European Securities and Markets Authority

Date: 14 March 2011

ESMA/2011/94

Mr Jonathan Faull
Director General,
Internal Market and Services
European Commission
1049 Brussels

Ref: Commission consultation on CSDs and securities settlement

Dear Mr Faull,

ESMA welcomes the European Commission's (Commission) *Consultation paper on central securities depositories and on the harmonisation of certain aspects of securities settlement in the European Union* (the "CP") and is pleased to submit its views on it. As in the context of the Commission Member States Working Group, where CESR provided the Commission with advice on settlement discipline and legal issues related to central securities depositories (CSDs) participating in TARGET2-Securities (T2S), ESMA's contribution is limited to specific issues of a technical nature, without focusing on policy options. For your convenience, the numbering and sequence of the CP is followed below and references are made to the relevant pages of the CP.

ESMA appreciates the fact that most of the *CESR-ESCB Recommendations on Securities Settlement Systems and Central Counterparties* were taken into account as a background for the Consultation Paper.

Part 1 of the CP: Appropriate regulatory framework for CSDs

1. Scope and definitions

Exemption on government debt management offices (Question 2)

The rationale of the possible exemption for the offices managing the issuance of government debt could be specified, as well as details on the possible implications of such exemptions on the stability of settlement systems.

Settlement function (Questions 3 and 4)

ESMA agrees with the Commission's approach of having a high level definition of settlement function (pp. 7-8). A possible fine-tuning of such a definition could be considered. Useful background may be found in the definitions included in the Commission Services' working document on definitions of post-trading activities[1] and in the Glossary annexed to the CESR-ESCB Recommendations.

In this context ESMA recommends to align the definitions in the CSD legislation with internationally adopted one and to consider a simpler definition of the settlement function, such as the exchange of securities against cash or free of payment with the aim of completing a transaction in securities.

The Commission suggests that the settlement function could be defined as the operation of a securities settlement system (SSS).

Although T2S is referred to in more detail in a separate section below (under outsourcing), ESMA notes that the definition of the settlement function should be compatible with the exemption proposed for CSDs outsourcing to T2S. The outsourcing of CSD tasks to T2S should not be prevented by the design of the definition of settlement function itself, notably taking into account the possible uncertainty in the status of T2S.

In particular, it is important to ensure that CSDs outsourcing essential tasks constituting the settlement function are still considered to be operators of SSSs and that T2S performing settlement tasks on behalf of CSDs does not qualify as an SSS operator.

Securities Settlement System (SSS) (Question 5)

ESMA considers that the definition of an SSS is key, as well as clarity in the core functions of a CSD (pp. 6 ff.). The Settlement Finality Directive (SFD) has represented a very important tool for ensuring safety in SSSs, as recognised by the Commission in the *Evaluation report on the SFD*[2]. Neither have the Member States nor the Commission raised any problems as regards the definition of SSS. ESMA believes therefore that the definition of SSS under the SFD should not be changed.

Non-designated systems

The CP suggests widening the definition of settlement function to '*include the operation of any other, non-designated securities settlement system*' (p.8).

It should be clear which precise systems correspond to such a category (non-designated), what their importance is, and in particular which the implications of such a change are.

Designated systems

[1] Working document/MARKT/SLG/G2(2005)D15283.
[2] http://ec.europa.eu/internal_market/financial-markets/docs/settlement/evaluation_report_en.pdf

The CP still refers to the notification of designated systems to the Commission (p. 8). Because Article 1 of the Omnibus Directive amended Articles 6(3) and 10(1) of the SFD, and added Article 10a, this reference may need an update. This change consisted of assigning to ESMA the duty to keep such a register and thus requires designated systems to be notified directly to ESMA. The legislation on CSDs could include an alignment of Article 2 of the SFD with the amended Articles 6(3) and 10a, thus expressly referring to the notification to ESMA.

Grandfathering clause (Question 11)

Whereas grandfathering clauses are mainly policy-related they do have some technical implications. The CP (p.11) includes a proposal that 'Member States could also notify to ESMA those CSDs that operated before the date of entry into force of future legislation. CSDs could seek authorisation for the purposes of future legislation within a certain period after entry into force of future legislation'.

ESMA supports the suggested approach that is in line with the EMIR proposal which will ensure that all existing CSDs will comply with the new legislation. In this respect, it is particularly relevant to establish a clear deadline for authorisation.

3. Access and interoperability

Access of market participants to CSDs (Question 16)

ESMA welcomes the fact that according to the CP limits on access should only be based upon risk grounds, following the main lines of CESR-ESCB Recommendation 14 (p. 16).

This is welcomed and confirms the interpretation that the criterion for refusals of access under Article 34(3) of MiFID is solely based on risk and not on commercial grounds that would facilitate discretion of entities receiving access requests.

Barrier 9 (Questions 18 and 19)

After some initial steps where the market was called to act, notably under the CESAME and MOG structures and the framework resulting from the Code of Conduct on Clearing and Settlement, the Commission has recognised that not all Giovannini Barriers have been dismantled. Legal change is therefore being proposed in several post-trading areas, EMIR, the Securities Law Directive (SLD) and the now expected legislation on CSDs being key examples.

For understandable reasons, the Commission has not considered changes to company law. As noted in the CP, '*the removal of restrictions would be 'without prejudice to company law"* (p. 17).

ESMA wonders whether an effective removal of barrier 9 could occur without harmonising certain aspects of company law, in particular if the barrier has a company law nature, i.e. if it is entrenched in national company law.

As recognised in the CP, there is a clear impact on company law that should not be disregarded, notably as regards the split of an issue. ESMA also considers that removing restrictions on existing issues would possibly have an impact on investor protection, e.g. by requiring a possible shareholder approval for the shift of an issue. It will, therefore, closely follow the future potential impacts of the foreseen provisions.

4. Prudential rules and other requirements for CSDs

Risks

Under section 4 on prudential rules and other requirements for CSDs (p. 20), the Consultation Paper includes definitions of several risks which SSSs and their operators are subject to. Also a mapping of these risks against the CESR-ESCB Recommendations is presented on p. 21 of the Consultation Paper.

ESMA suggests such definitions would be fine-tuned as described below.

Settlement risk vs. liquidity risk

It would be relevant to further clarify the concepts of settlement risk and liquidity risk and their relationship (p. 20).

Liquidity risk and settlement risk are presented separately in the CP, whereas the CESR-ESCB Recommendations consider that fails (covered under settlement risk) may result from credit risk and liquidity risk. The CP also suggests that both delays and fails ('*default of a payer*') are included under settlement risk and that liquidity risk only relates to fails.

ESMA also suggests to clarify the concept of delays, which are not different from fails in so far as they imply settlement after the intended settlement date. However, ESMA agrees that delays in settlement instructions during the same settlement date may result in liquidity risk.

Pre-settlement risk

A reference is made to such a risk when referring to securities lending (p. 23 of the CP) although in that regard one could refer instead to settlement risk as defined under the CESR-ESCB Recommendations and quoted above.

Liquidity risk

Regarding liquidity risk in particular, no reference is made to the applicable CESR-ESCB Recommendation in the table on p. 21 of the CP. Liquidity risk is however considered in the Recommendations, notably under Recommendations 8 to 10 and 19. Also Recommendation 6 includes a useful reference to the need for CSDs to avoid liquidity risk. For future reference, the table could therefore be updated in this respect.

Custody risk

As regards custody risk in both sections 4.1 and 4.11 (pp. 20, 31), no reference is made to misuse of assets, poor administration and inadequate recordkeeping. Although it may be the case that the Commission considered the first two under fraudulent action and negligence, it may be useful to keep the reference to inadequate record keeping, also specified in the CESR-ESCB definition. In this context the interaction between the SLD and the future CSD legislation should be considered.

Systemic risk

A similar consideration also applies to the definition of systemic risk (p. 20), which could be completed with the reference to spill-over effect and operational and financial reasons as stated in the CESR-ESCB Recommendations (Glossary, p. 213).

Securities lending (Question 27)

ESMA agrees that there should be no obligation to lend or borrow securities on CSDs, nor very specific requirements upon system operators in the design of such systems (p. 23).

It is however welcomed to mandate the offering of a securities lending service, either centrally or bilaterally.

Lending services are particularly welcome in the context of ex ante measures fostering settlement discipline.

It would however be useful to assess the impact of such systems on lenders liquidity (particularly when lenders are SSS participants or the SSS operator) and therefore to ensure the right balance between fostering lending and ensuring sound liquidity management.

This seems to be the Commission's line, in view of the reference to liquidity requirements for CSDs extending credit to system participants (p. 32 of the CP), but solutions are also required for system participants providing such lending, even if on a pool basis.

Guarantee funds (Question 31)

In the context of DVP the CP includes a reference to guarantee funds (p. 25).

Having in mind the diversity of available arrangements in that context (from simple insurance schemes, in small markets, to sophisticated CCP like systems, usually present in larger markets), ESMA advises the Commission to refer in the legislation to 'guarantee arrangements' instead of a 'guarantee fund'.

The CESR-ESCB Recommendations and CPSS-IOSCO Recommendations already consider this diversity of guarantee arrangements, even if under the context of CCPs.

Part 2: Harmonisation of certain aspects of securities settlement in the EU

Settlement discipline

ESMA appreciates the Commission's initiative to address the key issue of settlement discipline and fully supports the need for harmonisation in this regard (Question 44).

Short selling and settlement discipline

In the CP, a reference is made to an alignment with the Commission proposal on short selling: '*This would be in line with the proposed regulation on short selling*'. From a technical perspective and as previously noted by CESR to the Commission, '*Settlement fails may also occur for a number of other reasons, including frozen accounts and delayed deliveries on a back-to-back or a contingent transaction*' (p. 35). They may also be due to operational failures, including human error, among other causes. The Commission also recognises this wide span of reasons and this view is welcome.

Therefore, in view of the fact that short selling could be only one of several possible reasons for fails, the two initiatives could be referred to as complementary.

Definition of settlement fail (Question 46)

ESMA supports a high level definition of settlement fail. Although the concept of a settlement fail is commonly accepted (trades that are not settled on the date agreed upon by the buyer and the seller), an exact definition of settlement fail does not exist. Adopting a common definition would provide clarity as regards the application of a settlement discipline regime and would facilitate comparability between different CSDs. This could be complemented by regulatory technical standards to take into account the different type of financial instruments settled and the different settlement practices.

Scope (Question 47)

As regards the scope of markets to be considered, settlement discipline should be applicable irrespective of the trading method. Regulated markets, MTFs, other organised trading facilities and OTC trading should

be covered without discrimination. Adaptations may be justified on the basis of the settlement processes and practices associated with the execution method for a given transaction (pp. 36-37).

Ex ante measures fostering settlement discipline (Question 48)

Following up on CESR's earlier advice to the Commission in the context of the Member States Working Group, ESMA supports measures to reduce settlement fails, notably by:

(i) identifying beforehand a settlement instruction that will most likely fail (identification via 'pre-matching' procedures, for instance);

(ii) promoting techniques such as 'early matching' or 'early settlement';

(iii) splitting a failed settlement instruction in two instructions (one instruction that will settle and one instruction that will fail);

(iv) re-instructing a settlement to be made later during the day where possible, provided the risk of unattended consequences is mitigated; and

(v) promoting Straight Through Processing (STP), that may reduce the likelihood of operational errors and thus reduce the risk of fails associated to operational risk.

Ex post measures / enforcement and sanctioning (Question 49)

Following up on CESR's earlier advice to the Commission in the context of the Member States Working Group, ESMA suggests measures to enforce settlement discipline and sanction settlement fails, notably by:

(i) penalising participants that cause settlement fails or fail to match within specific deadlines, as well as dissuasive measures, from naming and shaming and/or cash penalties to prosecution by authorities, provided that the necessary powers are conferred;

(ii) designing dissuasive penalty regimes, where the costs of the penalty (e.g. financial or reputational) should outweigh the advantages of causing the fail and be applied consistently - rules in this regard should however be proportionate and should leave room for flexibility to allow for valid exemptions or other enforcement measures such as suspensions; and

(iii) imposing buy-in and cash compensation procedures, as these provide clarity on when a settlement fail will be avoided or its effects mitigated - harmonising these procedures at the trading level and by CCPs and CSDs is considered important because differences might become an undesirable means of competition between markets as the sums involved may be substantial.

Providing for cash compensation where the buy-in procedure is unsuccessful, to be calculated by the market operator, CCP or operator of an SSS and offered to the receiving party at the cost of the failing

party - the cash compensation would need to be based on the original value of the financial instruments to be delivered (percentage of this value) plus a fine for the damages incurred.

As regards fines, for each day a seller fails to deliver the financial instruments, a sufficiently high penalty should be imposed to encourage it to quickly settle pending transactions and to deter the seller from causing additional fails in the future. The level of the fine could be made proportional to the recurrence of the fails for a given person and apply either automatically (all cases of fails) or only after a certain number of fails by a certain party (tolerance level), but in any event the level of the fine should create a strong incentive to ensuring a very low level of fails.

ESMA welcomes the acceptance by the Commission of CESR's suggestion of a harmonised monitoring and reporting scheme for settlement fails. Reporting of failed transactions to the public and/or to the authorities may also be considered as an incentive to avoid fails (p. 37).

Public authorities have an interest in receiving information to analyse the level of settlement discipline. Public information is also desirable to help market participants to identify the most efficient CSDs. It is, therefore, advisable to establish a harmonised framework for reporting and for public disclosure (p. 37).

As anticipated, some measures would also impact legislation other than the one aimed at CSDs: buy-in procedures and cash compensation rules are generally imposed by CCPs and not CSDs, since the majority of the markets make use of CCP services. In this regard the Commission's approach of dedicating a separate section of the CP to the harmonisation of settlement (Part II) is wise, as Part I would only cover CSDs.

The proposal for technical standards on settlement discipline is welcome, particularly in order to ensure proper enforcement and consistency at the European level, with supplementary benefits for settlement efficiency and for the mitigation of regulatory arbitrage.

Settlement cycles (Question 50)

ESMA notes that the new legislation may be useful in the harmonisation of settlement cycles, but not necessarily sufficient if its personal scope only covers CSDs (p. 5 and pp. 36-37). This is due to the fact that settlement cycles are in many cases set by market operators. Additional legislation or an enlargement of the scope of the measures provided under Part II of the CP on the harmonisation of certain aspects of securities settlement may be needed, so as to cover other entities than CSDs, in case the Commission aims at full consistency within the post-trading environment. In addition, the impacts of such measure also toward non-EU markets should be properly analysed.

TARGET2-Securities

Status and implication of some definitions

In the case of T2S the participating CSDs are expected to carry out, as described in section 4.10 of p. 30 of the CP, '*an outsourcing of IT tasks necessary for the performance of the settlement function*'.

As referred to in the CP, '*the distinction between CSD functions and the corresponding tasks is often difficult to address*', IT systems being an example of such tasks (p. 30).

Under the outsourcing exemption, one of the requirements is an '*appropriate legal, regulatory and operational framework*' (p. 30).

Due to the definition of the core functions of CSDs as presented in the CP, there may be a risk that T2S qualifies as a CSD. T2S has however been designed as an outsourcee technical platform, rather than a CSD as such or a SSS. Its status must be clear from a legal, regulatory and supervisory point of view at launch time.

Exemption on full control

ESMA positively notes the narrow nature of the exemption from the duty to ensure full control for CSDs outsourcing their settlement function to T2S, as described in section 4.10 of the CP (p. 30).

Location of accounts

Although ESMA understands that the Commission's intention is to address the issue of location of securities accounts in one single piece of legislation, i.e. the SLD, a rule specifying the location as the place where the accounts in the T2S context are legally attributed (relevant CSD's place of incorporation and business) would be welcome in order to avoid divergent interpretations. This would reduce uncertainty on the relevance of the location of the IT infrastructure serving the settlement system managed by a given CSD, or whose operation is outsourced by a CSD to T2S.

Finality of transfer orders and of full title

Article 5 of the SFD provides that '*A transfer order may not be revoked by a participant in a system, nor by a third party, from the moment defined by the rules of that system*'. This SFD solution seems insufficient regarding multilateral contexts such as T2S.

Also under Article 2(i) of the SFD, transfer order shall mean:

'*any instruction by a participant to place at the disposal of a recipient an amount of money by means of a book entry on the accounts of a credit institution, a central bank or a settlement agent, or any instruction which results in the assumption or discharge of a payment obligation as defined by the rules of the system, or*

an instruction by a participant to transfer the title to, or interest in, a security or securities by means of a book entry on a register, or otherwise'

These provisions do not ensure that system operators will fully converge on finality as defined under their systems' operational rules. This may prevent the harmonisation required by the multilateral character of T2S.

ESMA welcomes therefore the proposed harmonisation of rules on the moment of entry of transfer orders and the moment of irrevocability of transfer orders (p. 18 of the CP).

Apologising for submitting this contribution following the close of the consultation period, we hope you will find it useful. ESMA remains at your disposal should you need further advice in the development phase of the Commission's legislative proposal.

Should you need any clarifications on the above, please contact either me, Jean-Pierre Jouyet, Chair of the Post-Trading Standing Committee or Carlo Comporti, Acting Secretary-General of ESMA.

Yours sincerely,

Carlos Tavares
Vice-Chair
ESMA