

ESMA Discussion Paper:

Draft Technical Standards for the regulation on improving securities settlement in the European Union and on central securities depositories (CSD).

Response prepared by the IRSG Post Trade workstream

The International Regulatory Strategy Group (IRSG) is a practitioner-led body comprising leading UK-based representatives from the financial and professional services industry. It is an advisory body both to the City of London Corporation and to TheCityUK.

The Post Trade Workstream includes representatives from financial services firms, investors and financial market infrastructures, including exchanges, clearing houses and CSDs.

The objective of the Post Trade Workstream is to provide a cross-sectoral review of post-trade services. These comments reflect a consensus of views within the Workstream. The views of individual members may differ from the consensus in some areas.

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The IRSG Post Trade workstream welcomes the opportunity to comment on the ESMA Discussion Paper: Draft Technical Standards for the Regulation on improving securities settlement in the European Union and on central securities depositories (CSD).

Overview

We support the objectives of standardising rules for CSDs and raising standards across the EU. However, we believe the response should be proportionate to the low level of the problem in order not to introduce distortions into the market. Also we identify areas where the proposals do not adequately address complexities in the market.

Proportionality

It is vital to ensure a proportionate response to the issue of settlement fails. Based on figures from ECSDA the settlement efficiency in March 2012 was 98.9% in value terms and 97.4% in volume terms. Given this very low level of settlement fails, indicating that they pose no significant nor systemic risk to European securities markets, we believe that the Technical Standards for Articles 6 & 7 should be framed so as to be proportionate to the degree of risk.

An over-strict settlement discipline regime could have perverse consequences, if it

- encouraged greater use of internalised settlement;
- incentivised market participants to trade and seek to provide liquidity in an uncleared environment away from electronic order books, contrary to the stated objectives of policy makers;
- caused these OTC transactions to be booked for longer settlement periods (as the mandatory T+2 settlement period applies only to transactions executed on trading venues); or
- led to the creation of more volatility in the prices of less liquid securities as market makers moved prices sharply upwards to limit their exposure to fines.

None of these outcomes would be beneficial for systemic risk overall.

Definition of key terms

We believe that the following will require precise definitions:

- A settlement transaction and how it relates to the underlying trade
- A buy-in – which should only be possible where there is a trade behind the settlement and where a settlement fail leads to an economic loss which justifies penalties and buy-ins
- Liquid and illiquid securities and SME growth markets – the logic that the reduced liquidity of SME Growth Market securities (as defined by MiFID2) justifies the extended timetable also applies to less liquid securities on regulated markets. This needs to be taken into account in the calibration of the buy-in process, such that this does not discriminate against successful existing SME markets that operate as part of a regulated market (as reflected in MiFID2).
- It is vital to ensure a consistent and uniform application of settlement and buy-in procedures across different trading venues. There must also be consistency with other related legislative measures eg MiFID/MiFIR 2.

There are four scenarios which occur today:

1. Trading on a trading venue with no clearing prior to settlement
2. Trading on a trading venue with clearing prior to settlement
3. Trading OTC but with clearing prior to settlement
4. Trading OTC with no clearing prior to settlement

Point 4 is the most problematic in terms of imposing a settlement discipline regime, as settlement without a trading venue or clearing house is dependent on the counterparties to the buyer and seller meeting the provisions of the CSDR settlement discipline regime. This gives rise to two difficulties:

- The CSD will see only the respective custodians (who are its participants) and not the actual counterparties to a trade. In this situation the buy-in liability will therefore fall on the custodians, who hold the assets but who have no legal power to buy-in the client.
- In the absence of a trading venue or CCP, responsibility for executing the buy-in will fall on the CSD. However, we believe it is inappropriate for CSDs to put their limited financial resources at risk by acting as intermediaries in the buy-in process.

The application of the regime to this fourth scenario therefore needs further consideration.

Avoid mandating detailed technical standards

We do not believe that it is appropriate to mandate detailed technical standards in regulations which relate to highly operational processes, as it prevents the flexibility which is often required for matters which are highly operational in nature. Market requirements can change and it should be possible for

technical standards to evolve flexibly in line with requirements, without the need for revising regulations.

Standards should be acceptable across the whole of the EU

There are several places in the Discussion Paper where it is proposed to adopt standards that have been agreed in the context of preparations for T2S eg use of ISO 20022 message format, harmonisation of mandatory matching fields. These standards do indeed have wide support. However, it should be noted that CSDs in only 20 member state markets have committed to participating in T2S. Acceptance of the T2S standards on this occasion should not create a presumption that standards agreed for T2S will automatically be accepted as applicable across the EU in future.

Involvement in the buy-in process

We believe that buy-ins should occur at the level of trading counterparties and not at the level of settlement intermediaries. To avoid the risk profile of a CSD being adversely affected by financial risk of undertaking the buy-in process, CSDs should help identify the failing counterparties but not intermediate the buy-in as buyer/seller, using their balance sheet. They could however choose to outsource this to a trading venue.

Timing – the impact of TARGET 2 Securities (T2S)

Significant changes will be required in the systems of both CSDs and market participants to accommodate a harmonised settlement discipline regime. In addition the parallel implementation of T2S and the move to T+2 settlement cycle will also need to be taken into account given the impact across all sectors of the market. IT work would typically begin only once the full specification of changes is known and would require a minimum of 12 months to implement. We therefore believe that the only realistic timeline for CSDs to implement fully the settlement discipline standards is after the final T2S migration wave is completed (ie by 2017). We would therefore urge ESMA to consider the merits of allowing a transition phase to enable market participants and infrastructures to make the necessary changes whilst avoiding unnecessarily complex and costly implementation of some functionalities that will be provided by T2S. In addition, by applying the buy-in regime after the full implementation of T2S, there will be more certainty around the fact that only intentional fails are penalised, not also those occurring due to problems with settlement infrastructure.

Q3: ESMA welcomes concrete proposals on how the relevant communication procedures and standards could be further defined to ensure STP.

As noted above, we do not believe that it is appropriate to mandate detailed technical standards in regulations which relate to highly operational processes, as it prevents the flexibility which is often required for matters which are highly operational in nature. Market requirements can change and it should be possible for technical standards to evolve flexibly in line with requirements, without the need for revising regulations.

We believe that ESMA regulatory and technical standards should take due account of CPSS-IOSCO Principles for financial market infrastructures. However the use of specific communication standards (eg ISO 20022) should not be mandated in Level 2 legislation as this would legally impede the evolution of such standards, as it would require amendment to legally binding technical standards should message standards need to evolve in order to support financial market developments. It is also the case that ISO standards do not cover all functionalities and services offered by CSDs; to limit CSD communication standards to ISO standards would result in the discontinuation of some services that are helpful to market participants and support an efficient settlement process.

On the other hand we strongly believe that the rules should set objectives and permit CSDs choice of means to achieve objectives. These Standards should provide a set of tools to prevent settlement fails, which a CSD could choose to use in consultation with its market and its Competent Authority. This would enable the CSD to retain flexibility to choose the most appropriate tools based on the needs of the particular markets in which it operates.

Furthermore, in relation to the ongoing work to finalise T2S, we believe that it should not be assumed that standards agreed in the context of T2S will automatically be accepted as applicable across the EU as a whole.

As the Technical Standards for other infrastructures (trading venues and CCPs) do not go to this level of detail, we see no reason to adopt a prescriptive approach on communication standards just for CSDs, when no market failure has been identified.

Q4: Do you share ESMA's view that matching should be compulsory and fields standardised as proposed? If not, please justify your answer and indicate any envisaged exception to this rule. Are there any additional fields that you would suggest ESMA to consider? How should clients' codes be considered?

In line with current industry practice and the fact that T2S will introduce a matching regime, we believe that pre-settlement matching should be made compulsory. The T2S matching standards should form the basis of this regime.

Furthermore as noted above in relation to the ongoing work to finalise T2S, we believe that it should not be assumed that standards agreed in the context of T2S will automatically be accepted as applicable across the EU as a whole.

Q51: Do you agree that the risk analysis performed by the receiving party in order to justify a refusal should include at least legal, financial and operational risks? Do you see any other areas of risk that should be considered? If so, please give examples?

We strongly support the aim of allowing open access to CSDs (and vice versa) in order to achieve the aims of EU policy makers to establish efficient, competitive, low cost, pan-European post-trade services (see also MiFIR regarding access to CCPs and trading venues). For appropriate asset classes, such as equities, we would also support the ongoing move towards greater interoperability. Any refusal to allow access by a CSD must be based on clear and objective criteria and technical standards should ensure that they do not inadvertently give CSDs an excuse to deny third parties access to their systems.

In addition, we believe that in paragraph 223, the references to “requesting CSD” should read “requesting CSD or other market infrastructure”, as the entity that is refused access by a CSD may be a CCP and not necessarily a CSD.