London Stock Exchange Group

LSEG Response to ESMA Discussion Paper:

Draft technical standard for the Regulation on improving securities settlement in the European Union and on central securities depositories

INTRODUCTION

The London Stock Exchange Group (LSEG) welcomes the opportunity to respond to the discussion paper on ESMA's draft technical standards for the Regulation on securities settlement and central securities depository (CSD-R).

LSEG supports the objective of seeking to strengthen the efficiency of settlement processes and of establishing a European regulatory framework for CSDs. We believe that efficient competition between post-trade providers with harmonised standards is the best way to ensure that post-trade service providers can, and will, respond to a dynamic and rapidly changing market place, and enable the EU financial market to remain competitive, attractive and accessible to international investors.

LSEG has significant experience of operating neutral, well regulated, fair and efficient settlement and custody services provided by Monte Titoli, the Italian Central Securities Depositary.

The Group also provides clearing services through LCH.Clearnet Group Ltd (with regulated CCPs in France and the UK) and Cassa di Compensazione e Garanzia (CC&G), a regulated CCP in Italy.

This submission represents the views and experience of those trading and post-trading services providers within the LSEG.

For this Discussion Paper, we have also contributed to the response submitted by the European Central Securities Depository Association (ECSDA) and European Association of Clearing Houses (EACH). We broadly support the views expressed and the responses to the questions contained in those submission.

We provide our response in two parts:

- **Part A** contains some comments on key areas of the consultation, which informs our approach to more detailed responses to the Discussion paper;
- **Part B** contains responses to ESMA questions with reference to our issues and interests.

We acknowledge that this response may be published by ESMA.

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PART A – General Approach

I. Preliminary remarks

- It is important for ESMA not to take too prescriptive an approach to drafting the technical standards. A principles-based approach will provide the flexibility necessary for CSDs to adapt their services to market developments and to compete and innovate safely and efficiently.
- RTS should not result in additional requirements to those prescribed by CPSS-IOSCO principles for financial market infrastructures. Any significant deviation from global standards would have an impact on the competitiveness of European CSDs. In any event, the draft technical standards proposed by ESMA should not result in higher standards than those intended by CSD-R.

II. Settlement discipline

- The timing for implementing settlement discipline measures under the CSD R should be phased in order to take into account the effort that CSDs are currently undertaking for TARGET2-Securities and the move to a T+2 settlement cycle. A transition period of maximum 3 years (2015-2017) would allow market participants, as well as infrastructure, to make the necessary adaptations and avoid an unnecessarily complex and costly implementation of some of the functionalities that will be provided by T2S. Such changes take many months to implement, and must also be implemented by CSD participants and other market infrastructure; the impact falls across all sectors of the market, not just CSDs, and this should be taken into account. As a result, the priority of EU law-makers should be to ensure that all CSDR technical standards are adopted on time, and prior to the launch of T2S in June 2015, while at the same time allowing for a realistic timeline for CSDs, participants and other market infrastructure to fully implement the settlement discipline standards, i.e. by 2017 after the completion of the 4th T2S migration wave.
- As for measures to prevent settlement fails, we support ESMA's approach that straight through processing (STP), matching and other functionalities are useful tools to enhance settlement, however the RTS should not go as far as mandating the use of specific functionalities or financial disincentives. In this regard, ESMA should recommend their use where practicable and available, leaving CSDs with the flexibility to choose the most appropriate tools to achieve the highest level possible of settlement efficiency, according to their service model and market needs.
- With reference to the buy-in procedure, the aims of our suggested approach are to ensure equal treatment between cleared and non-cleared trades and calibration of the buy-in procedures to support trading in less liquid securities, including through the activities of market makers.

III. CSD requirements

- We welcome ESMA's general approach to risk management (i.e. operational risk) and find that its proposals are more than consistent with CPSS-IOSCO principles. In this regard, our proposal is that ESMA should take a tailored approach as regards assessment of the risk posed by outsourcing arrangements and other interdependences, to be limited to critical service providers.
- The participation of a CSD in another entity should not be limited to entities that are part of the securities transaction chain as proposed by ESMA. This requirement is too prescriptive and we suggest it goes beyond the risk considerations required by both CPSS-IOSCO principles and appears to be inconsistent with the CSD-R Level I text. Furthermore, it restricts a CSD's business development in the area of complementary activities.
- As regard investment policy, our suggested approach is that the RTS made under CSD-R should not be more restrictive than EMIR, taking into account differences between the activities of CSDs and CCPs, especially from a risk management perspective.
- CSD governance arrangements must be flexible to allow for CSDs with different structures. In this regard, any requirement to set-up dedicated functions should be consistent with the efficiency of different corporate structures and should not prevent the use of other group/shared resources by means of appropriate outsourcing arrangements.

PART B – LSEG RESPONSE TO QUESTIONS

1. Measure to prevent address settlement fails (RTS referred to in article 6(4))

1.1 Measure to facilitate settlement on ISD, article 6(2)

(a) Automation

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.

1. In principle we share ESMA's view that the CSDs should employ a high level of automation and straight-through processing (STP) in order to ensure system efficiency and reduce settlement risk.

   However we note that the concept of "manual intervention" referred to the submission and processing of settlement instructions is very broad and would not be easy to define in RTS. Moreover it is unclear whether it refers only to intervention by the CSDs or also by its participants (**para 11**).

   ESMA should note that there are several circumstances in which manual intervention should be allowed, for instance, in order to perform actions required under default management procedures or limited types of operations and activities facilitating settlement that may differ from system to system.

   Therefore, it would not be possible to identify a precise list of exceptions which could be used to limit the use of manual intervention **(para 11).**

   Our opinion is that CSDs should retain the flexibility to implement and allow the use of manual intervention where deemed necessary, provided such manual intervention is included in standardized procedures which ensure that resulting operational risk is properly monitored and mitigated.

(b) 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.

1. As recognised by ESMA, STP throughout the security chain depends also on the level of automation of CSD participants and linked infrastructures (**para 13**). In this regard, we suggest

ESMA should define RTS recommending the use of "already matched" functionality, allowing for direct input of settlement instructions by trading venues and clearing infrastructures on behalf of their participants. The automation provided by this functionality favours early matching and traceability of trades, thus reducing likelihood of settlement fails. Moreover, this functionality is consistent with Article 6(1) of CSD-R requiring trading venues to "*establish procedures that enable the confirmation of relevant details of transactions*".

2. With reference to communications standards, we share ESMA's view that such procedures could facilitate and promote STP **(para 13)**. However, it should be noted that ISO standards do not cover all functionalities and services offered by CSDs and, in some cases, other local communication standards might be appropriate for services that are of benefit to market participants and support an efficient settlement process.

   Therefore, we suggest that the RTS should not go as far as mandating the use of single ISO standards where this is not practical and should allow for the use of local standards, on the condition that they are publicly available.

(c) 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

1. We support ESMA's proposal to require **compulsory and continuous matching (paras 15-16)**. However, we do not believe that the RTS should go so far as defining a binding list of matching fields. Having regard to the existing ESSF-ECSDA matching standards and in light of the current discussions within the T2S project, it is preferable to leave it to the industry to establish g the most appropriate practices in this regard.
2. However, if ESMA decided to pursue the proposed harmonisation of matching fields **(paras 17-19)**, we would suggest that, in order to accommodate the local characteristics of a CSD's services, ESMA should use the T2S standards, provided that this list is not treated as exhaustive. In this context, the client code should not be included in the list of minimum standardised matching fields.
3. As regard possible implementation of **matching tolerance levels in the settlement amounts** to facilitate timely settlement **(para 20)**, we suggest ESMA standards should allow a CSD to determine the appropriate optional tolerance amount within the following range:

   - between EUR 0 up to EUR 5 (or approximate value in the relevant currency) where the amount of transaction is under EUR 100,000;

- between EUR 5 up to EUR 25 (or approximate value in the relevant currency) where the amount of the transaction is EUR 100,000 or more.

For the purpose of matching, the relevant amount should be the one specified in the settlement instruction entered by the seller.

1.2 Incentive for timely settlement, article 6(3)

(a) 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?

1. We agree that early input and matching of instructions should be promoted.

   It should be recognised that timely input and matching of instructions are influenced by the business model and practices adopted by CSD participants and market infrastructure. Therefore, we believe that ESMA should focus more on the implementation of tools to manage settlement risk such as "Hold & Release" mechanisms, confirmation and affirmation measures required by article 6(1) of CSD-R, rather than imposing financial disincentives for late input/matching **(para 22)**.

   The latter should be applied at the discretion of the CSD where a specific market need has been identified.

2. If ESMA does set a standard in this regard, we suggest that it should be specified that financial disincentives do not apply in respect of "already matched" instructions sent by trading venues and CCPs.

3. Moreover, we do not support the proposed ISD-2 deadline that triggers the application of financial disincentives **(para 23)**, for the following reasons:

   - in the current post-trading practice, CCP and market trades are input to the SSS on ISD-1 (e.g. for fixed income cleared securities, the instruction is typically sent on either ISD-1 or on ISD itself, which is equal to either a T+1 or T+0 settlement. It follows that in many cases, a trade will not have not yet been executed on ISD-2 and, accordingly, such a deadline cannot apply);

   - timely input of instructions depends on how many participants are involved in the chain, so that there may be circumstances in which the end investor is not able to send an instruction to its settlement agent until ISD-1, in particular, for example, where it is

located in a different time-zone or where the length of the settlement cycles is different (outside the EU).

4. On **reporting of unmatched instructions (para 25)**, ESMA should take into account that a CSD is not always in a position to identify the reasons why an instruction has not been matched, although this information may be available to CSD members and participating market infrastructure (CCPs). In the T2S platform, for example, CSDs may be able to check the matching status of a settlement instruction but they will not receive information on the underlying reason. As consequence, we support a general requirement for CSDs to allow participants to access the matching status of pending instructions but the RTS should not require a CSD to identify and provide information on the causes for unmatched instructions.

(b) System functionalities

Q6: In your opinion, should CSDs be obliged to offer at least 3 daily settlements/batches per day? Of which duration? Please elaborate providing relevant data to estimate the cost and benefit associated with the different options.

1. We believe the RTS should not go so far as to specify the architecture of a settlement system (which is more likely to be determined according to participant/market needs) **(para 29)**, provided it delivers intraday finality that allows participants to use securities they receive to settle other transactions in different systems during the same day, thus reducing settlement risk.

Q7: In your view, should any of the above measures to facilitate settlement on ISD be mandatory? Please describe any other measure that would be appropriate to be mandated.

1. In our view, none of the technical functionalities listed by ESMA **(para 30)** should be mandatory. Such functionalities are not always required in a given market: for example, the shaping of trades is not a functionality offered in TARGET2-Securities.
2. We suggest ESMA technical standards should provide for a “toolbox”, allowing a CSD to choose the most appropriate tools to enhance settlement efficiency in their market, but should not seek to mandate specific tools when there is no evidence that such tools would substantially benefit settlement efficiency at a European level.

(c) 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.

1. Securities lending and borrowing (SLB) facilities (where the CSD acts as agent between lender and borrower) should be viewed as one possible option to prevent settlement fails but CSDs should not be obliged to develop such a central facility.

   Given that authorised CSDs already have the possibility, but not the obligation, to offer SLB services under Section B of the Annex of the Level 1 CSD-R ("organising a securities lending mechanism, as agent among participants of a securities settlement system"), there is no need for technical standards to cover SLB services of a CSD. SLB services are just another part of the toolkit available to CSDs to use as appropriate.

   Therefore we agree with ESMA's approach as described in paragraph **(34)** of the DP.

2. Measure to Address Settlement Fails (RTS referred to in art. 7(14))

2.1 Details of system monitoring settlement fails Article 7(1)

Q9: Do you agree with the above monitoring system description? What further elements would you suggest? Please present the appropriate details, notably having in mind the current CSD datasets and possible impact on reporting costs.

1. We support ESMA's proposal as regards the systematic monitoring of settlement fails. This harmonised methodology, if adopted by all EU CSDs, will allow for comparability across markets and for a meaningful aggregation of settlement fail data at EU level.
2. We also consider that the "template" proposed by ESMA for collecting reports from national regulators constitutes a workable basis for the harmonised fails reporting requirements.
3. As regards the adoption of a more detailed approach **(para 42)**, we believe that the RTS should not opt for a granular approach whereby a CSD is systematically required to report on the identity of the failing participant for each failed instruction. This would be too complex and unnecessarily burdensome as a CSD will often not know who is behind the fail (e.g. among the many underlying clients of a given CSD participant).

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

1. We agree with ESMA approach described in paragraph **(43)** with reference to the information to be provided to CSD participants. In all cases, it should be possible for the CSD to charge a reasonable fee to cover the cost of producing and sending fails reports to participants.

Q11: Do you believe the public information should be left to each CSD or local authority to define or disclosed in a standard European format provided by ESMA? How could that format look like?

1. We support the idea of the RTS setting a "minimum European template" to be used by CSDs for disclosing settlement fails data to the general public. This annual data should be aggregated to the level of all the CSD's participants and include the following information:
    - Total value of instructions settled by the CSD
    - % of fails by value over the past year
    - Total volume of instructions settled by the CSD
    - % of fails by volume over the year.

    The data should ideally contain figures for the past year and the previous year at a minimum, to allow for a comparison of the level of settlement efficiency over time.

2.2 Details of operation of the appropriate buy-in mechanism: extension period

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?

1. With regards to a **preliminary distinction based on asset type** (**para 50**), we support the ESMA proposal to apply a longer extension period to ETFs, bonds and government securities.

    In particular, when determining the relevant extension period for bond markets, the following characteristics of these markets should be taken into account:

    a. Very large numbers of individual instruments;

    b. High typical transaction values;

    c. Cross-border nature of markets;

    d. Multiple international custody structures, trading venues & CSDs;

e. Existing extended periods for resolution of delivery failures.

For these reasons, we believe an extension **period of 7 days is appropriate for bond markets, regardless of whether they are cleared or not.**

Considering the length of the instrument conversion/creation processes, cross-border nature of the markets and international custody structures involved, delivery failures in ETFs take more time to be resolved and thus justify the application of the longer extension period. For similar reasons we also believe that the RTS should provide for a longer extension period for **depository receipts and securitized derivatives** where they are deemed to be subject to settlement discipline under CSD-R (i.e. they are transferable securities).

For all these securities, in light of the characteristics mentioned above the appropriate extension period should of 7 days, **regardless of whether they are cleared or not.**

2. In terms of the **liquidity of financial instruments**, we agree with ESMA's observation and proposed approach, which recognises that a buy-in regime could have an adverse impact on the market for less liquid securities **(para 51)**.

   However, we would highlight here that where CSD-R rightly provides for a longer extension period (ISD+15) for SME Growth Market securities (under MiFID), the logic that the reduced liquidity of these instruments justifies the extended timetable also applies to less liquid securities on regulated markets. Indeed, the size/liquidity profile of shares on the AIM market in the UK (SME Growth Market) is similar to that for less liquid SME shares on the regulated market (see analysis in Appendix 1), yet the extension period for the regulated market securities would only be ISD+4/7. In our view, this needs to be taken into account in the calibration of the buy-in process – see also our response to Question 14.

   MiFID2 recognises the importance (Recital 134) of providing successful markets for SMEs without having to establish SME growth markets, as defined by MiFID2: *"(134) Given the importance of not adversely affecting existing successful markets the option should remain for operators of markets aimed at smaller and medium-sized issuers to choose to continue to operate such a market in accordance with the requirements under this Directive without seeking registration as an SME growth market. An issuer that is an SME should not be obliged to apply to have its financial instruments admitted to trading on an SME growth market."*

   A buy-in process that is not proportionately calibrated will risk creating different regimes for SMEs and create incentives for such companies to seek admission to an SME growth market, that goes against their wishes/interests and those of investors and market participants.

3. In addition, it should be noted that CSD-R restricts the extension period of cleared trades in shares to ISD+4, despite the fact that in some markets, some less liquid shares are fully cleared (i.e. guaranteed) by CCPs and are not simply routed to bilateral settlement. Analysis of trading in 2013, set out in Appendix 2, shows that:

- In the case of UK equities that are trading in the less liquid segments of the regulated market (companies below the blue chip and midcap indices), over 75% of these securities were "clearing eligible" where trades executed on the electronic order book were fully cleared (guaranteed);
- 75% of all on-exchange trading in these clearing eligible securities was cleared – the balance was transacted off order book, reported as on-exchange trades to LSE, not cleared by a CCP and bilaterally settled;
- The distribution of cleared trades shows that a significant number of securities with very low levels of liquidity had a large proportion of cleared trades (>50%).

4. The impact of having a different extension periods for cleared and uncleared trades in less liquid securities will be to:
   - Create different buy-in timetables, with the process out of line between the two types of trades, particularly with regard to the application of any cash compensation (an issue in particular for chains of trades involving cleared and uncleared trades);
   - Lead to a potential "bubble effect" in pricing as a result of the combination of shorter cash-out periods (2 days after end of buy-in execution/deferral period) and different buy-in timetables for cleared and uncleared trades, potentially resulting in disorderly markets in certain less liquid securities where participants seek to benefit from inflated cash-out values.
   - Incentivise market participants to trade, and to seek to provide liquidity, in an uncleared environment away from electronic order books, contrary to the stated objectives of policy makers (in MiFID and other measures), and further fragmenting liquidity on RMs and MTFs for illiquid shares.

   We urge ESMA to recognise that not only will a poorly calibrated buy-in regime affect liquidity and the number of settlement fails in less liquid shares (and the willingness of liquidity providers to commit capital), but that the different treatment for cleared and uncleared trades in these securities introduces a structural bias towards trading in an uncleared environment. We do not believe this should be the role of a buy-in regime and it is therefore vital that the buy-in process is designed to mitigate these effects. We propose an approach to this in our answer to question 14, below.

5. In the context of defining liquidity, it is not clear that "taking into account" the MiFIR definition of liquid market will be interpreted as taking the same definition/thresholds as MiFIR, or whether a different approach for CSD-R will be adopted and we would welcome clarification. That notwithstanding, we believe that ESMA should consider the adoption of a separate definition of "less liquid securities" specifically for the purpose of CSD-R Article 7. Such a definition should simply distinguish liquid and illiquid instruments and apply the ISD+7 extension period to the latter category (rather than apply a graduated approach of ISD+5 and ISD+6).

2.3 Details of operation of appropriate buy-in mechanism: execution of buy-in

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?

1. We would like to clarify that our response to this question reflects the text of article 7(3) of CSD-R as approved by EP Plenary which reads"….where a failing participant does not deliver the financial instruments referred to in Article 5(1) to the receiving participant within 4 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 party within an appropriate time frame". The underlined section does not read: "shall be subject to the buy-in" as quoted to in paragraph 48 of the ESMA DP.

   According to this EP Plenary wording, a buy-in process shall be initiated at the end of extension period, thus reflecting the intended flexibility with regards to the effective execution of the buy-in that, for instance, could foresee more than one attempt to buy securities within the appropriate timeframe. We suggest that the RTS should be fully consistent with such wording in order to avoid any misinterpretation around the buy-in procedure.

2. As for the role of the CSD in this respect, we believe that the RTS should not go so far as requiring the CSD to execute the buy-in or to process it actively **(para 53)**. In line with CSD-R level I text, the CSD should only be required to provide the proper "administrative" framework to support or facilitate buy-in procedure that will be directly managed by the involved counterparties. We would also welcome clarification on how a CSD and trading venue should enforce the obligation to perform buy-in on the receiving participant as part of their rules, in particular when the failing participant does not cover the difference between the price agreed at the time when the trade was concluded and the price paid for the execution of buy-in, where applicable.

3. Furthermore, we would welcome clarification on whether a CCP has the ability to avoid the deferral period where it considers that the extension plus the execution period give a sufficient time-frame for the execution of buy-in.

4. While we agree with ESMA that notification to the concerned parties can take place before the expiration of the extension period (buy-in notice), we would still expect notification to confirm the start of the buy-in procedure at the end of the extension period/start of buy-in execution period.

5. With reference to the timelines of the buy-in procedures, we broadly support the development of the RTS to establish harmonised execution period, thus avoiding misalignment between the procedures of different trading venues and market infrastructure.

However, as we have highlighted in our response to Question 13, the calibration of the execution period needs to reflect, and mitigate, the adverse impact of reduced liquidity/liquidity provision for less liquid securities and to avoid the introduction of any structural bias incentivising the trading of these securities in an off-order book, un-cleared environments.

LSEG suggested approach

As a starting principle, we suggest that the length of the execution period is equal to the extension period as defined according to the security asset type. However, we would also propose specific exceptions to this principle in order to avoid the adverse impacts referred to above. We therefore propose:

- For liquid securities, an execution period of 4 days;
- For **less liquid securities**, an execution period of **7 days** with the following exceptions:
  - **for less liquid cleared trades** (where the extension period is to ISD+4), an execution period of **10 days**, in order to, as far as possible, to align the execution period (and, crucially, the application of any cash out procedure) with that for uncleared trades in less liquid securities;
  - Where the national competent authority deems it necessary, for the purposes of maintaining and protecting market liquidity**, registered market makers in less liquid securities** would be subject to an execution period of **10 days for uncleared trades and 13 days for cleared trades**;
  - for SME growth market shares, the execution period should be 7 days, the same as that for less liquid securities. Where the competent authority deems it necessary, registered market makers would be subject to a 10 day execution period.

We believe that such an approach would, if adopted:

- Maximise the likelihood of delivery of securities to investors and reduce the need, or incentives, for cash compensation;
- Help to **align the buy-in process for cleared and uncleared trades in less liquid securities** and reduce the incentive for participants to seek to trade less liquid securities away from public limit order books on regulated markets and cleared environments;
- Remove the incentive to misuse the cash compensation provisions by taking advantage of different timetables for cleared and uncleared trades in less liquid securities;

- **Recognise the need for a proportionate regime for less liquid securities** on a regulated market, given that the size/liquidity profile, and the market structure on which they are traded mirror that of SME growth markets, where the need for flexibility is recognised in CSD-R;
- Not discriminate against successful existing SME markets that operate as part of a regulated market (as reflected in MiFID2);
- Be consistent with Recital 16 of CSD-R, which notes that the settlement discipline should be scaled *'in such a way that maintains and protects liquidity of the relevant financial instruments. In particular, market making activities play a crucial role in providing liquidity to markets within the Union, particularly to less liquid securities. Measures to prevent and address settlement fails should be balanced against the need to maintain and protect liquidity in these securities'*.
- **Reflect the value provided, and the additional risks taken, by market makers in less liquid securities** in meeting their obligations and reduce the risk of these participants increasing the costs of providing liquidity or withdrawing from these markets altogether, which would:
    - reduce liquidity and raise the costs, or inhibit the ability of SMEs, to list and raise finance on public markets;
    - have an impact on the ability of retail investors, which typically represent a larger proportion of the trading in these securities, to invest in such securities, or to exit/manage existing investments.

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?

1. As a first point, we would welcome clarification as to when the feasibility of the buy-in would fall to be evaluated, as this is not clear in CSD-R Level I. In our opinion, in different scenarios, buy-in feasibility could be assessed at the end of the extension period, before buy-in starts, and at the end of the execution period.
2. Generally speaking, we believe that a buy-in will not be possible when there is "unavailability of securities".

   In this context we support ESMA's view **(para 56)** allowing CCPs and trading venues, where relevant, to make a decision as to the feasibility of buy-in in order to efficiently manage fails involving:

- illiquid financial instruments (including where a security has limited free float and/or limited availability in the borrowing/lending market); or
- financial instruments for which there is reason to believe that they will not be available for settlement if the standard buy-in procedure were activated.

Such a process would be relevant, for instance, when securities to be bought-in cease to exist or are affected by public purchase offerings or other relevant transactions which can bring about the suspension of trading of the shares. In such a scenario we would welcome clarification on whether a CCP has the ability to avoid the deferral period and opt for cash compensation on the basis that that it is considered to be both the receiving and delivering participant.

3. In this regard, prior approval of the competent authority on a case by case basis would be unnecessary, as it could affect the timeliness of decisions by a CCP and trading venue and increase the overall risks of the procedure. General approval by the relevant competent authority should be sought in respect of any buy-in rules/procedures, including those relevant to this aspect of the process.

4. Finally we share ESMA's view that coordination on multiple buy-in would be important especially in a single or cross-CSD settlement scenario (e.g. T2S) **(para 57)**. This would also be beneficial for securities characterised by being traded in a very fragmented market with complex chain of trades, such as debt securities. Given that trades taking place on multiple trading venues (including OTC), in same bond for simultaneous delivery are netted within the settlement process, resolution of bond delivery failures has to take into account multiple netted trades.

   In such circumstances we believe that a CSD should be allowed to manage the buy-in procedure on the basis of multilateral netted trades, in coordination with the trading venues they serve. However, consistent with Level I text, this requirement should not be imposed by the RTS as CSDs and trading venues should retain the flexibility to implement such procedures where necessary.

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?

1. Typically bond repurchase (repo) operations are motivated by funding objectives or geared towards possession of the particular bond for a particular purpose for a specified period of time. Further, in the substantial majority of cases, the term of the repo is short.
2. We agree with ESMA's view that for short-term repurchase agreements, the buy-in regime is ineffective if the intended settlement date of the opening leg of the repo, plus the extension period of (4 or 7 days) the buy-in, is equal to or longer than the intended settlement date of the return leg of the repo.

2.4 Calculation of the cash compensation

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

1. In principle we agree with ESMA's view that cash compensation would only be due when the prices of financial instruments agreed at the time of the trade are lower than the last available prices for such instruments (para 62), although this should not be stated in RTS. In fact, in the case of CCP cleared trades this rule need to be adapted because the reference price for the cash compensation cannot be based on the original trade price and original trade source, because a single failed settlement instruction may be the net of many trades from many trade sources.

2. For this reason, a CCP should be able to determine the reference price and the method of calculation of cash compensation at its discretion, taking into account the need to ensure the compensation of the receiving participant and the characteristics of the netting model.

2.5 Conditions under which a participant is deemed to consistently and systematically fail to deliver financial instruments

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?

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

1. We believe that a suspension process should be only activated in extreme scenarios, given that it could have significant systemic consequences. Most importantly, suspension of a participant should never be triggered automatically when any thresholds are reached. Some degree of discretion is needed for the CSD, CCPs and trading venues to consult with regulators and assess the possible consequences of a suspension on systemic risk.
2. In this regard we would welcome clarification on how suspension effects would be handled across CCPs, CSDs and trading venues, especially where the decision taken by one of them could trigger the suspension by the others.
3. Further, ESMA should clarify where any quantitative threshold will be calculated on the "overall value/" or "number" of the settlement instructions across all venues (TVs, CSDs, CCPs) or separately on each venue. In this regard, we believe RTS should also allow each market infrastructure to calculate and apply those thresholds separately (e.g. for instance differentiating by market/cleared product).

4. For the reasons outlined above, we believe that any thresholds established by ESMA, applicable to suspending a participant, should be reasonably low (e.g. when a participant settles less than 75% of overall settlement instructions settled on ISD in terms of volume or value), and should be calculated over a sufficiently long period (e.g. 12 months).

2.6 Necessary Settlement Information

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.

1. As regards the process to buy-in CCP-cleared transactions, the processes currently in place are satisfactory and CCPs are able to access the information they need to effect buy-ins. **A requirement to segregate the accounts of clearing members at CSD level is thus unnecessary**.
2. As for trading venues, the Level I Regulation only requires them to "include in its internal rules an obligation for its members and its participants to be subject to the [buy-in] measures (…)." It does not require trading venues to execute buy-ins on behalf of participants that have suffered from a fail, but only to include a buy-obligation in its rules. It is thus not entirely clear what kind of settlement information trading venues would need to receive from CSDs for the purpose of complying with CSDR article 7(7).

   In this regard, it should be noted that both CSD-R and the revised MiFID establish a regulatory framework facilitating access to transaction feeds. Such feeds will be covered by a contractual agreement between a trading venue and the relevant 'linked' market infrastructures. The information flow to be provided for the purpose of managing/executing buy-ins could be specified in these agreements, where applicable. Depending on the specific market model such arrangements may include, for instance, details of the relevant trade fail on ISD+1 and then further updates to that record each day (or after an updateable event) with details confirming full or partial delivery, successful buy-in etc. so that the latest status of the transaction is known.

   It is unclear whether requiring a trading member or a clearing member to open a separate account at the CSD, segregated from other trading or clearing members holding securities with the same CSD participant, would solve this problem. The requirement to open such segregated accounts would in any event fall on the market participants, and cannot be imposed on the CSD itself, so it seems that such a requirement would go beyond the scope of the Level I mandate in CSDR article 7.

3. Authorisation and Supervision

3.1 Information to the CA for authorisation – Standard forms, templates and procedures

Q22: Would you agree that the elements above and included in Annex I are appropriate? If not, please indicate the reasons or provide ESMA with further elements which you find could be included in the draft RTS, and any further details to justify their inclusion.

Q23: Do you agree that the above mentioned approach is appropriate? If not, please indicate the reasons or provide ESMA with further elements which could be included in the draft ITS.

1. We agree ESMA information requirements referred to in Annex I are appropriate. However, we do not consider as set out that they are "minimum information requirements" **(para 80**), because they are already very detailed and extensive. We believe ESMA should define a single, harmonised list of elements to be contained in a CSD's request for authorisation in order to ensure a consistent and fair application process for all CSDs across the European Union.
2. In this context a CSD should be allowed to make references to the extensive information already available to the public or already provided to NCAs as part of their assessment against European and/or International standards such as CPSS-IOSCO Principles for Financial Market Infrastructures (PFMI), whenever these are relevant and applicable. Allowing CSDs to refer to or to re-use part of these existing assessments will not only avoid unnecessary duplications, it will also promote consistency with international standards.

3.2 Conditions for participation in other entities

Q24: Do you see other risks and corresponding mitigating measures? Do CSDs presently have participations in legal persons other than CCPs, TRs and trading venues that should be considered? Would banning CSDs from directly participating in CCPs be advisable, in your view?

1. We do not agree with ESMA's proposed approach of restricting the ability of a CSD to hold participations only in entities which are part of the securities chain (namely CCPs, TRs and trading venues). Indeed, there are many other types of entities which offer services that could be considered complementary to a CSD's activities, such as IT companies or financial information providers/data vendors, envisaged by Level I text.

   The need to ensure that participations in other businesses do not put the CSD activities at risk should not prevent a CSD from diversifying its activities and/or developing new business which are complementary to its market infrastructure services.

Therefore we recommend the removal of ESMA's proposal to limit CSD participations to other entities in the securities chain (**para 97**). Alternatively, ESMA could require a CSD to demonstrate that entities in which it wishes to acquire a participation must provide services which are "complementary" to their CSDR-authorised activities.

Similarly we suggest ESMA proposal to limit to 20% the revenue a CSD can receive from a party in which it has a participation (**para 96**) should be rejected, on the basis that it goes beyond what is required under the Level I text and is unnecessary having regard to the authorisation and supervision conditions for CSDs and considering that these types of risk should be effectively managed through the supervision by NCA. We suggest it could fundamentally impair the ability of the CSD to develop its business in complementary activities. It is also impossible to see how it could be practically applied and enforced.

3.3 Review and evaluation

Q26: Do you agree with this approach? Please elaborate on any alternative approach illustrating the cost and benefits of it.

1. We broadly agree with ESMA's approach to periodic review and evaluation. However we suggest the following principles should also be taken into account:
   - the notion of "materiality" could be further defined to ensure that a CSD's supervisor focuses on changes and processes that are material and could have a potential impact on a CSD's risk profile, without requiring duplication of the information provided in the context of the on-going supervisory assessments.
   - the draft technical standards should clearly reflect the principle expressed by ESMA in **(para 104)**, whereby the national competent authority should focus on the quality of the documentation rather than on the quantity and so that *"only relevant documents should be provided"*;
   - the annual review exercise should also leverage as much as possible on a CSD's assessments against CPSS-IOSCO PFMI, which will cover most of the information required for the review.

4. Monitoring tools for the risks of CSDs, responsibilities of the key personnel, potential conflict of interest and audit methods

Q27: Do the responsibilities and reporting lines of the different key personnel and the audit methods described above appropriately reflect sound and prudent management of the CSD? Do you think there should be further potential conflicts of interest specified? In which circumstances, if any, taking into account potential conflicts of interest between the members of the user committee and the CSD, it would be appropriate not to share the audit report or its findings with the user committee?

1. **Establishment of "dedicated" functions (chief risk officer, compliance officer, chief technology officer) and "separate" audit function**

   With reference to the establishment of "dedicated functions" (**para 113**), we believe ESMA should take into account the proportionality principle and different organisational structures of CSDs.

   In particular, we believe that RTS requirement to set-up those "dedicated functions" should not prevent CSDs from:

   - combining those "dedicated functions" with other corporate functions, (thus encountering organisational constraints of smaller CSDs);
   - performing these functions at group level, (allowing for a more efficient allocation of tasks and bringing some benefits such as developing an integrated, group-wide perspective on risks).

   Allocation of those functions within the company or the group should be supported by policies and procedures to disclose and manage potential conflicts of interests and establish proper outsourcing arrangements, in line with relevant provisions of CSDR.

   Similarly, the requirement to have an "independent and separate" internal audit function **(para 119)** should be applied proportionately and RTS should allow for outsourcing of this function to another entity of the group, provided that a sufficient degree of independence is guaranteed.

2. **Conflict of interest**

   We broadly agree with ESMA's approach, but suggest that some clarification is needed with reference to the list of potential conflicts of interest identified in the Discussion Paper **(para 116)**. The list is, in fact, quite extensive and could give rise to somewhat excessive interpretations. Tailoring the perimeter of potential conflicts would help a CSD to comply with the requirement to *"maintain and operate effective written organisational and administrative arrangements to identify and manage any potential conflicts of interest".*

   In particular we suggest ESMA should remove the general clause of *"indirect conflict with other connected persons"* from the list or at least further specify the circumstances to which it refers.

3. Audit methods

We believe ESMA needs to clarify that independent audit of a CSD's operations, risk management processes, internal control mechanism and accounts can be performed by the internal audit function, without requiring the appointment of an external auditor that would imply a duplication of costs.

As for the proposal to have a periodic review of the internal audit activity performed by an external auditor, we suggest ESMA follows best practice in this area, with such a review to be carried out every three (3) years.

4. User committee

We believe that "risk" audits, unlike financial audits, are likely to contain non-public information on detailed risk management processes and procedures which should not be disclosed outside the CSD and its regulator(s). For example, it is conceivable that such audits could contain information on the risks posed by (a) specific client(s) of the CSD, or (b) on very specific services, and such information should clearly remain confidential. This is particularly relevant given the competitive environment in which CSDs are, and will be, operating, and the fact that CSD participants are also often competitors to the CSD for the provision of certain services.

Therefore, having regard to the sensitivity of most internal audit findings, we believe that it would be appropriate for the CSD to share them with the user committee **only where such findings require corrective actions that would have an impact on users' operational activities,** also in accordance with the rule provided by Level 1 text that requires to specify the "*circumstances in which it would be appropriate, taking into account potential conflict of interest between the members of the user committee and the CSD, to share audit findings with the user committee* (...)".

5. Recordkeeping

Q28: Do you agree with this minimum requirements approach? In case of disagreement, what kind of categories or what precise records listed in Annex III would you delete/add?

Q29: What are your views on modality for maintaining and making available such records? How does it impact the current costs of record keeping, in particular with reference to the use of the LEI?

1. In our view, the list of items included in Annex III is again exhaustive such that it could not be considered "minimum requirements". We support a "maximum harmonization" approach, providing a harmonised list of records while giving some flexibility to competent authorities not to require records that are not relevant for the particular CSD.

In any event, some of the items in the proposed list generally do not seem relevant for the purpose of ensuring compliance with CSD-R. At a minimum, we suggest the following items should be removed from the list:

- SR3 Persons exercising control on Issuers
- SR13 Persons exercising control on Participants
- SR14 Country of establishment of persons exercising control on Participants

CSDs typically do not have access to such information and it is unclear how such records would contribute to evidence CSD's compliance with CSD-R requirements.

Moreover, some of the proposed technical requirements, such as online inquiry possibility, the possibility to re-establish operational processing, query function through numerous search keys, and direct data feeds, are much more demanding than current CSD recordkeeping practices. We would suggest that ESMA restricts the scope of this requirement to limit implementation costs.

2. As regards the format of the records to be stored, we think it is not necessary (and indeed sometimes not possible) to require CSDs to maintain records online (immediately available) but that it should be sufficient to store the data offline, provided this data can be retrieved within a few days. This is a much more practical approach, considering the large amount of data involved.
3. Without denying the benefits linked to the use of LEIs in terms of harmonisation, more analysis is needed, we believe that a gradual implementation of LEIs outside derivatives markets should be coordinated at global level, rather than imposed on EU CSDs via binding regulation.

6. Risk that may justify a refusal of access to participants and procedure in case of refusal

Q30: Do you agree that the CSD risk analysis performed in order to justify a refusal should include at least the assessment of legal, financial and operational risks? Do you see any other areas of risk that should be required? If so, please provide examples.

1. In order to define the risk that may justify refusal of access by a CSD, ESMA should take into account that according to Article 33(3) of CSD-R the "comprehensive risk analysis" is only required to justify refusal to a participant "**meeting the participation requirements**".

   Since such participation requirements must be risk-based and non discretionary according to article 33(1), our understanding is that cases of refusal are limited to circumstances whereby even if the applicant potentially meets general access requirements, the CSD has doubts on its eligibility considering the relevant situation and the specific risk profile of the single participant, such that it might impair its ability to satisfy its obligation towards CSDs and other participants.

   So, the "comprehensive risk analysis" should refer to the single applicant and while the examples provided by ESMA for each category of risk are helpful **(para 137)**, they should not be considered

as an exhaustive list. Nor should a CSD be required to include them in its membership criteria **(para 135).** The CSD should be able to retain the right to refuse access within the limits set by Level I regulation and according to an analysis of risk posed by the potential participant.

7. Operational risk

Q35: Is the above definition sufficient or should the standard contain a further specification of operational risk?

1. We agree with the definition proposed by ESMA and we consider it sufficient. We fully support the reference to the definition of operational risk included in the CPSS-IOSCO PFMI as we believe this will ensure consistency with global standards.

Q36: The above proposed risk management framework for operational risk considers the existing CSDs tools and the latest regulatory views. What additional requirements or details do you propose a risk management system for operational risk to include and why? As always do include cost considerations.

1. We welcome ESMA's approach, which is based on these CPSS-IOSCO Principles, and we believe that the proposed requirements are exhaustive.

   In this context we would welcome clarification on the following statements:

   - **(para 154) CSDs should have a "robust operational risk-management framework with appropriate IT systems, policies, procedures and controls":** please confirm that this principle should not be understood as a requirement for a CSD to use special IT tools for operational risk management. IT solutions for managing operational risk are not commonly used by CSDs and are not necessarily more appropriate than, or superior to, the established tools and systems for managing operational risk management within CSDs. This is especially true for CSDs not exposed to credit risk;
   - **(para 157) *"the CSD should have a central function for managing operational risk":*** the notion of "central function" should be interpreted proportionally as requiring that responsibilities for the management of operational risks are clearly attributed, not as a requirement for the function to be performed by a CSD employee on an exclusive basis, especially in smaller CSDs.

Q40: In your opinion, will these requirements for CSDs be a good basis for identifying, monitoring and managing the risks that key participants, utility providers and other FMIs pose to the operations of the CSDs? Would you consider other requirements? Which and why?

1. Yes, the requirements proposed by ESMA form a good basis for identifying, monitoring and managing the risks that key participants, utility providers and other FMI pose to the operations of the CSDs.
2. However the RTS should provide further guidance on the definition of "critical service providers". In this regard we believe that the scope of the RTS should be explicitly limited to interdependencies related to a CSD's strategic activities. To this end, a provider should be considered critical only where a failure in its performance would impair a CSD's ability to meet relevant regulatory requirements or the continued provision of a core function.

   An overly broad scope that is not strictly related to risk or other regulatory concerns would otherwise discourage outsourcing which is generally intended to achieve higher operational efficiency by reducing costs through a specialization of competences.

   We suggest that the provision of the following support services by third parties with respect to an activity that remains managed by the CSD (both operationally and in terms of decision-making), should not be considered critical providers :

   - personal security services, reception, mail sorting and cleaning of the premises;
   - hardware maintenance services and software used as a tool for individual computers;
   - payroll processing services;
   - advisory/consultancy services (legal, IT, business analysis).

   Finally, we believe that a proportionate approach is also warranted in the case of intra-group outsourcing of core activities, which implies a generally lower level of risk. The level of control over the service provider is a key aspect for the CSD to consider when defining the outsourcing requirements. Hence, while specific arrangements must be in place also for intragroup outsourcing, there should be considerable flexibility as regards the level of monitoring that the CSDs should conduct.

   Limiting the scope of the RTS to truly critical providers as suggested above will enhance the efficiency and standardization of supervisory practices and, at the same time, will avoid putting an excessive burden on CSDs, their providers and NCAs.

8. Investment policy

Q41: Do you agree with the approach outlined above? In particular, do you agree with the approach of not distinguishing between CSDs that do not provide banking services and CSDs that do so?

Q42: Should ESMA consider other elements to define highly liquid financial instruments, "prompt access" and concentration limits? If so, which, and why?

1. We believe RTS developed under CSD-R should not be more restrictive than EMIR, taking into account differences between the activities of CSDs and CCPs, particularly from a risk management perspective. Unlike CCPs, a CSD does not use its own capital to guarantee settlement obligation of its participants hence strict restrictions on the investment policy are not required or necessary. Moreover CSDs typically have a limited amount of capital to invest and generally keep that capital in cash deposits.

   In this regard, we note that EMIR requires CCPs to develop their own methodology for credit ratings instead of relying on ratings from external credit agencies for the purpose of determining whether a credit institution has a low credit risk, and is thus eligible to hold CCP assets. Conversely CSDs should be allowed to use credit ratings from external agencies for the purpose of managing their investment risk, given that, unlike CCPs they are usually not involved in managing credit risks. However, this should be without prejudice to the possibility of the CSD relaying on internal methodology where it is able to develop it.

2. We do not agree with ESMA's statement **(para 182)** that *"CSDs should not be allowed, as principle, to consider their investment in derivatives to hedge their interest rate, currency or other exposures."* A full prohibition of investment in all derivative instruments is not warranted and that in some cases it would be possible for CSDs to hedge against currency risk, as this is provided for CCPs.

9. Link assessment

Q43: Do you agree that links should be conditioned on the elements mentioned above? Would there be any additional risks that you find should be considered, or a different consideration of the different link types and risks? Please elaborate and present cost and benefit elements supporting your position.

1. We broadly agree with the categorisations of risks associated to link arrangements provided by ESMA (**para 188**).

2. However as regards conditions ensuring adequate protection for participants **(para 190)** we believe that ESMA's approach is too burdensome for the requesting CSDs.

   In particular we note that requesting CSD would be required to conduct an *"extensive analysis of receiving CSD's financial soundness, governance arrangements, processing capacity, operational reliability and reliance on critical service providers*" and take measures to monitor and manage identified issues. We believe that the scope of such analysis is unnecessarily broad and goes beyond CPSS-IOSCO principle 20 on FMI links.

   First, at least in relation to CSDs authorised or recognised under the CSDR, this requirements seems a duplication of the overall compliance assessment that competent authorities carry out during the authorisation, recognition and review processes when due .

   Moreover, we question whether a CSD could ever be in the position to conduct such an "extensive analysis" of the receiving CSD as regards its financial soundness, governance arrangements, operational reliability and processing capacity where the information required is likely to be confidential.

   In this regard, it should be recognised that international principles impose on both linked FMI a reciprocal obligation to disclose and provide an appropriate level of information, enabling each of them to perform an assessment of the risks associated with the link.

   Hence in our opinion the requesting CSD should perhaps be able to rely on less detailed information disclosed by the receiving CSD and the RTS should not go so far as requiring "an extensive analysis", in particular in case of standard and customised links.

   Therefore we suggest ESMA recalibrates the proposed approach to the RTS in line with CPSS – IOSCO principles, limiting the assessment to analysis of those operational features of the receiving CSD that are relevant to ensure protection of assets belonging to participants of the requesting CSD (e.g. accounting practices, reconciliation procedures and other proper arrangements to manage custody risk in the event that receiving CSD becomes insolvent) thus excluding governance and other financial aspects.

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APPENDIX 1

Table 1 – UK equity market - comparison of AIM (SME growth market) and less liquid securities traded on regulated market

Average trades per day by number of securities

Average trades/day	AIM	%	RM Less Liquid	%
0	-	0.0%	3	0.4%
1 - 5	553	50.0%	412	49.5%
5 - 10	183	16.5%	87	10.5%
10 - 20	157	14.2%	105	12.6%
20 - 50	133	12.0%	110	13.2%
50 - 100	43	3.9%	59	7.1%
100 - 250	21	1.9%	33	4.0%
250 - 500	9	0.8%	13	1.6%
500 - 1,000	4	0.4%	7	0.8%
1,000 - 2,000	2	0.2%	2	0.2%
2,000 - 5,000	1	0.1%	1	0.1%
5,000 - 10,000	-	0.0%	-	0.0%
10,000 - 20,000	-	0.0%	-	0.0%
	1,106		832	

Notes on analysis:

1. Source: London Stock Exchange Group. Trading data = calendar year 2013.
2. AIM = Alternative Investment Market – anticipated to qualify as an SME growth market under MiFID.
3. Less liquid shares on LSE RM – MiFID securities on LSE regulated market, outside blue chip (FTSE 100) and Mid Cap (FTSE 250) indices.

Chart 1

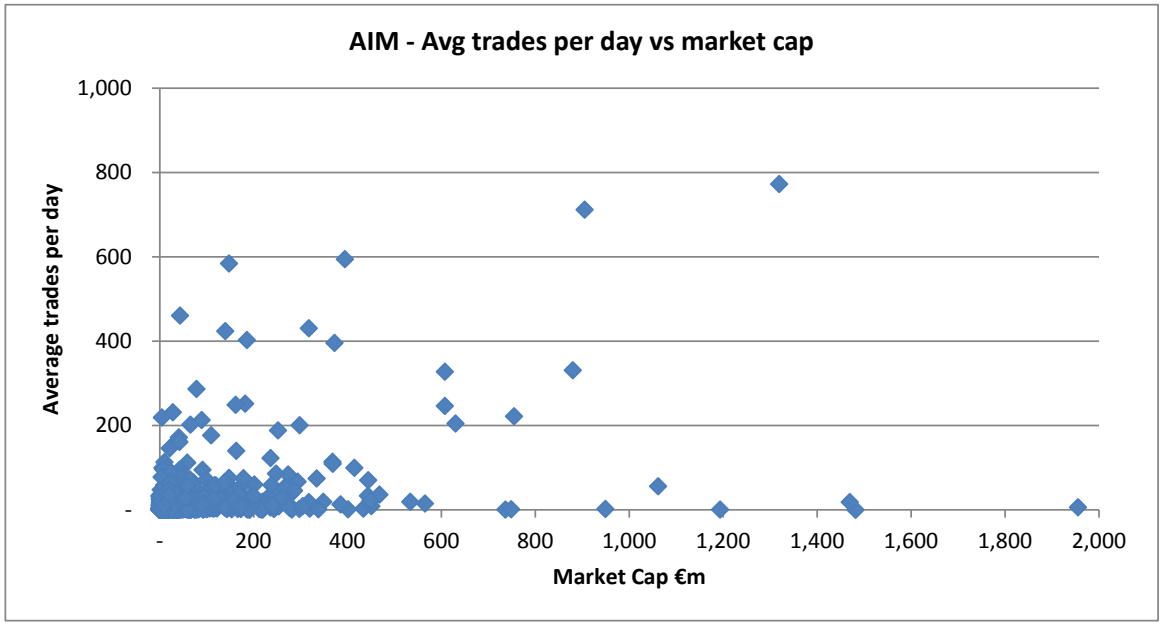
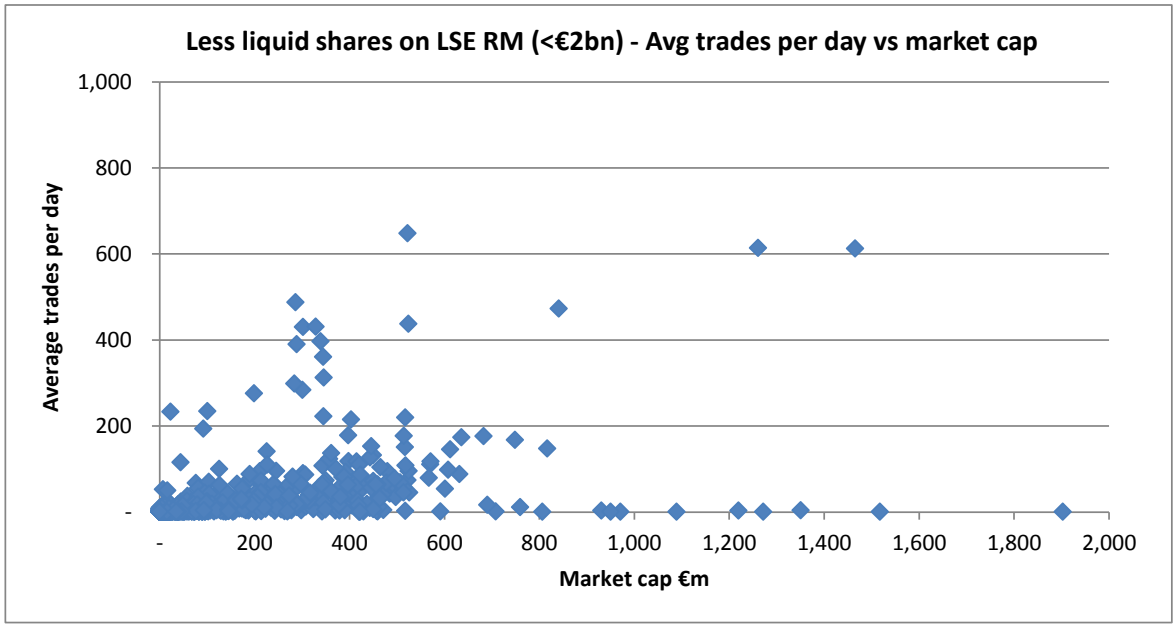


Chart 2



Notes on analysis:

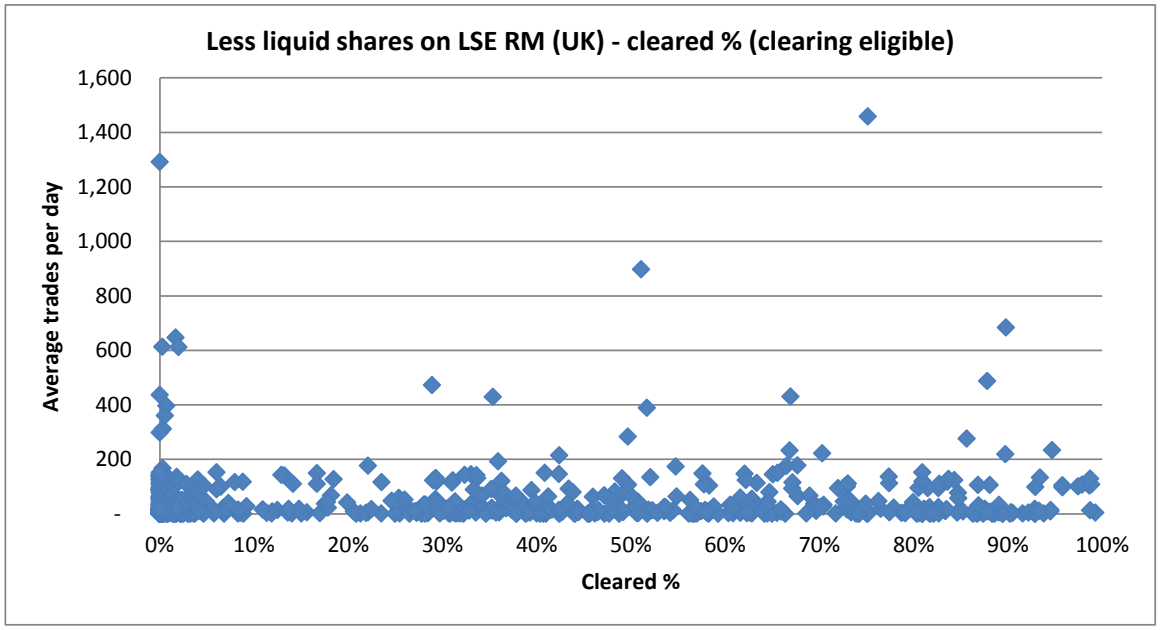
1. Source: London Stock Exchange Group. Trading data = calendar year 2013. Market capitalisation values as at 31/12/2013.
2. AIM = Alternative Investment Market – anticipated to qualify as an SME growth market under MiFID.
3. Less liquid shares on LSE RM – UK MiFID securities on LSE regulated market, outside blue chip (FTSE 100) and Mid Cap (FTSE 250) indices.

APPENDIX 2

Table 2 – Less liquid securities traded on regulated market – cleared vs non cleared (number of securities by average trades per day band)

Average trades/day	Not Cleared	Clearing eligible
0	1	2
1 - 5	149	263
5 - 10	13	74
10 - 20	8	97
20 - 50	4	106
50 - 100	1	58
100 - 250		33
250 - 500		13
500 - 1,000		7
1,000 - 2,000		2
2,000 - 5,000		1
	176	656

Chart 3



Notes on analysis:

1. Source: London Stock Exchange Group. Trading data = calendar year 2013.
2. Less liquid shares on LSE RM – MiFID securities on LSE regulated market, outside blue chip (FTSE 100) and Mid Cap (FTSE 250) indices.