Irish Stock Exchange

Irish Stock Exchange Response to ESMA's Discussion Paper on Draft Technical Standards for the CSDR

The Irish Stock Exchange (ISE) welcomes the opportunity to comment on ESMA's discussion paper on Technical Standards for the CSDR. As a market operator of a regulated market and MTFs, our response is mainly focused on the matters which impact on the ISE and our member firms.

We support the CSDR's objectives of improving settlement performance across European markets but we are concerned about certain aspects of the proposed settlement discipline regime: in particular, the proposed timeframe to implement Articles 6 and 7 of the CSDR. Detailed requirements may not become clear until the approval of the CSDR's Delegated Acts and Technical Standards, which is expected to be in 2015. Our understanding is that legally, Articles 6 and 7 will be in force on the approval of the Delegated Acts and Technical Standards, but this is impracticable as it does not allow for necessary systems development by market infrastructures.

In relation to trading venues, we have serious concerns over the practical aspects of applying a mandatory buy-in regime for non-cleared transactions in transferable securities. Trading venues may need to develop technical links to CSDs (as the only source of the necessary information for non-cleared transactions) and to implement new processes and procedures, which will require an implementation period after the approval of the Delegated Acts and Technical Standards. It is difficult to assess how much time would be required until further detail is available and an assessment of the necessary development work can be completed, but we believe that a lead-in time of six months would be reasonable.

This approach is necessary to reduce implementation risk and the risk of market disruption.

III.I Settlement Discipline

Measures to prevent settlement fails (Article 6(4))

No manual intervention

Q2: In your opinion, are there any exceptions that should be allowed to the rule that no manual intervention occurs in the processing of settlement instructions? If so please highlight them together with an indication of the cost involved if these exceptions are not considered? Do you consider that this requirement should apply differently to investment firms? If so, please explain.

We agree with automation being the preferred option for trading, clearing and settlement processing and this should be encouraged. Exceptional circumstances requiring manual intervention may include the receipt of a court order by a CSD to freeze settlement for a particular participant or issuance. This may also include where a participant goes into default. While we agree with the promotion of STP, we question whether the Level 2 Standards should set out specific cases where manual intervention is permitted.

Communication procedures and standards - STP

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

We agree with the promotion of STP through the securities chain and the use of agreed market standards, where possible.

Matching of settlement instructions

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?

Yes, we agree that matching should be compulsory at CSD level, where appropriate. We do not have a comment on whether matching fields should be prescribed.

Matching at CSD level will not be appropriate in certain circumstances, including for: (i) trades which have been matched prior to entering the CSD (ii) FoP transfers among accounts managed by the same CSD participant (iii) exceptional transactions such as those under court orders. CSDs may be in a position to provide other examples of circumstances where matching in CSDs is not appropriate.

We believe that clients' codes should remain non-mandatory in line with the approach for T2S.

We agree with acceptable tolerance levels being set by the CSD.

Incentives for early input of settlement instructions

Q5: Do you agree with the above proposals? What kind of disincentives (other than monetary incentives such as discounts on matching fees) might be envisaged and under which product scope?

We agree with the objective of encouraging early matching to reduce settlement fails but we do not agree with imposing additional matching disincentives as we consider the settlement discipline regime to be sufficiently robust to discourage fails. We support the proposals to require CSDs to provide participants with access to pending settlement instructions of their counterparties.

Lending facilities

Q8: Do you agree with this view? If not please elaborate on how such arrangements could be designed and include the relevant data to estimate the costs and benefits associated with such arrangements. Comments are also welcome on whether ESMA should provide for a framework on lending facilities where offered by CSDs.

We agree that stocklending is a useful facility and the inability to borrow less liquid securities may be a concern for market participants who may not be in a position to deliver securities, hence triggering buy-ins and settlement fines, due to circumstances outside of their control.

Details of the system monitoring settlement fails (Article 7(14)(a)

Q10: What are your views on the information that participants should receive to monitor fails?

We agree that participants should receive sufficient and timely data on their settlement fails, both as a deliverer and receiver of securities, to allow them to manage their settlement performance.

Details of operation of the appropriate buy-in mechanism: extension period (Article 7(14)(d))

Q13: CSDR provides that the extension period shall be based on asset type and liquidity. How would you propose those to be considered? Notably, what asset types should be taken into consideration?

The ISE is in strong agreement with ESMA's view that "the adverse effects of a buy-in regime could be a decrease in liquidity in certain instruments and an increase in the number of settlement fails where it can prove difficult to obtain the securities for buying-in" and therefore it is critical that the buy-in mechanism take into account the asset type (equity, fixed income, funds) and liquidity of securities, as less liquid securities may not be available to be bought in.

Given the specialised nature of the Sovereign Debt market, it is critical that there is engagement with individual national Debt Management Agencies, and/or the EFC Sub-Committee on EU Sovereign Debt Markets, in order to fully understand the implications for this market of the proposed buy-in regime.

In relation to equity:

- the ISE believes that the criteria for assessing liquidity under MiFIR is the appropriate criteria to apply as it is a transparent method which has been implemented for a number of years under MiFID I. As an interim measure, until finalisation of MiFIR, the ISE believes it is appropriate to use the current definition of a liquid share under MiFID. The ISE would also suggest that illiquid shares are then sub-categorised based on whether or not the securities are traded on a daily basis.

- it is important to have different buy-in processes for liquid and illiquid shares.
- shares which are not liquid as per the criteria for assessing liquidity under MiFIR but are, on average, traded on the order book on a daily basis, should be entitled to avail of a longer extension period than the current four days. The ISE believes that the maximum extension period of seven days would be the most appropriate for these securities, and that this should be decided on by the trading venue, CSD or CCP operating the buy-in process for those securities.
- the ISE is concerned that mandating buy-ins for illiquid shares not traded on the order book on a daily basis negatively impacts the liquidity of these securities. This view is supported by market feedback in recent years where (under difficult market conditions) there is increasing cautiousness amongst market makers to provide liquidity in illiquid securities. The difficulty in identifying alternative sources of stock in illiquid shares has been highlighted by our member firms in the context of the Short Selling Regulation ('SSR') and now, CSDR. Specifically, we have identified that the buy-in requirement on ISD+4 under SSR seems to have a disproportionate higher effect on highly illiquid shares, with half of the buy-ins which have occurred on the ISE in 2014 being in shares which do not, on average, have a daily order book transaction. Therefore for shares not traded on a daily basis, the ISE believes that these should be classified as securities for which a buy-in is not possible given the difficulty of sourcing such stock, and that cash compensation is more appropriate for these securities (as even the extension to ISD+7 is likely to be insufficient).
- Furthermore, consideration should be given to the potential for liquidity of a particular instrument to vary significantly across venues. Therefore even a 'MiFID liquid share' may need to be treated as illiquid by a particular trading venue, CCP or CSD.

In terms of ETFs, it is important that the extension period of the ETF exceeds, or at least matches, that of the longest extension period of any underlying security of that ETF.

In relation to the other asset types, the ISE also believes the liquidity of a security as measured by the frequency of transactions should be taken into account when determining the feasibility of a buy-in process and, if appropriate, the extension period. For asset types which exhibit greater liquidity as maturity approaches, the time to maturity should be a factor in deciding the appropriate extension period.

For non-equity:

- The ISE is in broad agreement with ESMA's assessment of the application of the extension period to bonds and government bonds.
- In relation to the extension period for government bonds, we agree that it would be beneficial to allow for the buy-in interval to "be in line with current market practices".
- Additionally the ISE agrees that the size and value of typical bond transactions should be taken into account when considering the extension period of bonds. The ISE feels it would be prudent to use the size and value of typical bond transactions on that particular market rather than market-wide determinations of typical sizes and values of

> transactions in bonds when deciding on the length of the extension period. Market-wide determinations could be skewed by outliers and, thus, may not accurately reflect the type of transactions on a particular market.

We note that there appears to be an error on paragraph 48 of the discussion paper, as the wording “be subject to a buy-in” in paragraph 48 should be “a buy-in process shall be initiated” as per Article 7(3).

> **“**where a failing participant does not deliver the financial instruments referred to in Article 5(1) to the receiving participant within four business days after the intended settlement date (‘extension period’) **a buy-in process shall be initiated** whereby those instruments shall be available for settlement and delivered to the receiving participant within an appropriate time frame.”

In relation to the exemption for repos, one consideration is that they will need to be identifiable by the CSD.

Details of operation of the appropriate buy-in mechanism (Article 7(14)(c))

Q14: Do you see the need to specify other minimum requirements for the buy-in mechanism? With regard to the length of the buy-in mechanism, do you have specific suggestions as to the different timelines and in particular would you find a buy-in execution period of 4 business days acceptable for liquid products?

The requirements set out appear to be reasonable and we do not consider it necessary to specify any further detailed requirements. We agree with ESMA’s view that it should be left to the responsible party to decide on the feasibility of each buy-in. Any approval by Competent Authorities should be in relation to the general approach of the responsible party, rather than on a case-by-case basis for each buy-in. We consider a buy-in execution period of ISD+4 to be acceptable for liquid securities.

Q15: Under what circumstances can a buy-in be considered not possible? Would you consider beneficial if the technical standard envisaged a coordination of multiple buy-ins on the same financial instruments? How should this take place?

As discussed in our response to Q13, the ISE believes that buy-ins in securities which do not, on average, have a daily order book transaction should be considered ‘not possible’. It is our belief that the buy-in process has a negative impact on the liquidity of rarely traded securities and that obtaining the stock of these securities is sufficiently difficult to render it unfeasible.

Half of the buy-ins initiated on the ISE in 2014 have been in securities with less than one order book transaction per trading day. This demonstrates that obtaining stock of these securities is disproportionally difficult and, thus, providing for cash compensation is necessary to prevent dis-incentivising investing or liquidity provision in these securities.

The ISE also believes that buy-ins should be considered 'not possible' in securities which are rights options. Furthermore in the case of securities which have undergone a corporate action which has materially affected either the price of the security or, by virtue of a merger, divesture, liquidation or otherwise, the nature of the company in the period between the transaction being executed and the buy-in process potentially being due, the buy-in process should be considered 'not possible'.

The ISE does not believe that it will be beneficial to coordinate multiple buy-ins on the same financial instruments given the practical difficulties of co-ordinating multiple buy-ins amongst multiple participants, in particularly due to time constraints, and furthermore that it could only potentially be achieved between interoperable CSDs. In addition, as the CSDR envisages buy-ins being operated by CCPs, CSDs and trading venues (potentially in the same securities), co-ordination amongst CSDs only may have limited benefits for the market as a whole.

The ISE recommends further discussion between ESMA and market infrastructures to discuss the operation and coordination of buy-ins.

Details of operation of the appropriate buy-in mechanism: operation types and timeframes under which buy-in is deemed ineffective (Article 7(14)(e))

Q16: In which circumstances would you deem a buy-in to be ineffective? How do you think different types of operations and timeframes should be treated?

The ISE believes that a buy-in is ineffective for rights options which are usually only admitted to trading on a venue for a very short period of time. Please also see our response to question 15.

Calculation of the cash compensation (Article 7(14)(f))

Q17: Do you agree on the proposed approach? How would you identify the reference price?

The ISE welcomes ESMA's approach of having more than one pricing structure which allows for the cash compensation to be linked to the type of transaction.

When determining whether cash compensation is due for transactions executed on trading venues and the amount of the cash compensation the ISE believes that only prices from that particular trading venue should be taken into account, as proposed by ESMA.

The ISE agrees that an average market price for securities across trading venues and/or brokers is more appropriate in calculating the reference price for OTC transactions.

However the ISE is concerned that the cash compensation shall only be due "when the prices of the financial instruments agreed at the time of the trade are lower than the last publicly available prices for such instruments" and does not consider when the prices are higher, as cash compensation is an essential alternative when a buy-in is not successful or possible.

Conditions under which a participant is deemed to consistently and systematically fail to deliver the financial instruments (Article 7(14)(g))

Q18: Would you agree with ESMA's approach? Would you indicate further or different conditions to be considered for the suspension of the failing participant?

We agree with ESMA's view that a proportionate approach should be adopted. However, given the potential serious market impact of suspending participants, we do not consider that participants should be automatically suspended should the level of fails exceed certain specified levels. This penalty should be retained as a final measure for extreme cases, which should be carefully considered on a case by case basis before deciding to suspend.

Furthermore, the ISE welcomes the fact that the type of instrument and the typical fail rate of such an instrument is taken into account but feels that it should be noted that the fail rate can differ significantly between securities within the same instrument class. The fail rate of a particular security should be taken into account when evaluating whether a participant should be considered for suspension.

The ISE is concerned that additional disincentives may further reduce the liquidity provided by market makers in illiquid securities. Therefore, the possibility of excluding fails resulting from market making activity, either in all or solely illiquid securities should be considered.

Q19: Please, indicate your views on the proposed quantitative thresholds (percentages / months).

In our view, a sufficient period of time, such as 12 month's settlement performance needs to be considered.

Q20: What is in your view the settlement information that CSDs need to provide to CCPs and trading venues for the execution of buy-ins? Do you agree with the approach outlined above? If not, please explain what alternative solutions might be used to achieve the same results.

As well as identifying the relevant CSD participant, CSDs will need to identify the relevant trading venue for each transaction. This field will need to be accurately completed by trading venue and CSD participants to be reliable. The timeliness and frequency of the information will need to be agreed between the CSDs and the relevant CCPs and trading venues, but will need to be on at least a daily basis.

Further discussion between the industry and ESMA is required to provide clarity on the best approach to providing the requisite information to trading venues and CCPs.

Reasons which may justify a refusal of access to issuers and the procedure in case of refusal (Article 49(5) and (6))

Q47: Do you agree that the risk analysis performed by the CSD in order to justify a refusal to offer its services to an issuer should at least include legal, financial and operational risks? Do you see any other areas of risk that should be considered? If so, please give examples.

We agree with the principle of issuer choice of CSDs and we consider the approach suggested by ESMA to be reasonable. We strongly support the view set out in paragraph 203 of the discussion paper that the national corporate law of the issuer, particularly for equities, should continue to apply. This is the approach adopted by EUI, the CSD for Irish equities, which is located in a different legal jurisdiction, and which we have found has provided a clear legal framework for Irish securities.