 - while Clearstream group stands for 288572 billion euro transactions, their relative shares amounting to 39% v 19% of the overall EAA market. To mentioned are the very low percentages in a certain Member States, which can be related to less familiarity with securities investments.

2. Buy-in as part of settlement finality

1. *Settlement finality* is a core element in the functioning of securities settlement systems. It was already the object of one of the first measures in this field, with the Settlement Finality Directive (SFD) in 1998[3], introducing a central risk reduction instrument, several years[4] before the fundamental CSDRegulation (CSDR) of 2014. The directive deals with the obligations of the parties to a settlement operation, stating that "even in insolvency proceedings, transfer orders and netting shall be legally enforceable and legally binding on third parties"[5]. No law, regulation or practice on the setting aside of contracts before the opening of insolvency … "shall lead to the unwinding of a netting". "Nor may a transfer order be revoked …from the moment defined by the rules of the system". These rules introduced a crucial feature of the settlement process, i.e. that once the process has reached the stage of execution – as defined or agreed - and has entered into the settlement system, it will not be interrupted for any reason, be it insolvency of one of the other participants, revocation of his settlement orders, inability to deliver the securities or lack of funding for making the payment, or any other cause affecting performance. The parties involved have absolute security that the settlement will go through and that the seller of the securities will receive payment, while the buyer will see the securities booked to his account.

This very strict reciprocity is needed to ensure this market, where considerable volumes securities and capitals are traded to function effectively, and avoid any disruption due to the non-delivery of the promised assets, or to failing payment. "Settlement finality" as this feature of the post-trade market in securities is called, is an essential building block in the build-up of confidence in the functioning of the securities markets settlement systems, securing speedy and reliable execution of the parties' obligations, while avoiding confidence risks. Settlement finality belonged to the early measures the EU adopted in this sector, based on recommendations and proposals developed in international statements and codes of conduct.

2. Finality is a major instrument in reducing risk: it refers to the irrevocable and unconditional character of the settlement which is achieved by "delivery versus payment" (DvP), i.e. the simultaneous delivery of the securities against the transfer of the payment, and both booked in the accounts of the respective parties. If DVP cannot be achieved, one of the parties not offering to transfer the promised consideration, the transaction will not go through, and leave the parties with open positions, and consequent risks, causing damages and triggering penalties due by the party who failed to execute its part of the transaction[6]. The failure to perform does not terminate agreement, as the parties may attempt other ways to achieve performance or equivalent outcomes. But at the same time, the regular settlement process will have been interrupted, and the confidence of the counterparty shaken. This may undermine the reliability of the settlement process, affecting the regular functioning of market, and in periods of great unbalances, when numerous settlements would fail, even contribute to the market's destabilisation[7]. The Commission especially qualified the Settlement Finality Directive (SFD) as a systemically important regulatory regime, implying minimum exposure of CSD participants to

[3] Directive of 19 May 1998, 98/26 on Settlement finality in payment and securities systems

[4] DvP has initially been formulated by the Group of Thirty in its 1992 report as mandatory for all securities settlement systems, Also: CPSS-IOSCO, Principles for financial market infrastructures, April 2012, Principle 8 on Settlement Finality; see also the Giovannini barriers, see for a recent comment. AFME welcomes publication of EPTF report, 23 August 2017.

[5] Article 1, Regulation No 909/2014 of 23 July 2014 on improving securities settlement … and on central securities depositories, ("CSDR"). The rule only applies to orders entered into the system before the opening of insolvency proceedings

[6] Non-DvP transactions may be stipulated as Free of payment (FoP), delivery versus free, which refer to transactions in which the securities are transferred for other assets than cash payment, are gifted , inherited, or transferred between accounts at the same custodian. The agreed absence of consideration will not prevent the transaction to be implemented. Should these be concluded in the internalized data?

[7] Systemic risk is often mentioned in this context: FSB, Guidance on Central Counterparty Resolution and Resolution Planning , 7 July 2017 and 16 November 2020

counterparty, credit and liquidity risks by applying the principles of irrevocability and finality to all transfer orders.

Originally formulated in the 1998 Directive, the settlement finality principle was further developed in the 2014 Delegated regulation on Central Securities Depositaries, the "CSDR", which constitutes the core regulatory basis for this field of financial activity. The principles laid down in the CSDR on settlement finality and related rules and procedures[8] are further elaborated in the Commission delegated regulation of 25 May 2018[9]. The principle of "delivery versus payment", according to which the delivery of the securities should only intervene – or will only become legally effective if simultaneously and irreversibly the agreed payment is received, is confirmed. - while the failure to settle is usually called a settlement 'fail"[10].

3.The 2018 Delegated Regulation mainly dealt with the settlement discipline, requiring CSDs to provide to participants "a functionality that supports fully automated, continuous real-time matching of settlement instructions throughout each business day". The 2018 regulation also dealt with aspects of not living up to DVP whether on a preventative basis, or ex post (fails). The former refers to the mentioned techniques to prevent settlement fails, such as a mutually agreed facility to cancel settlement instructions, or to allow partial settlement. The provisions dealing with settlement fails detail the monitoring obligations, the information on the characteristics of the settlement instructions [11], the reporting on the fails and finally the price compensation[12] and penalties to be imposed by the CSD to the failing party, to be collected by the CSD and distributed among the parties who have been affected by a settlement fail [13].

4.The 2018 regulation also introduced a new regulatory instrument for dealing with settlement fails, the basis of which was laid in the 2014 CSDR: this is the "buy-in" tool[14]. The objective of the new regime is to improve settlement efficiency, the buy-in becoming applicable on the last day of the extension period of 4 business days after the intended settlement date[15], the settlement agent stepping into the shoes of the defaulting party.

The buy-in tool addresses transactions for which the securities are not proposed for delivery on the intended settlement date, or where the transaction price is not forthcoming. Depending on which party has failed, the agent will substitute himself to the buyer who has not offered payment, and acquire the securities from the seller, and sell them in the market, paying the price to the seller. In the case in which the holder of the securities failed to deliver, the agent will deliver the securities to the original buyer, having acquired the securities in the market[16]. Fails in a transaction chain will cause a series of fails; a single buy-in could be started allowed to settle the entire chain[17], the other parties not being held to start a buy-in.

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[8] Chapter III on Settlement discipline of CSDR, applicable to all transactions to be settled on CSD and traded on an EU trading venue. Shares traded on a third country market are excluded from the fails system: article 7(13).On the relations with third countries, see article 25 CSDR

[9] Commission delegated regulation 2018/1229 of 25 May 2018 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on settlement C(2018) 3097 final ("regulation 2018/1229"); also: Commission Delegated Regulation (EU) 2020/1212 of 8 May 2020 amending Delegated Regulation (EU) 2018/1229 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on settlement discipline, OJ L 275, 24.8.2020, p. 3–4, postponing to 1 February.2022

[10] Article 7 (13) , CSDR; not applicable to shares listed in a third country.

[11] ESMA, in cooperation with the ESCB members will develop regulatory technical standards allowing to monitor CSD's systems for settlement fails, report on the settlement fails that occurred and the details of the operation of the buy-in process[11]. operation of the buy-in process, Article 6(5) and 8 (2) CSDR

[12] Article 7(6) and (7) CSDR,the price difference to be paid to the receiving participant within 2 business days after the delivery of the securities.(or cash compensation after the deferral period is the securities cannot be delivered)

[13] See article 16 e.s. Regulation 2018/ 1229; Commission Delegated Regulation (EU)2017/389 of 11November 2016 supplementing Regulation(EU) No909/2014 as regards the parameters for the calculation of cash penalties for settlement fails and the operations of CSDs in host Member States . CSDs should only be responsible for charging, collecting and distributing those cash penalties (Recital 18).

[14] See article 7 (3) CSDR under the general CSDR settlement regime; article 16 e.e. Regulation 2018/1229.

[15] As provided in article 7 (3) CSDR

[16] See Deutsche bank , pointing to greater efficiency and therefore investor safety, https://corporates.db.com/files/documents/Your-guide-to-csdr-an-overview.pdf?language_id=1Positive; See for differences with the traditional buy-in operations: ICMA, Mandatory buy-ins, European settlement regulation with global trading level implications, July 2018 https://www.google.com/search?client=safari&rls=en&q=Commission+buy-in+CSD&ie=UTF-8&oe=UTF-8

[17] Where a receiving trading party in a transaction chain initiates the buy-in process, all other receiving trading parties in that transaction chain are relieved of any obligation to initiate a buy-in process. See the case of ETFs, where settlement will often be calling for an additional process involving a new issuance in the primary market for the creation of the instruments to be delivered.

The irrevocability and finality of transfer orders would not be affected by the failure of a participant to deliver the securities against payment by another party. More generally the settlement process would be safeguarded, at least in financial terms, while the buy-in agent will further proceed to the implementation of the transactions by whether substituting for the failed securities, or table the agreed funding from his own funds, or from the market. The buy-in tool as detailed in the delegated regulation is a binding intervention in the settlement process and has since been the subject of an extensive public discussion and controversy within the securities trading profession[18]. It is especially important for short transactions.

5. The buy-in technique aims essentially at reducing the deleterious effects of fails and reducing their number by identifying certain techniques to whether prevent a fail, or more importantly by dealing with them once they occurred, so that the market driven process can continue. Similar techniques are already applied today on an individual basis, based on contractual arrangements, but leaving the buy-in party a wide freedom for organizing it, e.g. by pursuing partial settlement[19]. According to the Commission's regulation proposal, the buy-in process would be mandatory for all participants and be enforceable accordingly on the same conditions in all relevant jurisdictions[20].

Upon failure, there will be a grace period allowing for an extension of the delivery date[21]. After the extension period, a mandatory buy-in process will become applicable for all types of securities on the basis of a standardized contractual arrangement applicable to all participants in the settlement service[22]. This would be achieved by the mandatory intervention of the buy-in agent - a neutral third party, designated by the CSD – who will acquire the securities for delivery to the receiving party if the latter has not done so within 4 business days[23]. Penalties and a cash compensation [24] become due and will be imposed on the failed party[25]: these will be collected by the buy-in agent and credited to the non-failed participant. From then on, the original securities cannot be delivered except to the buy-in agent. The agent will deliver to the buyer "replacement" securities within 4 days[26]. He will organize automated auctions in order to acquire the securities from the network or in the market and deliver these to the receiving buyer in the original transaction. Funding of these purchases will be made available at market prices by the parties participating in the buy-in agent. The failing party will be responsible for penalties, execution fees, and also for price differences [27] vav the original transaction.

This buy-in process would be neutral and therefore protects the interests the different parties involved, the failing counterparty and also of a later buyer in the market. It would be applicable to all types of securities, mainly to shares, but also to bonds. The CSDs would not be incurring any liability[28]. The rules applicable to the buy-in process should moreover be uniform: the major lines of the process were spelled out in the delegated act, a directly applicable EU regulation, and therefore uniformly applicable on all EU markets[29]

6. The regulatory implementation of the buy-in has been postponed for some time. Due to Covid-19 and the already large work overload for CSDs and market participants, the entry into force of this delegated

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[18] See below nr .8

[19] ICMA, CSDR Settlement discipline, Mandatory buy-ins, European settlement regulation with global trading level implications, July 2018 gives a detailed overview of the then applied Buy-in procedures. See for former statements: : ICMA Buy-ins, how they work, and the challenge of CSDR: An ICMA briefing note, July 2015; ICMA, Mandatory buy-ins, European settlement regulation with global trading level implications, July 2018 https://www.google.com/search?client=safari&rls=en&q=Commission+buy-in+CSD&ie=UTF-8&oe=UTF-8,

[20] Recital 15, CSDR; article 25(2) regulation 2018/1229

[21] See article 7(3) CSDR providing for a 4 days extension period; recycling of failed orders is mandatory under article 9, 2028/1229

[22] Recital 28 Commission delegated regulation 2018/1229 referring to the buy-in as a mandatory contractual arrangement

[23] Or 7 business days for illiquid instruments, article 7(4) CSDR. The procedure should not be applied to SME growth markets, Recital 17

[24] See article 29,(9) ;calculated according to article 32, Regulation 2018/1229. The indemnity will be paid to the non-defaulting party. See also for the price difference of the securities between market price and fail price, article 35, Commission delegated regulation 2018/1229.

[25] Art 7(2) CSDR; see also ESMA, Questions and Answers , Implementation of the Regulation (EU) No 909/2014 on improving securities settlement in the EU and on central securities depositories , ESMA 70-708036281-2 "settlement discipline" pt 5

[26] Every bought-in financial instrument should therefore be delivered to the buyer, even if the number of bought-in financial instruments does not allow for the full settlement of the relevant settlement instruction, Recital 38

[27] Art 7(2) and (8) CSDR According to article 35, Regulation 2018/1229 on the price difference; see also ESMA, Questions and Answers , Implementation of the Regulation (EU) No 909/2014 on improving securities settlement in the EU and on central securities depositories , ESMA 70-708036281-2

[28] Recital 18 to Regulation 2018/1229 who should only be responsible for charging, collecting and distributing the penalties).

[29] Article 28, of Regulation 2018/1229 of 25 May 2018 referring to the buy-in agent. Based on a regulation, the same regime will apply in all EU states. The regulation's entry into force is postponed until 1 February 2022: see Commission Delegated Regulation (EU) 2021/70 of 23 October 2020 amending Delegated Regulation (EU) 2018/1229 concerning the regulatory technical standards on settlement discipline, as regards its entry into force

regulation has been postponed, originally until February 2021, now until 1 February 2022[30]. In the meantime, some CSDs have prepared the new Buy-in regime and announced the identity of their settlement agent: this is the case for the two main systems.[31] [32]

7. In policy terms, the buy-in process would facilitate the way parties deal with settlement fails, which today are reducing the effectiveness of the settlement process, by taking these blocked transactions out of the settlement process. This would be a considerable benefit, expediting the main settlement process, creating clarity, and putting the burden on the failing party. It amounts to requiring both parties to well prepare their positions before putting these through the settlement process, so that the transaction may go through at full DVP speed, STP being the most evident[33] . But other techniques of intervention may safe the automated settlement process; the regulation, mentions manual intervention, partial settlement, a cancellation facility, tolerance levels, a hold and release mechanism or extending the period for settling, but this would increase risk, and is putting the burden on parties other than the defaulting one[34]. These processes are today being practiced on an individual, voluntary basis. In case of major market turmoil however, such as was illustrated in the US GameStop case, when many transactions without meeting the criteria for DVP, were coming to the settlement phase, the regular functioning of the settlement process has been deeply affected.[35]. The buy-in agent would be confronted with a very considerable number of failed or failing transactions, probably preventing the settlement process to continue[36]. Special attention should also go to the securities made available for to settling transactions that are unblocked as a consequence of this process, as their price movements may have become erratic.

8. The introduction of this new regime for dealing with settlement fails as was laid on the table in 2018, as raised some hefty reactions especially from associations of market professionals [37] especially ICMA [38],

[30] ESMA has published a Q&A on the different dates at which the numerous regulations have entered into force, or will soon do but the RTS 2018/1229 has not entered into force, having been postponed, and last until 1 February 2022 , ESMA, CSDR RTS on Settlement discipline, Postponement until 1 February 202226 August 2020, ESMA70-156-3490

[30]. The entry into force of regulation 2018/1229 is postponed until 1 February 2022 by Commission delegated regulation 2021/70 of 23 October 2020, on the basis of ESMA 70-156-3490, final report

[31] Euroclear has announced to organize a buy-in regime by the separate company Taksize, a UK limited company, majority owned by Euroclear SA; see for further information: Taksize Helping you comply with CSDR Settlement Discipline, https://www.euroclear.com/taskize/en/taskize-settlement-discipline.html; https://www.euroclear.com/newsandinsights/en/Format/Videos/csdr-buy-in-reporting-with-taskize.html; Taksize is up to now mainly a communication tools- "query tool"- between the clients banks and the Euroclear client service teams, allowing for a speedy solution for issues .Its role as Buy-in agent starts on February 2021.

[32] Also: J.Watkins Eurex STS Buy-in Agent Service, https://www.deutsche-boerse.com/dbg-en/products-services/ps-market-data-and-regulatory-services/ps-buy-in-agent**.** Eurex Securities Transactions Services GmbH Eurex STS, starting summer 2021. For an analysis: Introduction of new mandatory buy-in regime according to EU Central Securities Depository Regulation, https://www.clearstream.com/clearstream-en/newsroom/202103-1653758, 1 March 2021; .

[33] See recital 5 to Reg 2018/ 1229 and the article 2 to 12, referring i.a. to automation (limiting manual interventions) . Real Time Gross Settlement (RTGS) should be offered by CSDs. recital 10, regulation 2019/1229.

[34] See articles 3 to 11, Regulation 2018/1229

[35] On the US Gamestop case: Gamestop case puts the focus on market plumbing, FT 5 February 2021

[36] In the US, the settlement time period of 3 days has been criticized as allowing for unhealthy speculation as was prevalent in the US markets. DTCC proposes shortening the settlement cycle from T +2 to T +1 . See DTCC, the key benefits of T+1 settlement, https://www.dtcc.com. After the US GameStop case, DTTC is arguing for an even shorter cycle to avoid requiring even more margin and more insurance to cover fails. as the two-day process lies at the basis of the decisions to restrict share trading see , Ph. Stafford, US clearing house seeks quicker settlements after GameStop sage, FT, 25 February 2021.

[37] See e.g. The TRADE, Esma rejects industry calls for changes to the CSDR buy-in regime,

[38] ICMA objections in its April 1, 2021 communication declared that the MBI (Mandatory Buy-In) proposal is "not fit for purpose and requires substantive revisions". It points to the negative impact on market liquidity, functioning and stability, as occurred in the March-April 2020 bond market, the efficiency and liquidity of which may again be affected. The cost to the markets, especially to retail investors might be considerable. ICMA proposed to make buy-in discretionary, not mandatory. It further presented a list of 7 "essential revisions"ICMA,CSDR-Review-RoadmapFeedback-010421.pdf.. Referring to its submission in the Targeted consultation, it pleaded for ESMA to provide for timely clarification to market participants and stakeholders, and to introduce certain changes such as a pass-on mechanism, narrowing the scope more workable cash settlement for illiquid bonds, adapting timeless of completing the buy-in, and guaranteed delivery for the buy-in process. ICMA also referred to the joint position with AFME proposing a pass-on mechanism between failing transactions which have different intended settlement dates (See ICMA , CSDR-SD Working group, March 2020); see also: ICMA, Mandatory buy-ins, European settlement regulation with global trading level implications, July 2018, ; AFME Position Paper: Review of CSDR, February 2021, AFME Consultation Paper on Draft Regulatory Technical standards on the CSD Regulation - The Operation of the Buy-In , August 2015

ECSDA[39], ISDA[40] , AFME but also several other associations[41], individual banks and financial institutions expressing their reservations as to the appropriateness of the Buy-in proposal, the likely costs to be expected, and calling for a thorough reassessment. Some reactions were rather angry. The CSDs also expressed their concern in the context of the Commission's Targeted Consultation of February 2021[42]. The French regulators have also expressed their concern[43]

9.The arguments against the buy-in regime are numerous and multiple: ICMA[44] published a detailed description of the Buy-in process, and listed the challenges: the process is time consuming and costly; distortion on market pricing due to the mandatory nature of the buy-in regime; difficulty to execute due to illiquidity of the underlying securities; disputes if the original execution price is much higher than the market price; difficulties in legal enforcement in some jurisdictions.[45] ICSDA also called for a 'significant revision', and considered that the buy-in should not be applied in the Eurobond markets as it could undermine market liquidity and stability. It is unclear whether several of these flaws would only occur in in an officially organized and structured buy-in regime. They probably also occur under the present regulatory system, although not in a structured, not mandatory way, so that the introduction of the regulatory buy-in regime would not be a major change. On many points, the associations[46] asked for further clarifications, and in the meantime as suspension of the further work on the buy-in.

10. There is one more fundamental objection formulated by several participants in the consultation: it related to the mandatory nature of the buy-in. But would an optional buy-in offer the same benefits to the involved market participants?[47]. And can bought-in securities be placed with local banks, dealing mainly with internalization, by-passing CSD services and related safeguards? Taking into account the numerous objections and remarks, it would be useful for the Commission to proceed with

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[39] ICMA CSDR Settlement discipline, 2 March and 11 March 2021, referring to the opposition of 15 trade associations https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/secondary-markets-regulation/csdr-settlement-discipline/ and mentioning ESMA's refusal to postpone the project. Especially the "cash bond market and subsequent liquidity impacts " would be negatively exposed. Societe generale The future settlement discipline, https://www.securities-services.societegenerale.com/en/insights/views/news/csdr-the-future-settlement-discipline-regime/ 5.3.2020, calling the "Mandatory buy-in a nuclear option". It asked on behalf of the industry for postponement to allow a more in-depth assessment of the impacts. It pointed to the danger with respect to Chains of transactions, where it may will lead to numerous fails impacting all buyers. Also, the regulation would not be applicable to certain transactions e.g. the transfer of a whole portfolio between same buyers and sellers. In the same sense: FIA, FIA Epta and ISDA, 2 February 2021, pointed to the detrimental effects from the Buy-in rules for derivative markets. The Commission rules should clarify that the buy-in requirements do not apply to margin transfers, physically settled derivates and emission allowances: ISDA, FIA and FIA EPTA joint response to the European Commission Targeted Consultation on the CSDR Review. 1 February 2021 https://www.fia.org/epta/resources/fia-fia-epta-and-isda-offer-joint-response-european-commission-targeted-consultation AFME criticized the mandatory buy-in rules for non-centrally cleared transactions, as it was considered a significant risk to Europe's recovery, The buy-in should be discretionary, and will impact disproportionately SMEs and illiquid securities.It would lead to high volatility and low liquidity would have been exacerbated during the Covid 19 crisis, in case the Buy-in would have been applicable. The buy-in is disproportionate to address settlement fails. See AFME Position Paper, Review of the CSDR , 12 February 2021 proposing to do away with a buy-in agent but introduce a pass-on mechanism allowing the buy-in notice to be passed-on to a counterparty with which he has an in-scope failing receipt.
Joe parsons, European Commission launches consultation to review CSDR and buy-in Regime, The trade, The trade, December 9, 2020 ; The TRADE, ESMA rejects industry calls for changes to the CSDR buy-in regime, 21 April 2020

[40] ISDA International Swaps and Derivatives Association, Futures Industry Association(FIA) and European Principal Traders Association (FIA EPTA) have published their position in the framework of the Commission Targeted Consultation 1 February 2021

[41] According to 51 out of 91 respondents to the CSDR consultation the buy-in regime should be a voluntary one, while 14 preferred the regime to be retained : Securities Finance times , CSDR: there are yet to be changes in industry behaviour , 23 March 2021

[42] ECSDA, pointing moreover to the unlevel playing field with non-EU countries without a buy-in regime : See https://ecsda.eu/wp-content/uploads/2021/02/2021_02_01_ECSDA_response_to_the_CSDR_Consultation.pdf. The Commission suggested a further postponement, referring i.a. to the work overload due to the Corona crisis, see FISMA letter, FISMA C2 SK/cv Ares(2020) 3761873

[43] AMF and Banque de France in their response to the Targeted Consultation: reponse-amf-bdf.pdf

[44]ICMA Buy-ins, how they work, and the challenge of CSDR An ICMA briefing note, July 2015; ICMA Mandatory Buy-in Provision of the EU CSDR, January 2020, https://www.icmagroup.org/assets/documents/Regulatory/Secondary-markets/ICMA-CSDR-mandatory-buy-insOverviewJanuary-2020-160120.pdf; Also: ICMA, Detailed reponse to the Targeted Consultation, February 2021, ICMA proposed to maintain its "well established and widely used Buy-In Rules" But the buy-in regime should be delayed, as ICMA tabled a 'waterfall of proposals" such as "implement cash penalties, all firms should have contractual frameworks to remedy falls and regulatory buy-in should be last resort, but critical revisions are needed. Preference for pass-on mechanism, which is not compatible with CSDR.

[45] See: ICMA, ICMA Detailed Response (February 2021) and especially its "Overview of ICMA's position on Settlement Discipline" .ICMACSDR-Review-Targeted-ConsultationFeb-21Detailed-response-020221.pdf

[46] Nt. 39

[47]The buy-in process was already mentioned in the CSDR in 2014. Among many : Hill, Mandatory buy-ins: Five reasons why the buy-side should care, https://www.globalinvestorgroup.com/articles/3691398/mandatory-buy-ins-five-reasons-why-the-buy-side-should-care, expressing his preference for the existing system, including the contractual buy-in frameworks and cash penalties. Also: mandatory buy-ins would have been disproportionate as they would have heavily impacted market making and liquidity for certain asset classes (in particular the non-cleared bond market). However, in some cases, voluntary procedures were not followed up, or took a long period of time before being settled in the market; discussions about penalties and other add-on were difficult.

circumspection, after having analysed in detail the arguments proposed by the professional associations and by other market participants, and this to not compromise the wider revision of the regulation[48]. A comparative analysis, based on objective arguments separating the proposed buy-in procedure and the present comparable ones, preferably established by an objective third party, would contribute to more clarity and better decision making.

For further initiatives, it would be useful to develop a comparative analysis which would consist of comparing the regime of fails in accordance with the Buy-in rules and the fails regime as applied today. Under the buy-in regime, the fails regime will be fully applied, on a mandatory basis and according to uniform rules and conditions[49]. Effectiveness and equal treatment will be the rule. Supervision i.e., with a view of convergence of the buy-in practices will be easier, and uniform data on the actual practice will become available. Both from the angle of investor protection and efficient functioning of the settlement processes, this option will be convincing.

On the other hand, the present practice is more flexible and based on the individual decision of the financial intermediary whose client is confronted with a fail[50]. The CSD can offer certain preventative facilities such as a cancellation facility and other derogatory solutions. [51]. Whether the CSD will extend the 4-day period or abandon the process[52], or look for other ways of settling the proposed transaction, will be his decision, along with the calculation of the penalties, fees and compensation. It will also decide on the distribution of these sums which will not benefit the CSD, and the penalties, paid to the CSD, will be distributed to the receiving participants. These cash payments will only be considered as paid when received by the receiving participants. The process may be partly confidential,[53] creating competitive differences, and allowing more limited reporting on the actual practices.

The final decision will have to be based on the interest of the investors and the efficient functioning of the markets.

11. Brexit. As far as the application of the CSD regulation to the UK is concerned, the Commission[54] decided to consider the regulatory framework applicable to central securities depositories of the United Kingdom of Great Britain and Northern Ireland as being equivalent in accordance with Regulation (EU) No 909/2014 and this until 30 June 2021. ESMA declared that EUI is recognized as a third country CSD after the transition period from 31 December 2020 and may continue to provide services in the EU until 30 June 2021. Issuers may transfer securities to EU CSDs.
The UK authorities have decided not to implement the CSDR but would undertake legislative changes referring to "legitimate industry concerns" [55].UK firms active in the EU markets will have to take account of CSDR, especially of the buy-in regime. In the meantime, the UK regulator (FSA) declared that it may "take advantage of the experience" of ESMA and the EU in key areas like mandatory buy-ins[56] .The buy-in regime was mentioned by ECSDA as a negative element in the competition with the common law regimes. ESMA also announced the creation of a Supervisory Convergence Network with respect to the treatment of authorisation requests by UK firms to EU27 NCAs in the context of the UK's withdrawal from the EU.

This long and winding development illustrates how much this part of the settlement subject raises a lot of controversy and due to the important stakes involved, will trigger strong negotiations. It is not unlikely that, after a first postponement, the regulation on the buy-in will not be postponed again.

3. The use of DLT in CSD activities

12. Among the subjects frequently mentioned in the context of the settlement process is the usefulness of building the securities clearing and settlement activity on DLT or "Distributed Ledger Technology" -

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[48] In the same sense: ICMA, Feedback in 1st April 2021, https://www.icmagroup.org/assets/documents/Regulatory/Secondary-markets/ICMACSDR-Review-RoadmapFeedback-010421.pdf
[49] See articles 24 and 25, Regulation 2018/1229
[50] See article 13 e.s, regulation 2018/1229
[51] Article 6 e.s 2018/1229
[52] Article 7(3) by bilateral cancellation.
[53] The information on the fails will be communicated to the NCAs on a monthly basis and be made public an annual basis: art 15 ,2018. 1229. The first data were by ESMA collected in 2019., and partly for 2020ESMA 70-156-3729
[54] Commission Implementing Decision (EU) 2020/1766 of 25 November 2020, until 30 June 2021.
[55] Pershing, https://www.pershing.com/uk/en/news/what-is-big-in-our-world/regulation/csdr
[56] E.S. Latter, A forward look at regulation of the UK's wholesale financial markets, 16 March 2021, https://www.fca.org.uk/news/speeches/forward-look-regulation-uks-wholesale-financial-markets ; This also was the opinion of Pershing, BNY Mellon UK entity: CSDR, https://www.pershing.com/uk/en/news/what-is-big-in-our-world/regulation/csdr, . The UK will develop legislative changes responding to legitimate industry concerns. In the meantime the UK regulator will take advantage of the experience of ESMA and EU in key areas like mandatory buy-ins. \

often also referred to as Blockchain - for the C+S of securities traded both on exchanges and OTC. It is mentioned as especially effective for bond markets[57]. The use of this technology could considerably facilitate the processes, make them faster and more reliable, and due to their uniform model, reduce the number of transactional steps, and therefore their costs[58]. There is strong awareness that the successful application of DLT could revolutionise the C+S business[59], standardising and streamlining processes, leading to cost savings (by reducing unnecessary duplication of activities, e.g. for reconciliation) and better risk management. Issues of fragmentation and interoperability will rank high in the list of concerns.

The technical difficulties are increasingly identified and controlled, and some focused projects are reported to be tested or are even operational. While the costs for the investors would be reduced, these would set off against the increased costs for the intermediaries. Some refer to the deleterious effects on the environment due to the excess consumption of electrical power [60]. As one writer stated: "the reflection on this matter is worthwhile"[61]. The Australian Stock Exchange has decided to introduce DLT, starting from 2022.The project was criticized for its lack of clarity on technical and operational aspects and its launch may be delayed again. Credit Suisse and Instinet announced that they had settled stock in a private company by using blockchain, the deal being completed in about two hours.[62]

13. In the European Union, the Commission, as part of Digital Finance Package plan, issued a Proposal for a Regulation on a
pilotregime on market infrastructures based on distributed ledger technology[63]. In its consultation the Commission mentioned that it envisages a DLT driven system as a multilateral scheme, the participants often being unidentified, no one being a central operator[64]. Putting DLT in the existing regulatory context raises questions of scope – payments being excluded – and of definitions and concepts, which have to be redefined. The supervisory issues should also be highlighted as legal and regulatory uncertainty is mentioned as one of the key handicaps for introducing DLT. Numerous states and authorities have already undertaken detailed work or adopted regulations in this field[65]. As there is not enough experience, the Commission has announced a pilot project.[66] Research activities on DLT in the financial field are under way in a great number of states worldwide and this in at least 9 EU states[67].

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[57] See ICMA New FinTech application in bond markets, https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/fintech/new-fintech-applications-in-bond-markets/

[58] See; G. Callsen, FinTech, DLT and regulation, 2017, 45, https://www.icmagroup.org/assets/documents/Regulatory/Market-Infrastructure/FinTech-DLT-and-regulation-by-Gabriel-Callsen-160517.pdf points among the advantages that the STP will be facilitated as it will not be governed by a disparate number of applications. Settlement will be almost instant reducing the need for collateral , and relevant information will be accessible for both parties based on the same source. ESMA has pointed to the need of suitable governance arrangements with clear liability rules, including on conflicts of interest, warning for cyber security and the danger of loss or theft of access keys.

[59] See ECB, The use of DLT in issuance and post-trade Processes" https://www.ecb.europa.eu/paym/groups/shared/docs/c3c3e-joint-ami-pay-ami-seco-2020-06-29-item-3-fintech-tf-executive-summary-the-use-of-dlt-in-issuance-and-post-trade-processes.pdf: "The change from incumbent bilateral system of exchanging information to a shared communication model enabled by DLT as well as use of digital assets and tokens could impact existing roles of capital market players or even require new ones."; R. Priem Distributed ledger technology for securities clearing and settlement: benefits, risks, and regulatory implications, February 2020, https://jfin-swufe.springeropen.com/articles/10.1186/s40854-019-0169-6; mentioning the absence of quantitative data on this topic.

[60] See Coletta, LSE, Bringing tokenisation to life, Euroclear collateral conference, 4 May 2020; also R Fulterer j Oesc, Eine einzige Überweisung in Bitcoins verbraucht so viel Energie wie ein Schweizer in eineinhalb Monaten, 5 April 2021,

[61] R. Priem, Distributed Ledger Technology for securities clearing and settlement: benefits, risks and regulatory implications, Financial Innovation, 6, 11 (2020) https://doi.org/10.1186/s40854-019-0169-6; see: A new Vision for Europe's capital markets; Final Report of the High Level Forum on the Capital Markets Union , June 2020, p.80 calling for a appropriate legal environment; ICMA Distributed Ledger Technology (DLT) Regulatory directory. https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/fintech/icma-distributed-ledger-technology-dlt-regulatory-directory/.G. Callsen, FinTech, DLT and regulation, https://www.icmagroup.org/assets/documents/Regulatory/Market-Infrastructure/FinTech-DLT-and-regulation-by-Gabriel-Callsen-160517.pdf ICMA; ICMA Distributed ledger technology (DLT) in the international bond markets over the last three years., or in international capital markets, list the DLT-related legislation and regulatory framework in capital markets, 08-04-21 See for the states which have started legislative work in the field: ESMA, Level 2 measures, on CSDs Internal Settlement, Drafts technical standards. Guidelines, Q& As, Notifications, Reports on the implmene\tation of the CSDR, SFD, T2S

[62]Ph.Stafford, Clearing system faces rivalry from blockchain technology, FT, 7 April 2021. ; G. Tett, Blockchain may change equities trading for good, FT 9 April 2021

[63] Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on a pilot regime for market infrastructures based on distributed ledger technology, COM/2020/594 final; see also: OPINION OF THE EUROPEAN CENTRAL BANK, 28 April 2021 on a proposal for a regulation of the European Parliament and of the Council on a pilot regime for market infrastructures based on distributed ledger technology, (CON/2021/15)

[64] This would raise a difficulty in markets where a CCP plays a central role.

[65] See for an overview, R.Varrall, ICMA Brief, DLT-related legislation and regulatory frameworks in capital markets December 2019, https://www.icmagroup.org/assets/documents/Regulatory/ FinTech/DLT-related-legislation-and-regulation-201219.pdf

[66] Proposal for a REGULATION on a pilot regime for market infrastructures based on distributed ledger technology

[67] See ICMA Distributed ledger technology (DLT) Regulatory Directory , 26 January 2021, listing the numerous developments in regulation in different parts of the world. It is unclear which ones have been operational

The subject of DLT in the settlement activity has also been included in the Commission's Targeted Consultation[68] ECSDA commented that some of the present SFR provisions create obstacles for the use of DLT and the tokenisation of securities[69], while the definitions in the CSDR will have to be adapted or specified for use in the DLT context[70]. It further identified a list of different concepts and techniques which will have to be adapted. This would be the case of the settlement in Central bank Digital Currencies, or commercial bank money related to cash tokens. This rejoins the statement by Coletta[71], of the LSE, that: "DLT is to weave its benefits into existing standards and procedures, rather than try to create new regimes and new silos of information"[72]. A subject to be followed with great attention.

14. The ECB has also been following DLT developments as these may directly affect its activity.[73] In April 2021 the ECB published an extensive analysis of the implications of the introduction of DLT in post-trade processes[74]. From this highly technical and detailed overview of the different aspects of the transition from the present processes to DLT, one can mention a few striking issues which will make the introduction quite complex. DLT will lead to different concepts with different players and different procedures. Existing securities will be replaced by tokens on a distributed ledger[75]. Asset protection will need to be reformulated as structured custody in the DLT network, with specific safeguards for insolvency, or cyberattacks. The compatibility among the different DLT schemes and the present architecture will raise numerous questions, to be clarified in a new regulation, and integrated in the DLT context in a "smooth transition". The report did not mention any issue related to fails.

The conclusion of the Bank is that "a clear business case has not yet emerged for the use of DLT in post-trade processes". This does not mean that further research should not be undertaken as the situation might evolve rapidly, and that coexistence of the different networks should not disturb the integrated market for post-trade services. The report heavily underlined the importance of interoperability, calling for a need of common protocols and standards. New barriers – alongside the existing hurdles – should be avoided when adopting DLT-based solutions

4. Settlement internalisation

15. In the general discussion of the settlement processes, the subject of settlement internalisation is receiving more attention[76]. Regulatory attention is now being paid to the settlement internalisers, for which the applicable regulations – and related data collections - have only been operational from 2019 on.[77]. Internalisation is a process in which an intermediary executes transfer orders on behalf of his

[68] See Commission Targeted Consultation Review of regulation on Improving Securities Setllement … and on Central securities depositories, 8 December 2020.
[69] See M.Bech, J,Hancock, T.Rice A.Wadsworth, On the future of securities settlement, linking DLT to tokenization, BIS Quaterly Review, March 2020,
[70] See for a list of examples: ECSDA, https://ecsda.eu/wp-content/uploads/2021/02/2021_02_01_ECSDA_response_to_the_CSDR_Consultation.pdf p. 25 ; also on settlement discipline p. 40 e.s. Are DLT addresses "accounts"? or are to be qualified as 'omnibus accounts'? p. 31. Also the position of an MTF, is it to be qualified as an internaliser, p. 27 . The number of subjects to be redefined raises questions of insecurity and instability, , with many unclear terms, or terms to be refined, obscuring the essential issues. Complexity as this has its price.
[71] See M. Coletta, https://www.euroclear.com/newsandinsights/en/Format/Articles/bringing-tokenisation-to-life.html
[72] Commission, Blockchain strategy, Shaping Europe's digital future, 9 March 2021 https://digital-strategy.ec.europa.eu/en/policies/blockchain-strategy, listing the different workstreams
[73] See the AMI-SeCo report entitled "The potential impact of DLTs on securities post-trading harmonisation and on the wider EU financial market integration", September 2017.
See the AMI-SeCo report entitled "Potential use cases for innovative technologies in securities post-trading", January 2019.
[74] ECB, The use of DLT in post-trade processes- Key features of using DLT for issuance, custody and settlement , . ecb.20210412_useofdltposttradeprocesses~958e3af1c8.en
[75] The ECB mentioned "projected cost savings and efficiency gains. Nevertheless, the use of DLT would entail similar challenges to those faced by solutions relying on conventional technology (such as fragmentation and interoperability issues) and would potentially create new ones (for instance relating to the legal validity of tokens)."
[76] See for an overview of the regulatory and other measures adopted by ESMA: Settlement, CSDR Internalised Settlement , Report to the European Commission ESMA70-156-3729; Commission Delegated Regulation (EU) 2017/389 of 11 November 2016 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council as regards the parameters for the calculation of cash penalties for settlement fails and the operations of CSDs in host Member States ;Commission Implementing Regulation (EU) 2017/393 of 11 November 2016 laying down implementing technical standards with regard to the templates and procedures for the reporting and transmission of information on internalised settlements in accordance with Regulation (EU) No 909/2014 of the European Parliament and of the Council; ESMA Guidelines on internalized settlement reporting under article 9 CSDR, ESMA 70-151-1258; Commission Delegated Regulation **(EU) 2017/391** of 11 November 2016 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards further specifying the content of the reporting on internalised settlements; ESMA, CSDR, Article 9 - Internalised Settlement Reporting, 31 July 2019, ESMA65-8-6561
[77] Art 9 CSDR and ESMA Technical guidance, validation rules, 31 July 2019, ESMA 65-8-6561 Settlement internalisation was practised since many years among others in Sweden; ESMA CSDR Internalised Settlement, Report to the European Commission, 5 November 2020, ESMA 70-156-3729 **,** stating that no major risks have been identified But NCAs referred to operational risk

clients on its own books, bypassing the securities settlement system. In most cases there is no financial consideration: free of payment transactions, inheritance transfers, transfers between accounts of the same owner, or between an owner and a beneficiary of a gift, collateral transactions etc. The transaction will be booked twice in his books, once a debit, another a credit for the same securities[78]. Some banks have used it as a regular booking method for their clients acquiring securities held or the account of the client, and with the client's funds, held at the bank. Internalisation can be practiced by all financial institutions, and informally by some asset managers as well. It may apply to all securities, even those initially recorded at a transfer agent, or a registrar. As data about this practice are crucial, the Commission adopted two regulations on the reporting by internalisers [79] but the overviews of the internalized transactions have only recently been published. In general, internalisation is not subject to any specific supervision, but ESMA has adopted Guidelines[80] and Q&As which contain useful information.[81] It also addressed a comprehensive report on the subject to the Commission[82] .

The internalization subject has drawn attention from ESMA and the Commission due to the impressive volume of securities transactions being dealt with this way, and the high degree of these being concentrated in a few Member states, and the high level of concentration with some settlement internalisers, adding that " the "extremely high values and volumes of internalised settlement, it seems clear that this practice cannot be continued further as it will undermine the confidence the markets have in the CSD's functions." [83]. The published figures indicate that concentration of those practices is very different depending on the Member States involved, and for some types of products, while no clear justification for this practice has been identified[84] . Notwithstanding these findings, ESMA did not announce specific measures, but would further investigate this segment of the market, collecting more, and better reliable data[85]. It also remarked that this development was not visibly due to the CSDR settlement discipline requirements. ESMA's data collection started in 2019, and is only complete until Q3, 2020. Even today, the quality of the data is still improvable, as has been remarked in then public consultation[86]

Internalised Settlement Instructions per country	instructions/ear	value/year	value/ instruct	number of Internalisers
Belgium	132233372,00	122223351,30	**0,92**	11,00
Germany	143626896,00	242715119,35	**1,69**	1228,00
France	24158360,00	67648696,37	**2,80**	129,00
Luxembourg	28185348,00	19859582,89	**0,70**	71,00
Netherland	45983936,00	19859582,93	**0,43**	15,00
Sweden	38599708,00	2012349,83	**0,05**	32,00

Internalised Settlement instructions

Per asset type	instructions/year	value/year	2020 **value/instr**	ESMA Data Fails/Number	Esma Data Fails/value

and custody risk, p. 8.ESMA pointed to the high level of concentration, an element of relevance for custodians and their clients ; See also Coletta, LSE, Bringing tokenisation to life, Euroclear collateral conference, 4 May 2020

[78]. An internalising instruction failing to settle for several days will be reported as having failed each of the days in which it failed, see ESMA Report, 5 November 2020, 70-156-3729, p 21 for an example This may inflate the fail figures

[79] See: Commission Delegated Regulation (EU) 2017/391 of 11 November 2016, Commission Implementing Regulation (EU) 2017/393 of 11 November 2016, supra nt 75

[80] ESMA70-151-367 of 30 April 2019, Guidelines on Internalised settlement reporting,; ESMA709-151-1258 of 28 March 2018 Guidelines on Internalised settlement reporting under article 9 of CSDR;

[81] See ESMA Q&A , Implementation of the Regulation (EU) No 909/2014 on improving securities settlement in the EU and on central securities depositories, 17 February 2020, 70-708036281-2, https://www.esma.europa.eu/document/questions-and-answers-csdr

[82] ESMA, CSDR Internalised Settlement, Report to the European Commission 5 November 2020, ESMA 70-156-3729. Custodian banks may prefer to record the securities of their clients in their own books for a series of -unverified – reasons: continuing relationship with the client, proximity contributing to confidence, lower cost, control, easier access for later internalized transactions, lack of information of the clients, ….

[83] ESMA, 5 November 2020, ESMA70- 153,3729,

[84] See about the data ESMA 70- 153,3729, and further below.

[85] The extensive list of data to be transmitted to the NCA on a monthly basis are listed in the annex to regulation 2018/1229. ESMA's data collection started in 2009, and is only complete for Q1-3 of 2020. Data should be related to the overall settlement activity in the same markets, an calculate the proportion of the internalized transactions to the overall securities settlement activity in the same markets

[86] See ESMA, Information about the systematic internaliser activity under Mifid II, see: https://www.esma.europa.eu/data-systematic-internaliser-calculations, 28 April 2020

Equity	289253932,00	105246481,37	**0,36**	23,45%	5,91%
Sovereign Debt	74852000,00	84426023,66	**1,13**	0,01%	0,84%
Bonds	42416256,00	45064907,66	**1,06**	1,32%	3,52%
ETFs	27458832,00	6401003,81	**0,23**	17,51%	6,39%
Other fin Instruments					20,86%

Internalised Settlement instructions

Per Transaction type				ESMA Q3	**ESMA data**
	instructions/year	value/year	value/instruct	nr instruct	value/instruc
Sec buy/sell	183614144,00	19301694,82	**0,11**	23,45%	59,47%
Collateral Mgt	193982804,00	144368296,82	**0,74**	0,01%	0,05%
Sec Lending.borroiw	76692304,00	80316972,32	**1,05**	1,32%	3,09%
Repurchase	315096,00	3230973,85	**10,25**	0,93%	0,80%
Other	10503740,00	20590036,81	**1,96**	8,40%	24,85%
total				22,88%	11,38%

Total internalised settlement value Q 3	**Nr instructions-3rd Q**	**Value-3rd Q**
Professional Clients	7,97%	**6,94%**
Retail clients	16,69%	73,40%

Source;ESMA, CSDR Internalised settlement
https://www.esma.europa.eu/sites/default/files/library/esma70-156-3729_csdr_report_to_ec_-_internalised_settleme

The internalisation data are incomplete: they result from the extrapolation of the 2020 Q 3 date over the 4 Q of 2020. U present relatively high on the concentration of internalization, which can be related to the structure of the banking syst dispersed banking structure, he values can be expected to be lower, e.g., in Germany, but France is an outlier here. The percentages of fails in equity – and other financial instrument, mostly occurring in the securities buy/sell activity, where high.

16. ESMA has not observed major risks due to internalisation, but mentions some practices inherent to the position of the internalisers, such as operational risks, custody, weak operational processes e.g. with respect to the identification of its clients and the amount held for their account, especially in omnibus accounts. Fails in the internalisation process should be analysed in more detail, e.g. with respect to the causes of these fails, their higher frequency in some jurisdictions, or differences depending on the type of security, the relationship with failed CSD processing, and more generally whether the fail regulation applies[87] . Clients should be informed about the risks and costs of internalized settlement, as these are different from CSD settlement. Some internalized position may have been created as a consequence of settlement fails. The possibility that settlement was moving away from CSD to internal settlement was not considered high by the NCAs and the trade associations but should be monitored. It was described as not being a separate business model, but rather an accidental phenomenon[88]

The subject was included in the Targeted Consultation, although only for asking whether a minimum level for reporting should be considered. It was also considered that proposals for more freely allowing the buy-in but also the use of DLT, may support the attractiveness of internalised settlement as a simpler and more easy to handle process. Some internalized positions may have been created as a consequence of settlement fails. A more ambitious initiative would be indicated.

17.The volume of these internalized transactions is impressive: in the EEA, in 2020, it reached between 123 and 116 million instructions per quarter, considerably higher than in 2019[89]. Most internalisation

[87] See below the data for 2019 (Q2 to 4) and 2020 (Q 1to 3)
[88] See nr. 21
[89] On the basis of : COMMISSION DELEGATED REGULATION (EU) 2017/391 of 11 November 2016 with regard to regulatory technical standards further specifying the content of the reporting on internalised settlements. The data for 2019 are incomplete. The Commission mentioned that the quality of the data needs improvement

instructions were noted in Belgium, Germany Italy and Luxembourg, Sweden, amounting in total to 116 million for Q 3, 2020, these figures being in line with their position in the CSD business. In terms of value, these instructions amounted to 66.951 trillion euro. ESMA has only collected data since 2019, but has not adopted any specific measures in its recent consultation nor did it announce specific measures, but expressed its concern, as this activity implies bypassing the role of the CSD and takes places without the same safeguards and supervision. Whether transactions settled according to internalisation will lead to the same protection e.g. with respect to legal certainty? When changes in beneficial ownership are not communicated to the CSD, this may create tensions with other regulations such as the shareholder identification regime or for tax purposes [90].. ESMA considered on the basis of the "extremely high values and volumes of internalised settlement, it seems clear that this practice cannot be continued further as it will undermine the confidence the markets have in the CSD's functions". The subject will have to be further studied and monitored on the basis of additional data. It was included in the Targeted consultation focusing on the reporting requirements. An analysis of the drivers for internalization could leads to a comparative analysis of the settlement in CSDs or by way of internalization, allowing to improve on each of them. Further data are needed with respect to the relationship of internalisation and CSD settlement, i.a. with respect to the type of transactions remaining unsettled , whether the buy-in process is applied and how the penalty mechanisms is applied, especially as to the time of calculation and the collection and distribution of cash penalties.[91] The reform of the settlement process by allowing the buy-in, but mainly the use of DLT, might change the attractiveness of internalised settlement. One could also argue that internalization could continue to be practiced for failed transactions for lower amounts.

18. The following table gives an overview of the internalized transactions for Q 3 2020, as the figures for the full year 2020 are not available. Only for the jurisdictions where internalization has been most frequently practiced have been selected. The table also gives an overview of the proportion of internalized transactions to the total number of transactions processed by the CSD in the selected jurisdictions[92] Internalisation for the different types of financial instruments illustrate that mostly shares, sovereign debt and bonds are subject to internalization. Data about the fails point to a high frequency for shares and ETFS, much lower for bonds, which is a more professional market. Fails deserve attention also from a market structure point of view.

5. Supervision of the settlement process

19. The reform of the supervisory system has been an recurrent topic in the recent discussion documents. Supervision is exercisedby the NCA of the State whose law governs the settlement system and by the EU central bank responsible for the cash leg[93]

Reform proposals relating to the role of CSDs have been issued in the context of the *Capital Market Union*. In the Capital Market Union 2020 Action Plan[94], the Commission tabled as an objective the "integration of national capital markets into a genuine single market"[95], followed by the introducing remark that "Europe's capital market does not match the significance of its economy". Among the concrete steps, it called for an improvement of the conditions for cross-border settlement services, and relaunching the "consolidated tape" in order to have a better view on the overall price movements[96] . These ideas were further discussed in the June 2020 report of the High-Level Forum on the Capital markets Union, stating "in the context of integrating the national capital markets and the improvement of the cross-border settlement services in the EU" as evidenced from the overview of the present CSD landscape above, CSDs are organized on a national basis, allowing for some cross-border activity

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[90] In that sense: ECSDA ; see also the notification of shareholdings to the issuer company under the shareholders rights directive, directives 2007/36 and 2017/828

[91] See Regulation 2018/1229

[92] ESMA, CSDR and Internal settlement, 5 November 2020, https://www.esma.europa.eu/sites/default/files/library/esma70-156-3729_csdr_report_to_ec_-_internalised_settlement.pdf The fail rates differ depending on the type of security involved. High volume high concentration with some internalisers may lead to operational and custody risk. ESMA also identified common errors in the data.

[93] Article 12, CSDR; see ESMA 70-151-887

[94] Commission Capital Markets Union for people and businesses-new action plan COM/2020/590 final, https://ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union/capital-markets-union-2020-action-plan_en, 24 September 2020, Com (2020) 590 final

[95] A new Vision for Europe's capital markets , p.9, referring to forthcoming Commission initiative, https://ec.europa.eu/info/sites/info/files/business_economy_euro/growth_and_investment/documents/200610-cmu-high-level-forum-final-report_en.pdf; **Commission, Integrate national capital markets into a genuine single market, Action 14, adding as a further suggestion ":**Improved dispute resolution mechanisms at national and EU level and other measures such as, for example, gathering information on investors' legal rights" **24 sept 2020 , https://ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union/capital-markets-union-2020-action-plan_en**; Final Report of the High Level Forum on the Capital Markets Union June 2020, https://ec.europa.eu/info/sites/info/files/business_economy_euro/growth_and_investment/documents/200610-cmu-high-level-forum-final-report_en.pdf

Borderless market in the EU, determines the competence of the home member state by the competent authority as established by each state, including the central banks as issuers of currencies

[96] Commission, CMU action 14

through a complex and incomplete network of group structures and of links. This "network" is still incomplete: as far as their settlement business is concerned, several CSD are not linked to other European CSDs, although they are connected with indirect links - often of variable intensity -, leading to considerable differences in cross- border involvement, but also efficiency. This makes the overall system less than fully effective, more costly and might reduce easy access to some securities in other markets. With respect to the future supervisory system, the independent report of the High Level Forum on the Capital Markets Union[9798] rightly states that a well functioning capital markets need a high quality, well resourced and convergent supervisory system based on a single rulebook. This will call for a strengthening of the present powers of ESMA and EIOPA, esp. for crisis management reforming their governance[99]. The adoption of a enhanced single rulebook is put forward[100] But no additional areas of competence are proposed: the two ESAs should move to an "efficient federative European model, split between prudential and market conduct." . These ideas have been discussed at different levels, but no political initiaive has been forthcoming [101].

Interesting is the (concluding) statement that "the strengthening of EU level supervision should take inspiration from the existing EU supervisory architecture. This is a cooperative model with a coordinating decision-making body at EU-level, with appropriate independence and accountability, and an implementation structure that capitalizes on the existing expertise and involvement of national authorities". Is this the SSM – ESCB model pointing at the horizon? The Commission from its side made a similar statement: "Truly integrated and convergent supervision is needed to ensure a genuine level-playing field for all market players. It is an essential condition for a well-functioning CMU". ESMA also mentioned a similar idea even adding direct ESA supervision[102] ECSDA stated that convergence would contribute to consistent and efficient supervision, including in the authorisation process[103] There is wide agreement that a more harmonised application of passporting rules for CSDs and converging supervision across Member States are essential to deliver efficient post trading services in the EU.

How a more efficient single European securities market has to be developed will be the subject of difficult discussions and negotiations, also in the field of C+S. starting with the national character of the trading markets, the different characteristics of the securities, not to mention differences in the company laws which determines the rights of the securities traded. The basic building blocks of this business are still very much rooted in national law[104]. Also, both the NCAs as the national CSDs will not be very keen on further centralisation, a condition for more integration.

CSDs are a typical example: there are today 22 CSDs[105] established in the EU, and 6 more in the EEA states. These are still very much related to their national securities markets, the two ICSDs excepted[106]. Their freedom of establishment, mentioned in article 23, CSDR, allows them to create branches in the other EU states: this freedom has been extensively used by the two largest CSD groups, but not by the many individual CSDs. The same apply for the links network, although the latter cover a larger network, not only with the two largest groups, but also with other, often neighboring CSDs. The overall view is that for most of the EU CSDs, the activity is mainly confined nationally, with some extension by their links network. Integration in this segment of the financial markets is still principally focuses around the two largest CSD groups. On the free provision cross-border of CSD services, and the free issuance of

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[97] Commission, Integrate national capital markets into a genuine single market, 24 sept 2020
A new Vision for Europe's capital markets, Final Report of the High Level Forum on the Capital Markets Union June 2020, https://ec.europa.eu/info/sites/info/files/business_economy_euro/growth_and_investment/documents/200610-cmu- mentioning the consolidated tape among the issues with which the Commission is dealing with

[98] A new Vision for Europe's capital markets, June 2020
https://ec.europa.eu/info/sites/info/files/business_economy_euro/growth_and_investment/documents/200610-cmu-high-level-forum-final-report_en.pdf; See also> Commission A capital markets Union for people and business - new action plan, Commission communication, 24 sept 2020, Com (2020) 590 Final, Annex, item 16

[99] The European Parliament mentions the need for binding emergency powers and instruments addressing cyber risks; the prohibition of certain products or activities referring in EU case law.

[100] See Commission, CMU action plan Action 16

[101] See the suggestion of the European Parliament, i.a. granting ESMA direct supervisory powers cooperation of the ESAs, while respecting the role of the NCAspt.34 REPORT on further development of the Capital Markets Union (CMU): improving access to capital market finance, in particular by SMEs, and further enabling retail investor participation (2020/2036(INI))

[102] Commission CMU Action plan, Actions15 and 16" consider proposing measures for stronger supervisory coordination or direct supervision by the European Supervisory Authorities"

[103] ECSDA, Answer to EC consultation 1 febr 2021, with the list of topics where convergence could be useful.Cooperation of ESMA and EBA were considered useful

[104] The High level report recommended to tackle the key remaining obstacles to market integration: taxation, non-bank insolvency and company law (p. 22) ; caused by divergent, burdensome, lengthy provisions; but a fully fledged regulatory review was considered premature(p.77) .

[105] The register mentions 24; ECSDA, Answer to the EC consultation, mentioned 22 out of 33, the difference relating to CSDs managed by Central banks. Moreover 7 CSD of EEA EFTA states are awaiting their authorisation

[106] 7 existing CSD have not finalized their authorisation process

securities, several limitations still apply[107] leading to some segmentation. At the same time, a certain number of CSDs have a limited settlement activity, leading to an increase of costs, and sometimes in more limited expertise. If centralisation is politically not feasible, at least delegation of certain functions could reduce the burden, and the cost.[108]

The links network could be remodeled along the lines followed by T2S, creating a central platform where all transactions to be settled could be matched electronically, book for recording securities, and transmitting the payment messages to the T2S platform.

This raises the question why all EU member states needed to create a separate CSD, likely to have been a quite expensive undertaking. Protection of the assets deposited by the home investors at the CSD may have been a reason, but with today's integration of these markets is less convincing. The Commission's intention to contribute to more market integration should take this structural element into consideration.

As evidenced from the overview of the present CSD landscape, CSDs are organized on a national basis, serving fragmented national capital markets, allowing for some cross border activity although with variable intensity, leading to considerable differences in cross-border involvement[109]. The granting of an EU wide cross-border passport is a useful instrument, for subsidiaries or branches, providing for a short-form authorisation process for subsidiaries (art 17(7) while information requirements would apply for branches (article 23)[110]. The extension of the network of links to all CSDs might also simplify the cross CSD settlement transactions; indirect links or other intermediaries should be avoided. The Buy-in procedure would eliminate failed transactions and allow the other transactions to go through and motivate clearing members to carefully prepare for DVP. In a second stage, the most active custodian banks could directly take part in this network. The relationship with T2S should be considered, creating a platform for both sides of the transaction. The CSDR contains the basic elements for this scheme.

At the same time there is quite some criticism about the present situation. The complexity of the regulations, guidelines, Q & As and other statements of different nature in this field is impressive. The market participants complained about this aspect mentioning that a simplier regulatory apparatus would be more effective[111]. They mentioned that authorization process is burdensome, very lengthy and complex, which can be explained due to complexity of the process itself[112]. In some cases the registration in the ESMA register seems to imply a separate administrative decision[113]. The administrative burdens are considerable, not always proportional and time consuming, while the outcome of the process is difficult to predict. ECSDA suggested stronger cooperation and harmonisation among NCAs and the European authorities.

A certain number of preliminary steps have been mentioned in the statement of the professional associations: these are worthwhile to be analysed, and if adequate pursued. Complaints have been made about the lack of clarity of definitions in many of the concepts and wordings used in the regulations. Some of these have been dealt with in ESMA Q & As. But more harmonisation and clarity should be considered where possible, e.g. for the statistical data, or the periodical reporting documents.

Another suggestion relates to the characteristics of the securities traded, and especially their legal regime, also pointing to the differences in the underlying civil law regimes[114]. Harmonisation of these features could be considered, but more efficient techniques may be found in opening the token regime for securities: this would eliminate the national features by replacing them with a neutral, easily transferrable token[115]. A similar reflection applies to the differences in custody of securities at CSDs and at national level, when securities are held at local banks after internalisation: are investors exposed to different risks, lower legal certainty, risk of insolvency?

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[107] ECSDA Answer to the EC consultation p.15 e.s.

[108] In other fields, delegation of day-to-day supervision has been introduced while maintaining the policy matters at the national level. See e.g. in the prospectus directive

[109] Under national law, different legal rules may apply as to insolvency, liability of directors, conflicts of laws issues, competence of local tribunals, arbitration, etc.

[110] See ECSDA Answer to EC consultation,1 February 2021, p.14, calling for a simplification of the CSDR, a more integrated landscape, mentioning the burdensome processes, due to different interpretations of the applicable requirements, and a more integrated landscape Simplify CSDR _ more integrated.

[111] The Commission made reference to the "one-in , one out rule" for simplifying regulation

[112] ECSDA considered that improvement may be also achieved by more convergence among the NCAs on the requirements for authorizations, Answer to EC consultation,1 February 2021, see p. 17 on the difficulties in the administrative processes esp. for the passport

[113] And this notwithstanding article 21, CSDR

[114] ECSDA, Answer to EC consultation,1 February 2021 suggested simplifications on the frequency of certain reporting requirements, some having to be finetuned, or more clearly defined.

[115] See about this: ECB,The use of DLT in post-trade processes, April 2021, p. 22

A useful step towards better integration of the markets would be the introduction of the *consolidated tape,* which has been on the list of proposals for many years[116], as a true single market cannot exist without a more integrated view of EU trading. A consolidated tape will provide consolidation in data on prices and volumes of traded securities in the EU, thereby improving overall price transparency across trading venues and increase competition. It would also improve competition between trading venues. Together with the single entry point for company information (Action 1), it would give investors access to considerably improved information at a pan-European level.

A certain number of preliminary steps are worthwhile to be analysed, and if possible pursued. Complaints have been made about the definitions of many of the concepts and wordings used in the regulations. Harmonisation and clarity should be considered. The coordination among the different regulations and an overview of the different versions would be helpful.
Another suggestion relates to the characteristics of the securities traded, and especially their legal regime also pointing to the differences in the underlying civil law regimes Some statements referred to the lack of clarity in the concepts and definitions used in this context. Details can be found in ESMA Q &.A.

The complexity of the regulations and guidelines and statement of different nature in this field is impressive. The market participants complained about this aspect mentioning that a simpler regulatory apparatus would be more effective[117]. The authorization process is burdensonme, very lengthy and complex, but can be explained due to complexity of the process itself. The administrative burdens are considerable, not always proportional and time consuming, while the outcome of the process is difficult to predict. ECSDA suggested stronger cooperation and harmonisation among NCAs and the European authorities.

The work in the CSD field is far from over. The European Parliament urged the Commission and the Member States to commit significant efforts to streamline and harmonise existing and future rules, phasing out national exemptions and preventing gold-plating … for a smooth and steady path to regulatory convergence "[118]

[116] 5 12 2019; Previously, the Commission considered that this issue to be solved by the private sector. Although a considerable amount of data is available, these are mostly very general and do not meet the degree of relevance of the consolidated tape.
[117] E.g. that the penalty calculation is too complicated and too costly. Also the entry into force of the regulatory provisions is confusing
[118] European Parliament, REPORT on further development of the Capital Markets Union (CMU): improving access to capital market finance, in particular by SMEs, and further enabling retail investor participation (2020/2036(INI))

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