

Advice to ESMA

SMSG advice to ESMA on consultation papers on CSDR and the draft RTS on the substantial importance of a CSD

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1 Executive Summary

In this Advice, the SMSG provides its views on specific questions raised by ESMA in the consultation papers on CSDR as well as comments on more general issues that are related to the topics discussed in the consultation papers on CSDR and the draft Regulatory Technical Standards on the substantial importance of a CSD.

In order to incentivise the settlement of transactions by their intended settlement date, CSDR introduced settlement discipline measures in the form of (i) cash penalties for market participants that cause settlement fails and (ii) a mandatory buy-in regime to force the settlement of transactions still failing after a determined extension period. CSDR Refit significantly detailed the specifications related to the disciplinary measures, while explicitly differentiating the buy-in regime from the penalty regime. The SMSG believes that the differentiation of the penalty and of the buy-in regime was of the utmost importance to optimize

the effect of the settlement discipline measures while avoiding unintended consequences on the functioning of markets.

The SMSG invites ESMA to adopt a carefully defined approach to exemptions from the buy-in process in order to cover all types of transactions for which buy-ins would not be helpful. The SMSG proposes starting with a clear, fixed list of exempt transactions which is reviewed on a regular basis to ensure that it remains relevant and can evolve to include new types of transactions if and when necessary.

The SMSG notes and fully supports the requirement for indications of “costs and benefits” relating to the implementation of the contemplated exemptions. Opting for solutions with a suboptimal cost / benefit ratio would translate into unnecessary increase in the operating costs of the intermediaries involved in settlement operations, ultimately impacting investors in European assets and affecting the attractiveness of EU financial markets.

The SMSG also provides its advice on the draft technical standards on the criteria under which the activities of a CSD could be considered of substantial importance. The SMSG shares the principles stated by ESMA regarding the indicators to assess the substantial importance of CSDs. The SMSG also shares ESMA proposal that each indicator to assess the substantial importance of CSDs is to be looked at separately and the determination of the thresholds is of utmost importance. The SMSG supports ESMA proposal to set the thresholds at 15% as, among other things, this proposal ensures continuity and reflects the smooth functioning of the framework observed so far.

2 Initial comment

1. While fully appreciating the deadlines by which ESMA is required to submit the draft Regulatory Technical Standards (RTSs) and to resolve the issues being consulted on in the present packages, the SMSG regrets the relatively short timeframe available for the production of its advice. While we have strived to provide a substantive and constructive contribution to the key issues raised in these consultations, the recent reconstitution of the SMSG and the overlap between the consultation period and the summer recess have made the delivery of this advice particularly challenging.
2. We would therefore welcome the opportunity to maintain an ongoing dialogue with ESMA as work on these progresses and invite ESMA to consider how the overlapping summer period may have impacted the level and quality of stakeholder responses to the present consultations. We would also encourage ESMA to avoid such situations to the extent possible in the future.

3 Introduction

3. Modifications brought by CSDR Refit¹ to CSDR² include a certain number of new or renewed mandates for ESMA.
4. Article 7(9) of CSDR, as amended by CSDR Refit, asks ESMA to provide technical advice to assist the European Commission in preparing a delegated act to supplement the Article 7(3) providing exceptions to the penalty mechanism by specifying i) the underlying causes of settlement fails that are considered as not attributable to the participants in the transaction, and ii) the circumstances in which operations are not considered as trading.
5. Article 22(10) and article 22(11) of CSDR as amended by CSDR Refit respectively mandate ESMA to develop draft regulatory technical standards (RTS) specifying the information required from CSDs in the frame of their periodic review and evaluation by national competent authorities and draft implement standards (ITS) setting standard forms, templates and procedures for the provision of such information.
6. Articles 25(13) and 69(4a) of CSDR as amended by CSDR Refit contain mandates for ESMA to develop draft RTS in relation to the information that third-country CSDs will be required to notify to ESMA when providing notary services, central maintenance and/or settlement services in relation to financial instruments constituted under the law of an EU Member State.
7. On 9 July 2024, EMSA launched a public consultation, inviting comments on the draft technical standards and proposals related to the aforementioned mandates and requested MSG's advice.
8. In parallel, according to the new mandate set out in Article 24a(13) of CSDR, as amended by CSDR Refit, ESMA prepared draft RTS specifying the criteria under which the activities of a CSD in the host Member State could be considered to be of substantial importance for the functioning of the securities markets and the protection of investors (the Final Report³). On 30 July 2024, ESMA requested the MSG to provide advice on such draft technical standards.

¹ Regulation (EU) No 2023/2845 of the European Parliament and of the Council of 13 December 2023 amending Regulation (EU) No 909/2014 as regards settlement discipline, cross-border provision of services, supervisory cooperation, provision of banking-type ancillary services and requirements for third-country central securities depositories and amending Regulation (EU) No 236/2012.

² Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012.

³ ESMA, Final Report - Draft RTS on the Substantial Importance of a CSD, 31 July 2024 (ESMA74-2119945925-1951).

4 SMSG advice on the proposals on the exceptions to the penalty regime

9. In order to incentivise the settlement of transactions in financial instruments by their intended settlement date, CSDR introduced settlement discipline measures in its article 7, in the form of (i) cash penalties for market participants that cause settlement fails and (ii) a mandatory buy-in regime to force the settlement of transactions still failing after a determined extension period.
10. CSDR Refit significantly detailed the specifications related to the disciplinary measures, while explicitly differentiating the buy-in regime from the penalty regime through a dedicated article 7a.

4.1 The importance of differentiating the scope of exceptions from the penalty and from the buy-in regimes

11. The SMSG believes that the differentiation of the penalty and of the buy-in regime was of the utmost importance to optimize the effect of the settlement discipline measures while avoiding unintended consequences on the functioning of markets. This differentiation should be completed through the specification of the scopes of exemptions.
12. The SMSG suggests that also under article 7.3. (b) CSDR the ESMA's proposal to exclude free-of-payment (FoP) securities transfers to securities accounts at CSD 's in the context of the (de)mobilisation of collateral (cf. ESMA consultation number 19 (a)) should be further clarified. It is not clear which market operations should be considered as FoP transactions in the case of (de)mobilisation of collateral. If FoP collateral transfer transactions are excluded, there could be a fundamental risk that, for example, in cases of late recalling of a securities lending transaction due to a sale, the cash claiming process vis-à-vis the lending counterparty could no longer be carried out. Both lending instructions and transactions for bilateral collateralization are mainly transmitted as FoP transactions via SWIFT. Exempting FoP security collateral transfers may sometimes break the immunisation principle. Therefore, the SMSG encourages ESMA to further clarify what is meant by a free-of-payment security transfer to securities accounts at CSD's in the contact of the (de)mobilisation of collateral.
13. Under the article 7.3. as amended by CSDR Refit, the penalty regime does not apply to (a) settlement fails the underlying cause of which is not attributable to the participants in the transaction, (b) operations that are not considered as trading, (c) transactions where the failing participant is a CCP, except for transactions entered into by a CCP where it does not interpose itself between the counterparties; or (d) transactions where insolvency proceedings are opened against the failing participant.

14. Article 7a.7. introduced by CSDR Refit defines the exemption scope for the buy-in regime as (a) transactions exempted from the penalty regime under article 7.3.; (b) securities financing transactions; (c) other types of transactions that render the buy-in process unnecessary; and (d) transactions relating to the buy-in procedures that central counterparty in a Member State that provides clearing services for shares are required to have in place under Article 15 of Regulation (EU) No 236/2012.
15. The mandate given to ESMA by Article 7a.15. (d) introduced by the Refit CSDR to clarify the scope of "other types of transactions that render the redemption process unnecessary" explicitly mentions "financial guarantee agreements or transactions that include netting and termination provisions".
16. When considering this mandate, the SMSG invites ESMA to adopt a carefully defined approach to exemptions from the buy-in process in order to cover all types of transactions for which buy-ins would not be helpful. For example, in the case of a portfolio transfer between custodians on behalf of the same asset owner, while the opportunity of applying penalties on fails may be discussed, the SMSG is of the opinion that buy-ins would be unnecessary. The SMSG proposes starting with a clear, fixed list of exempt transactions which is reviewed on a regular basis to ensure that it remains relevant and can evolve to include new types of transactions if and when necessary. Against this background, the SMSG considers that a dedicated impact assessment could be conducted to evaluate the potential effects of these exemptions on market quality indicators (e.g., liquidity, spreads, and costs), including for retail investors.

4.2 The need to consider costs and difficulties of implementation upstream

17. The SMSG notes and fully supports the reiterated requirement by ESMA, across the consultation paper, for indications of "costs and benefits" relating to the implementation of the contemplated exemptions. Opting for solutions with a suboptimal cost / benefit ratio would translate into unnecessary increase in the operating costs of the intermediaries involved in settlement operations, ultimately impacting investors in European assets and affecting the attractiveness of EU financial markets.
18. Limiting the implementation costs of the penalty regime and of its exemptions is all the more important as the intermediaries involved in settlement activities are set to be deeply impacted, and their project resources to be strained, by the projects required for the envisaged shortening of the settlement cycle in the EU ("T+1 transition").
19. With this in mind, the SMSG calls ESMA to carefully weigh the costs linked to alternative solutions, specifically in the choice between ex-ante application of the exemptions and ex-post correction, and between automated processes and appeal procedures. A dedicated

impact assessment study, based on aggregated expected volumes, may be worthwhile in this domain. The SMSG also believes that a transparent and predictable process is expected to foster market integrity. In this respect, if exemptions are handled more predictably (ex-ante), this might increase confidence among investors.

20. By the same token, ESMA should take into account from inception the way to provide market participants with those instruments features that may trigger the application of exemptions to the penalty regime. This would notably be the case for (i) securities under sanctions or anti-money laundering proceedings or (ii) securities suspended from trading or from settlement, where ESMA needs to consider the practical implications related to the implementation of the regulation.
21. For example, to minimize the compliance costs referred to in Q2 of the Consultation Paper, it would be useful to specify which sanctions are referred to and the exact meaning of anti-money laundering proceedings. The SMSG recommends envisaging FIRDS as a golden source for that purpose, to avoid differences in interpretation from market participants about the scope of concerned instruments.

4.3 The need to anticipate on the possible impact of a transition to T+1 on the quality of settlement in the EU

22. The SMSG notes that, because of the complexity of EU post-trading landscape (primarily linked to the fragmentation of infrastructures, the multiplicity of currencies involved, the use of batches rather than continuous processes in the settlement operations, etc.), the move to T+1 in the EU could result in a temporary increase in settlement fails.
23. This effect could be particularly pronounced for certain classes of instruments that present specific features, notably bonds and ETFs.
24. The bond market relies on the intervention of market makers, who take risks to offer the immediacy required by investors for the execution of their orders. Market makers do not always trade on the ground of their inventory. When a transaction leads to a net short position, the market maker has to borrow the bond in order to settle the transaction. Despite the 2014 move to T+2 for cash transactions, the EU overnight borrowing market remains underdeveloped. Market practice and availability of overnight borrowing could take some time to adjust, leading to more frequent fails in that period. A temporary suspension in cash penalties might be considered to avoid a negative impact on the willingness of market makers to provide liquidity. However, such measures should be carefully scrutinized and closely monitored to make sure they do not undermine market efficiency and integrity.
25. From an EU ETF standpoint, the situation is even more complex. On the one hand, SMSG members note that the current global misalignment may generate fails given that for US

underlying instruments (primary) trades settle T+1 while fund unit (secondary) trades in the EU settle T+2 or later. In addition, the current misalignment appears to impact the ETF market itself, with wider spreads, ETFs trading at premiums to their fair value, volumes being determined by the day of the week, different prices for T+1 vs T+2 settling in the same ETF, and potential underperformance in UCITS (not just ETFs) due to the funding gap caused by misaligned settlement. An exacerbation of these trends can be anticipated as more and more countries migrate to T+1. From this standpoint, when ETF primary and secondary settlement cycles do align on T+1 across the board following a European migration, settlement quality could be expected to improve.

26. At the same time, and similarly to bonds, the ETFs market largely relies on the intervention of market makers, with the specificity that some market makers (“Authorised Participants”) can ask for the creation or redemption of ETF shares to the issuer, when they are short or long on such shares. The creation/redemption process is made all the more burdensome as (i) the process may depend on the ability to transact on securities located in different time zones and as (ii) many ETFs are issued with different CSDs, so APs have to manage their positions across multiple CSDs using transfers between CSDs. This already explains the lower timely settlement rate observed for European ETFs relative to other assets. Without additional measures to improve settlement efficiency, moving to T+1 could make the process more difficult to operate. The SMSG calls on ESMA to ensure that these operational challenges do not harm investors and market integrity.
27. The SMSG encourages ESMA to contribute to the acknowledgement of these specific issues through its participation to the work surrounding the envisaged transition to T+1 and its planned consultation on other measures to improve settlement efficiency. Potential attenuation measures (e.g. the ability to temporarily suspend the penalty mechanism, at least for the most exposed classes of and to avoid making significant changes to current penalty rates or methodology) will need to be assessed well ahead of the transition to T+1.
28. The SMSG also emphasizes that individual investors – who often use ETFs as an accessible and lower-cost investment vehicle – should be shielded from any negative impacts arising during the transition (e.g., increased costs, widened spreads, or liquidity shortages).

5 SMSG advice on the draft RTS on the substantial importance of a CSD

5.1 Background

29. One of the objectives of CSDR is to create an internal market for CSD services. To achieve this objective, Article 23 of CSDR allows CSDs to provide their services in any Member State of the Union (passport rights).
30. In this respect, Article 24 of CSDR provides for various measures to cooperate and exchange information between home and host Member States' competent authorities (NCAs) where a CSD provides its services cross-border. The former version of paragraph 4 of Article 24 of CSDR specified that home and host competent authorities should establish formal cooperation arrangements for the supervision of a CSD where the activities of such CSD have become "of substantial importance for the functioning of the securities markets and the protection of the investors" in the host Member State. According to the same paragraph, where a CSD has become of substantial importance for the functioning of the securities markets and the protection of the investors in more than one host Member State, the home Member State may decide that such cooperation arrangements include colleges of supervisors.
31. However, the option to set up colleges of supervisors has only been used in one case. For this reason and in order to ensure the effective and efficient coordination of the supervision by competent authorities, the CSDR Refit deleted paragraph 4 of Article 24 and introduced the new Article 24a that requires the establishment of colleges of supervisors in relation to CSDs whose activities are considered of substantial importance (i.e., mandatory colleges), with the aim of ensuring an effective and efficient coordination of the supervision by competent authorities.
32. Against this background, ESMA is expected to develop draft regulatory technical standards specifying the criteria under which the activities of a CSD in the host Member State could be considered of substantial importance for the functioning of the securities markets and the protection of investors.

5.2 SMSG opinions and comments

33. With respect to the proposal regarding the indicators to assess the substantial importance of CSDs (Section 3.2 of the Final Report), the SMSG shares the principles stated by ESMA that the number of indicators, the respective thresholds and the frequency for assessments should be defined in a way to: (i) capture CSDs of substantial importance with respect to core services offered to host Member States, (ii) allow for a practical and straightforward

indicator based framework to be regularly assessed by competent authorities, (iii) avoid the creation of colleges of supervisors where there is no excessive risk, while ultimately ensuring an efficient and effective supervision of CSDs.

34. The SMSG also shares ESMA proposal that each indicator to assess the substantial importance of CSDs is to be looked at separately and the determination of the thresholds is of utmost importance.
35. As regards the thresholds to consider the operations of a CSD of 'substantial importance', ESMA proposal is to set the thresholds at the level of 15%, which is the same thresholds set under the previous regime.
36. ESMA considered the possibility to lower down the percentages to 10% and conducted an analysis based on data submitted by CSDs in 2023 and in 2024, looking at the possible outcomes of applying either 15% or 10% thresholds. In this regard, as expected, it was noted that the outcomes in terms of the composition and number of supervisory colleges would increase when lowering down the thresholds⁴.
37. The SMSG supports ESMA proposal to set the thresholds at 15% as, among other things, this proposal ensures continuity and reflects the smooth functioning of the framework observed so far.
38. The SMSG appreciates the in-depth scenario analysis presented in Annex V regarding the level of the thresholds for the indicators. The scenario analysis shows that lowering the thresholds to 10% would not remarkably alter the outcome.
39. The SMSG also supports ESMA proposal to assess the substantial importance of a CSD in a host Member State on an annual basis, as this frequency trades off the need to reflect the changes in a market in a timely manner against the costs related to the implementation of a more frequent assessment.
40. Lastly, the SMSG highlights that it would be valuable to state the rationale behind the calibration of the thresholds at the 15% level to define as 'substantial' the importance of a CSD for (i) the functioning of the securities markets and (ii) the protection of the investors. Sharing the reasoning that brought to the 15% level is useful to check whether the underlying assumptions are valid over time or need to be reconsidered on the occasion of the periodic assessment of the substantial importance of a CSD.

⁴ Based on 2024 data (covering the year 2023), the results are the following: (i) maintaining the thresholds at 15%, the number of CSDs whose activities are considered of 'substantial importance' in at least two host Member States is equal to 7 and (ii) reducing the thresholds to 10%, both the number of CSDs whose activities are considered of substantial importance and the scope of authorities invited to the colleges would increase. In particular, the number of CSD would increase to 8 and additional authorities would be invited to take part to colleges.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

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[signed]

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[signed]

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