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CSDR 2022

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Settlement discipline regime: next steps

As the industry meets the 6-month mark since the enactment of the settlement fines and reporting provisions of the Central Securities Depositories Regulation (CSDR), market participants reflect on the next steps to improving settlement discipline. The Settlement Discipline Regime, implemented on 1 February 2022, saw the introduction of cash penalties and settlement fails reporting — with mandatory buy-ins being postponed until 2025, to the relief of the Joint Trade Associations.

With firms adapting to the new regulatory landscape, improvements to the regime are in the pipeline as the European Commission proposes a review of CSDR. Amendments to the ongoing regulation aim to make securities settlements in the EU safer and more efficient, and will be discussed within working groups of the key industry associations.

In this year's CSDR Annual, Ted Allen, director of business development, securities finance and collateral at FIS, discusses moving toward a digital future to improve settlement risk for the sector, incorporating the use of distributed ledger technology and smart contract. From an environmental, social and governance (ESG) perspective, Jacob Gertel, senior content manager, legal and compliance data at SIX, looks at the impact of ESG on the securities lending process, taking into consideration the effect on CSDs. SFT will also explore the reaction from market participants to the delay of the mandatory buy-in rules.

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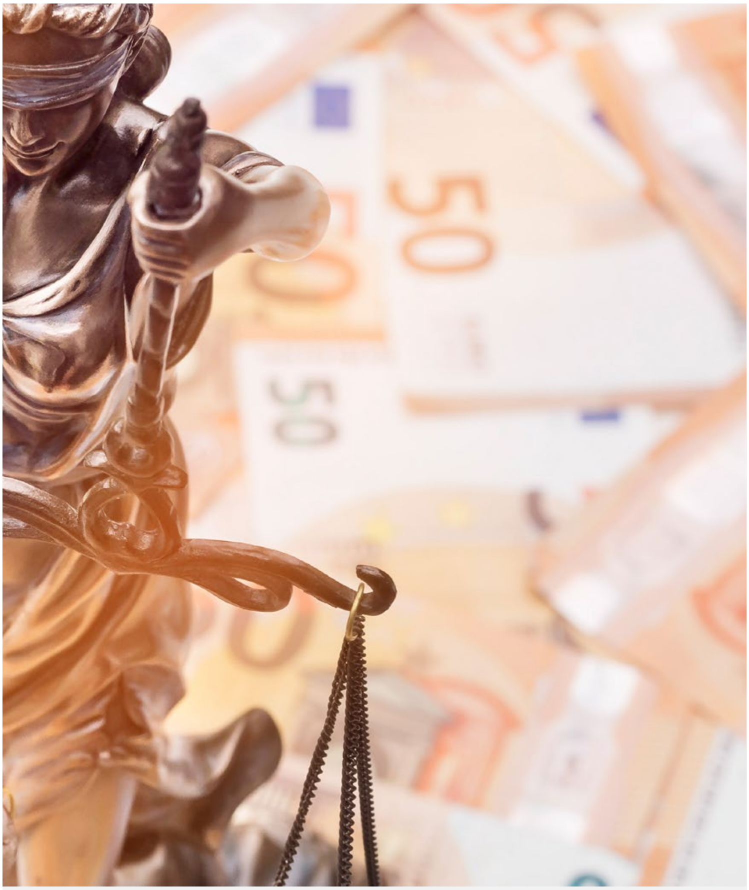
Inside this handbook



ESMA consults on cash penalty procedures under CSDR

The European Securities and Markets Authority has launched a consultation to assess industry reaction to potential changes to cash penalty procedures under the Central Securities Depositories Regulation (CSDR).

These proposed changes would allow central securities depositories (CSDs) to collect and distribute all forms of penalties for failed settlement under the CSDR settlement discipline regime, including penalties for centrally cleared transactions.

Under the current regime, which was enacted in February 2022, cash penalties applied to settlement fails for centrally cleared transactions are collected and distributed by central counterparties (CCPs).

Respondents have been asked to submit their input to the consultation process before 9 September 2022. ESMA expects to publish a final report analysing the consultation findings, along with revised regulatory technical standards (RTS), before the end of the year.

European Commission publishes proposal for CSDR review

The European Commission (EC) has published a proposal for the review of the Central Securities Depositories Regulation (CSDR).

As part of the Capital Markets Union Action Plan — a project launched to establish a true single market for capital across EU member states — the review aims to make securities settlements in the EU safer and more efficient.

Additionally, the proposal aims to facilitate CSDs' ability to offer cross-border services and improve their cross-border supervision.

In the review, amendments are required under the settlement discipline regime of CSDR, which states that settlement fails are not subject to the penalty mechanism in situations where "a settlement fail is caused by factors not attributable to the participants to the transaction or where a transaction does not involve two trading parties".

Furthermore, it specifies that cash penalties should be calculated either until the end of the buy-in process, if the Commission has adopted the relevant implementing act, or until the actual settlement date, whichever is earlier.

The proposal continues to amend matters relating to third-party CSDs, the passporting regime and banking-type ancillary services.

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The International Securities Lending Association (ISLA) has announced that it will be reviewing the proposal within the Market Practice Steering Group and Regulatory Steering Group.

To accompany the package, the EC has also issued a chapeau communication and Q&As, as well as an impact assessment and a summary of the impact assessment.

Numis extends partnership with Torstone Technology

Numis, a UK-based investment bank and corporate adviser, has extended its partnership with Torstone Technology to manage its obligations under the Central Securities Depositories Regulation (CSDR).

Under the renewed partnership, Numis will continue to utilise the technology vendor's Post-Trade platform, a cloud-based SaaS solution, covering electronic trade capture, allocation, confirmation, settlement, accounting, risk, corporate actions, reconciliation and regulatory reporting.

The platform is designed to increase automated straight-through-processing and reduce manual effort.

Torstone's partnership with Numis began in 2019, when Numis first onboarded Torstone's Post-Trade platform.

Commenting on the decision, Tim Valmas, head of technology at Numis, says: "For CSDR, having a best-in-class solution that meets our obligations and gives us the flexibility to adapt to the regulation as it evolves is vital. As an existing user of Torstone Post-Trade, extending our use of the platform was a natural choice as it suits our needs, ensuring we are fully prepared for the regulation."

Brian Collings, CEO of Torstone Technology, comments: "We are delighted that Numis has extended their use of Torstone Post Trade to manage the requirements around CSDR. As this regulation evolves, we remain committed to supporting Numis, and all of our clients, in meeting their regulatory obligations and achieving greater operational efficiency."

Euroclear to use Taskize for CSDR Settlement Discipline Regime

Euroclear has selected a Taskize solution to appeal penalties on both its international central securities depository (ICSD) and its domestic CSDs, following the implementation of the Central Securities Depositories Regulation (CSDR) Settlement Discipline Regime on 1 February 2022.

The Settlement Discipline Regime of CSDR requires impacted European CSDs to automatically apply financial penalties to market participants that fail to complete transactions on the contractual settlement date and subsequently report those failed trades.

To meet standards of the CSDR, Taskize's Bubble has been specifically built around a Euroclear penalty appeal template – allowing Euroclear and their members to efficiently process penalty appeals.

By using Taskize, Euroclear members benefit from a single, streamlined digital channel to manage the penalties and appeals process, in addition to achieving reduced resolution times for daily operational issues.

The platform also enables market participants to report buy-in trades, as and when this element of the Settlement Discipline Regime is introduced.

Stéphane Bernard, chief operating officer at Euroclear bank, comments: "Taskize is our preferred client service channel and has been successfully deployed globally across Euroclear. The ability to extend its use to support the specific workflows for appealing penalties under the new CSDR Settlement Discipline Regime means we can bring further efficiencies to our members who can join the network free of charge as part of our sponsoring licence."

Philip Slavin, CEO and co-founder of Taskize, says: "Extending Taskize to support custom workflows is part of our wider strategy, so we are thrilled that Euroclear has used this capability to build out a specific penalty appeal process to enable their members to manage appeals more efficiently under CSDR."

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Ted Allen
Director of business development, securities finance and collateral
FIS

CSDR: let's get digital

Ted Allen, director of business development, securities finance and collateral at FIS, discusses why moving to a DLT and smart contract future is a better fix for settlement risk

Death and taxes are two certainties of life. Certainties, even when unattractive, give confidence and assurance that an action, or indeed inaction, will achieve a given result, whether that result is dictated by nature, circumstance, or government. Timely settlement, by contrast, is hardly a certainty in securities finance. Regulations, market behaviours and client expectations have been moving increasingly toward a risk-minimised environment with ever improving levels of certainty.

If this is indeed a desirable end-state, how can the desired levels of certainty really be achieved? In delaying, and perhaps abandoning, mandatory buy-ins while a distributed ledger technology (DLT) pilot is given the chance to prove its mettle, the EU has been bold. We will discuss why we think mandatory buy-ins was a flawed approach and why the DLT pilot, if adopted, can address not only settlement risk, but also a host of other shortcomings.

Controllable risks

Mandatory buy-ins were mooted because markets require confidence to function: confidence in prices, liquidity, and certainty of transactions in terms of commitment to deliver what was promised. Regulators balance free, open and transparent markets with providing sufficient safeguards for controllable risks.

Controllable is the key word because there needs to be some level of risk to justify the returns on offer. No legislation can or should eradicate risk and retain some degree of return; markets cannot exist without a certain amount of both. They must rely on some degree of 'caveat emptor' — let the buyer beware — as there will always be investors or traders that cannot be protected from themselves, as many on the losing side of the Terra Luna debacle will attest. So, what are the controllable risks for securities finance, and should we be addressing the symptom or the cause?

Why buy-ins?

The safety net of a buy-in has long been a market feature, but not one that is applied lightly. There are two key reasons for this. The first is that relationships still matter. Undertaking a buy-in has ramifications for future trading, more so in the still relationship-driven world of securities finance compared with the relative anonymity of some other markets. In securities finance, your counterparty is known to you, and it is likely that future trades will be proposed and others in place already. That issue works both ways, of course. Lenders that enact a buy-in too quickly can be just as unpopular as borrowers that fail to return a security on time.

The second reason is market impact. Buy-ins are less likely to occur in a liquid security easily available on the open market, whether to borrow or buy. They are more likely when a security is already difficult to obtain either through an alternative borrow or purchase in an already frothy market. Adding a mandatory buy-in would have simply added to the supply-side pressure with potentially little advantage to the instigator.

These issues are why many market participants and trade associations pushed the European Commission to reconsider the CSDR rules, and in particular mandatory buy-ins. With discretion, market participants can make a call based on the circumstances of the failure to deliver and the prevailing market conditions to determine whether a buy-in is the right path to resolution, or indeed even possible without actually making the overall situation worse.

Understanding the concerns

CSDR already seeks to increase the certainty of settlement through the fines for poor performance or behaviour. The buy-in proposal itself does include criteria upon which it cannot be actioned, such as the bankruptcy of one party or the issuer of the security in question. However, the lack of discretion and self-regulation absent from the buy-in mandates were particularly troubling.

> *"Getting ahead of the game reduces the causes of failures and brings benefits to the broader financial market and all its stakeholders as a result"*

So of the three pillars of CSDR — transaction reporting, cash penalties for settlement fails and mandatory buy-ins — only the first two remain for now. As the CSDs took on reporting, FIS as a primary technology and market data provider to the securities finance markets built our solutions for the second pillar.

On the basis that prevention is always better than cure, we worked hard on integrating these two weapons in our armoury to identify and mitigate failure risks wherever possible. That effort ranges from working with other market infrastructure providers to increase the accuracy of standard settlement instructions, errors of which cause many of the far leg settlement fails in the market, to integrating our intra-day market data into all our systems. This provides early warnings of short squeezes and other liquidity crunches that can bring destabilising effects to the market.

We are now investigating enhancing that with AI-driven predictions for settlement fails. Getting ahead of the game reduces the causes of failures and brings benefits to the broader financial market and all its stakeholders as a result.

We have also provided more automation around partial settlements and holds to ensure these can be accepted, and the fines therefore minimised, if both parties agree. We have added the ability to import and process the fines for maximum straight-through-processing (STP). Some argue that mandating partials would go further to alleviating the problem and our clients can support this right now with automated STP.

Enter the DLT pilot

The third pillar of mandating buy-ins has been delayed, partially in favour of a DLT pilot regime announced by the EU in June. This scheme will test the capabilities of secondary market infrastructure for digital securities covering tokenised traditional securities as well as digital native securities.

The key provisions of this regime are that investment firms can operate a DLT-based multilateral trading facility (DLT MTF) and CSDs can operate a DLT securities settlement system (DLT SS). Interestingly, both can also create a combined DLT trading and settlement system (DLT TSS). The scheme will commence in March 2023 and run for six years. There are limits on the size of the individual securities and issuers and the overall size of the markets, so it really is a pilot — but this kind of adoption would create a technical solution not only for the settlement fails, but for a host of other causes of friction, inefficiency and costs in the current market.

DLT and smart contract-based securities finance markets would benefit regulators as well as market participants. As the trades are agreed, the smart contract is created. With a node on the networks, the regulators could get all the reporting they need directly, rather than rely on the CSDs or transacting parties to report. Transaction reporting would happen immediately as the trade is agreed and settlements completed with a single golden source of truth. Such digital regulatory reporting would eliminate the inconsistencies in current reporting and give regulators the full, accurate, real-time view of the deals generated directly from the smart contracts. The regulators could be proactive in real-time and not have to deal with delayed, inaccurate or wrongly formatted data as is the case now.

The benefits of smart contracts

Smart contracts will also address other sources of risk and friction in the markets. For example, eligibility schedules can sit directly in smart contract in a consistently interpretable manner, as with the Common Domain Model (CDM) currently. Widespread adoption will mean that algorithmic collateral optimisation tools can then really take advantage to allocate collateral globally in the most efficient way.

DLT-based collateral with integrated networks will allow collateral to move instantly between parties regardless of the location. Contrast that with the current situation where, if you want to move collateral from one venue to another, it is slow, costly, inefficient and with potential to fail causing unintended further costs and credit exposures.

Global firms have to keep significant buffers in multiple locations for intraday liquidity risk and they take on the risk of settlement failures for any cross-venue collateral move or substitution. DLT-based networks will allow collateral to be called, moved and optimised in real time. This would benefit participants in enabling a more efficient asset allocation globally, as well as reducing systemic risk and costs arising from the current operational constraints.

There are further potential benefits, such as less need for a post-trade reconciliation or comparison process, and for the processing of corporate actions as well as the obvious benefits of 24/7 trading and settlement capabilities and atomic settlement. Meanwhile, reduced barriers to entry will open up the capital markets to a greater number of institutions and ultimately enhance overall liquidity.

Overcoming the obstacles

The benefits of moving to a DLT and smart contract future are manifold and manifest, but we also must be realistic. These markets are slow to change, and there are obstacles and entrenched interests that can hold things back.

For one thing, the question of public and private chains will need to be shaken out. We are already now seeing all the major custodian banks have some kind of DLT initiative, which is giving rise to multiple private chains. Some are using commercial bank coins to represent cash; others are operating DVD or FOP only. For the global benefits to be realised, these networks will need to interoperate while still providing all the safety features of regulated ecosystems. That may be in the form of permissioned forms of public chains with central bank digital coins.

"The benefits of moving to a DLT and smart contract future are manifold and manifest, but we also must be realistic. These markets are slow to change, and there are obstacles and entrenched interests that can hold things back"

We are confident the market will get there and are supporting the initiatives, but we will see how things evolve over the next few years. We are finally getting to the point where a wholesale overhaul of market infrastructure is not only possible but probable. We must applaud the foresight of the regulators to put their faith in the potential of these new technologies and, as a key technology provider to these markets, we are adapting our systems and investing in the future. Getting it right will always trump doing it more quickly.

ESG principles in securities lending – the essential role of data

As concerns around sustainable finance increasingly interact with securities lending businesses, the role of high-quality, highly available ESG data takes on new importance for market participants, in particular CSDs. Jacob Gertel, senior content manager, legal and compliance data at SIX, evaluates ESG impacts on the securities lending process and how data providers can provide the answers

Responsible investing is one of the most widely discussed issues within the securities business. Concerns around climate change, diversity, equality, governance and data privacy have driven environmental, social and governance (ESG) concerns to the top of corporate agendas, while asset owners, investors, lenders and borrowers are looking for ways to incorporate ESG principles into their investment strategies.

Regulators and policymakers are also exploring ways to incorporate and standardise ESG requirements within the regulatory framework. Although specific regulations covering ESG have yet to be codified, a wealth of academic literature, market surveys and pronouncements from the regulators themselves makes clear the direction of travel: ESG considerations will become standardised and embedded as part of a sustainable finance model.

ESG and securities lending

Demands for more sustainable finance now touch almost every area of the investment process, and that includes securities lending. Given its central role in, for example, meeting settlement and collateral requirements, liquidity provision, price discovery, hedging and central banks' monetary policies, this should not come as a surprise. Indeed, a recent survey by the Risk Management Association's Council of Securities Lending found that 95 per cent of respondents believe that ESG investing and securities lending can coexist.

Even though it is still currently a small minority that always consider ESG in their securities lending process, we are seeing a growing number of issuers, lenders and borrowers of financial instruments investigating the ESG footprint of their investment and lending decisions and the processes behind them.

For investors with an ESG agenda, this is often about directing capital in ways that encourage 'good' behaviour – for example by raising the cost of capital for firms whose activities are deemed not to align with responsible investing. More generally, the decision to incorporate sustainability considerations into lending and investment decisions is more about building up a positive brand identity and avoiding the reputational damage and costs that stem from associations with firms that are losing social permission to operate.

At its most pragmatic, the decision to incorporate ESG thinking into investment processes is simply to avoid being left with stranded assets that are difficult to sell on in the future.

Challenges and questions

Whatever the driving factors, thinking about securities lending in this way does raise a number of fundamental questions. Without standardised regulation for combining the requirements of sustainable finance with those of securities lending, careful consideration is needed. Issues around who qualifies as an approved counterparty, which restrictions are in play, recalls for proxy voting and rules for reinvention, all fall under this umbrella.

Take the counterparty issue as an example. Questions naturally arise around whether and how far the ESG credentials of that potential trading partner should be considered. Additionally, there are challenges around how best to assess the ESG credentials of issuers whose securities are being purchased and whether to apply criteria such that certain securities are never lent at all. This has implications for the level of granularity required when looking at a basket of securities received as collateral, and whether a lender should examine individual components or take a more holistic view.

As to the borrowers in any transaction, should the borrower use their voting rights in cases where the securities come with voting rights, and if so, how? How does a lender respond to a borrower who would vote against the lender's ESG principles and intentions? A lender who takes this stance would need to understand the borrowers' own intentions, their beneficial owners' identity and intentions and the borrower's own ESG parameters and ratings.

These questions are important for lenders whose policy is to invest solely in sustainable products and would not want their borrowers to use borrowed securities in a way that is counter to its ESG values. The 'Know

Your Borrower' (KYB) approach could mitigate such a risk, such that the lender approves the transactions only after a solid borrower screening and evaluation of their intentions, particularly where voting rights are concerned, has been conducted.

Borrowers can carry out similar Know Your Lender (KYL) checks, therefore ensuring that the lenders' ESG principles are also in line with their own. KYB and KYL due diligence can both be supported by data on the corporate level: lender, borrower, 'investee companies', as well as the underlying securities of the securities lending transaction.

There are also internal processes that may need to be updated. Overall, adoption of ESG principles in securities lending raises questions about how industry participants can develop communication and reporting lines between managers of their securities lending programmes and ESG management within the organisation.

At a more technical level, when a beneficial owner wishes to measure the effectiveness of its ESG efforts in its securities lending programme, the measurement methodology needs to be both appropriate and adequate. That may require policies on when to recall on loan securities and how these kinds of customisations should be implemented, all the while taking into account any potential impact on overall flow and revenue.

As for proxy voting, a lack of timely information about proxy record dates and voting questions complicates the process of recalling stock that is on loan. When RMA survey participants were asked to name 'measures that might facilitate the application of ESG principles to their securities lending programme', 43 per cent said that they want more transparency around proxy record dates and questions.

Collateral, CSDR and data

One of the more interesting and consistent themes running through debates about ESG policies and securities lending is that of collateral.

In general, less collateral is required for securities lending of assets marked positive for ESG. That is good for market participants broadly. However, it is less good news for the EU's central securities depositories (CSDs) which — facing the complexities of the penalty regime inherent in the Central Securities Depositories Regulation (CSDR) regime — have many more questions to think about.

As with other aspects of CSDR more generally, the Classification of Financial Instruments (CFI) code that describes the structure and function of any given instrument plays a critical role. To ensure that financial institutions involved in the transaction have the right CFIs, it is important to have a so-called golden source of data, which encompasses all the data in every system of record within a financial institution. Timely data generation, collection, enrichment, processing and distribution are therefore key factors for the integration of ESG into the securities lending process.

Ensuring that data is of sufficiently high quality and accuracy requires significant resource and expertise. Specialised data vendors like SIX, that have market leading coverage of regulatory and ESG data, offer the required data to support financial institutions with their lending processes. Indeed, the use of this valuable data is highly recommended since it reduces the process costs of ensuring an adequate securities lending transaction.

Data for ESG monitoring and compliance

Of course, the same standards apply to sustainable securities financing as they do to all other financial transactions. At SIX, we decided to delve deeper into the issue. We looked at aggregated information from existing reports and studies to clarify the different types of ESG-specific data that is required, along with its various attributes and challenges, including adoption, coverage, input data sources and metric offerings.

We found that the main concerns regarding ESG data are:

- The general lack of availability, with timeliness and coverage of given regions, markets, segments or instruments raised as specific concerns.
- The quality of the data inputs, as inconsistencies,

reliance on self-reported data, lack of completeness, obvious errors and the use of subjective or unaudited information are all contributing factors to lower data quality.
- The risks associated with over-dependence on large volumes of data, with issues such as cybercrime, data ownership, theft and misuse all shown to be of significant financial relevance.

In this sense, data considerations for sustainable finance and securities lending are no different from other transaction types: availability, sourcing and quality are fundamental properties that any data provider should be able to guarantee.

However, there are also specific data requirements that any securities lending business needs to understand when monitoring their overall processes and individual transactions against internal or external ESG standards. At both pre- and post-transaction stages, data of the highest standard is necessary to perform the following key functions:

- **Sanctions monitoring**. As with any area of securities trading, both the lender and borrower, whether legal entities or private persons, need to be constantly screened against national and international sanctions regimes — as should all securities that are part of the transactions. Sanctions monitoring should be part of the pre-contractual processes around KYL, KYB and KYC standards, as well as throughout the contract lifecycle. If required, compliance professionals should alert the responsible and involved business units of any potential breaches or problems as soon as they are aware of them.
- **Meeting both parties' ESG preferences**. Investment firms should be able to identify, define and understand ESG preferences, based on regulatory and industry standards. This can include, but is not limited to, any EU Sustainable Finance Disclosures Regulation (SFDR) Principal Adverse Impact indicators. Preferences and indicators should be reflected in the investment firms' ESG questionnaires and core IT systems. They should also be able to ensure that the lending transaction matches these preferences during the entire lifecycle of the transaction.
- **Identifying ESG factors for issuers and securities.** Investment firms should be able to define and introduce a process that ensures ESG indicators are sourced on issuer and security levels, so basic reference data of the securities involved in the transaction, such as voting rights, trading venues, restrictions and ESG data, should be clearly available. Firms also need to monitor any acute change to those lender or borrower preferences. In the event that such changes occur, they must be able to alert the relevant business units and trigger required actions. In the case of positive developments, this might include the modification of transactions, such as reduction of credit spreads. In the case of a negative development, the action might involve offsetting or even cancelling the transaction.

In general, we found that market participants from the buy- and sell-side are often unsure about how best to align their lending programmes with their ESG objectives. Agent lenders that participate in open dialogue on how to balance lending decisions with ESG philosophies will be in a stronger position to capture a rare opportunity to distinguish their programmes from those of their peers and competitors.

However, that can only be achieved with the highest standards of data availability, sourcing and quality from data providers able to meet the new demands that ESG-focused investing now places on all market participants, including for securities finance. Market participants that choose data providers that deliver high quality reference, pricing, corporate actions, sanctions and regulatory data alongside ESG data in a standardised, easy to deploy format will be able to more comfortably adapt their activity and meet the needs of their clients.

An extended article by Jacob Gertel and Heiko Stuber has been published in the Journal of Financial Compliance Vol. 5, No. 4 2022.

Survey figures come from The Risk Management Association (RMA) (2021) 'Complementary, not conflicting: securities lending and ESG investing coexist'

Managing a new settlement regime

Broadridge's Paul Clark, head of international post-trade pre-sales, breaks down the Central Securities Depository Regulation and discusses key focus areas for market participants

Since its initial publication in the European Journal in 2014, the Central Securities Depositories Regulation (CSDR) has faced a variety of hurdles and challenges, but with its latest milestone – the Settlement Discipline Regime (SDR) – which came into force on 1 February 2022, the EU has taken a major step forward in harmonising securities settlement across all market participants in the region.

It is however important to recognise that there is still a significant amount of effort needed to resolve some of the most contentious topics in this regulation, especially regarding the mandatory buy-in process. It is likely that the latest postponement proposed by the European Securities and Markets Authority (ESMA) and its approval by the EU legislators will push back the overall timeline.

This is an opportunity for market participants to recommit their efforts to achieving industry best practices, streamlining functions and processes impacted by the CSDR regulation and supporting their clients throughout the journey.

CSDR overview

The CSDR aims to harmonise the authorisation and supervision of CSDs across the EU. It establishes both uniform requirements for the settlement of financial instruments in the EU and rules on the organisation and conduct of CSDs to promote safe and efficient settlement.

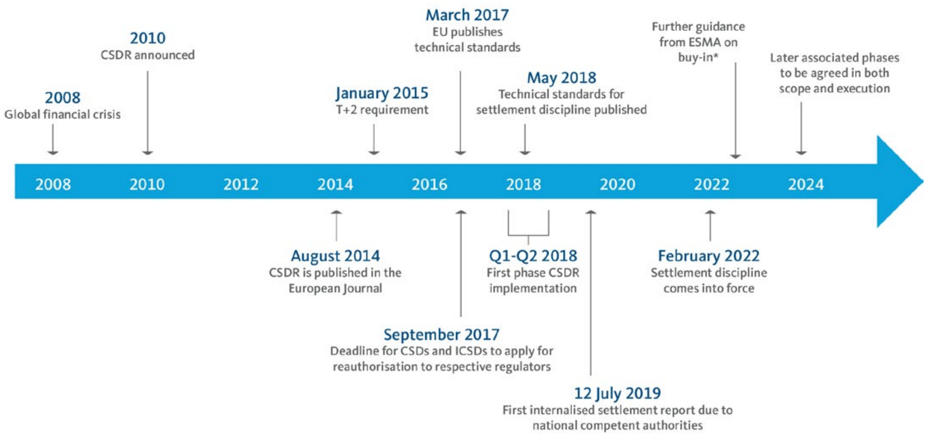
The regulation applies to EU CSDs (and ICSDs), issuers that issue securities in EU CSDs, participants and indirect participants at CSDs, and banks offering services to EU CSDs in the EU.

Originally introduced in 2014 along with MiFID II and EMIR, the CSDR regulation has achieved a significant milestone with the SDR which went live on 1 February 2022.

While viewed as contentious by some, the SDR has always been a central component to achieving the overarching objective of the regulation – to provide a set of common requirements for CSDs and their interaction with market participants across the EU, to harmonise aspects of the settlement cycle and to mitigate settlement risks.

In December 2021, the EU's securities markets regulator, ESMA, published a public statement calling for, "…an urgent change in CSDR to allow postponing the application date of the buy-in regime, while noting the importance of the entry into of

Figure 1: Significant CSDR events timeline



force of the rest of the settlement discipline regime measures (settlement fails reporting and cash penalties) on 1st February 2022 as planned."

This amendment to CSDR by co-legislators paved the way for the de-coupling of the applicable date for the provisions dealing with the buy-in regime from the provisions dealing with penalties and reporting.

As a result of these developments, ESMA does not now expect National Competent Authorities (NCAs) to prioritise supervisory actions in relation to the application of the CSDR buy-in regime.

Mandatory buy-in postponement

The postponement of mandatory buy-ins came perhaps as a relief to many market participants, as the delay allowed a further review of the scope of the rules. Nevertheless, it may have left some participants in a state of ambiguity on how to move forward today.

The amendment is expected to allow ESMA to develop draft technical standards addressing design challenges, as well as to reduce ambiguity around scope and process, not only from an implementation and operational perspective but also with respect to the potential implications for EU bond market liquidity in general.

2022 EU review proposal

In March 2022, the EU Commission published a series of proposals aimed at improving the EU settlement market without compromising its financial stability.

Following an impact assessment and comparison of all policy options, the proposals are intended to lower the regulatory burden on CSDs while improving their ability to offer a wider range of cross-border services. The proposals involve:

- Simplifying the passporting process by removing the possibility for the host supervisors to refuse the passport, and instead replacing it with a single EU-wide licence
- Enhancing cooperation between national supervisors by establishing colleges of supervisors and providing more powers to monitor risks
- Allowing CSDs with a banking licence to offer banking-type ancillary services to other CSDs within certain thresholds
- Modifying the timeline for implementation of mandatory buy-ins (two-step approach)
- Introducing an end-date for the grandfathering clause for EU and third-country CSDs

Any implementation of mandatory buy-ins could take the "wait and see" approach. While preliminary, there is evidence suggesting cash penalties will incentivise improvements in settlement efficiency, without endangering stability and liquidity across markets and financial instruments. After cash penalties have applied, the EU is likely to assess how best to apply the mandatory buy-in in light of the evolution of settlement efficiency.

Market participants' ability to implement the SDR will be directly impacted by these proposed changes, and they are likely to face increased costs as they align with the potential amendment of buy-in rules, which will most likely require additional changes to their systems and processes.

Outlook for 2022 and beyond

We believe a considerable amount of effort by all market participants is still necessary to define a streamlined value chain that clearly identifies trades that are in scope, agree on the expected buy-in costs, and the overall process of claiming, tracking, and processing those costs with the buy-in agents or counterparties.

Although the de-coupling of the buy-in regime with the rest of the SDR has certainly added an extra layer of ambiguity and complexity, we believe this is an opportunity for market participants to take stock of the progress made to date and re-commit efforts towards successful implementation.

Conclusion

Broadridge has held workshops with Special Interest Groups to continuously understand clients' CSDR needs. Our settlement products and services have been developed with core enhancements to support these needs. We welcome the opportunity to discuss these services with our clients to address their settlement discipline requirements. ■

Figure 2: Key focus areas across market participants in 2022 and beyond

Sell-Side

- Adequately resourced fully dedicated team to address settlement management processes
- Analyse historic trade settlement failures to avoid future penalties
- Enhanced communication internally across Front Office and Back Office and collaboration with market participants
- Efficient, automated and real-time inventory management processes
- Clear demarcation of Stock Borrow/Loan inventory across normal trading and market making
- Well-defined and stringent reconciliation processes

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- Enhanced collaboration with buy-side and sell-side to identify root cause of settlement failures
- Efficient onboarding processes to provide discretionary services such as account segregation and partial settlement

Buy-Side

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ESMA postpones buy-in regime to 2025

After a much anticipated announcement by the European Securities and Markets Authority, industry participants reflect on a three-year delay to the implementation of the CSDR mandatory buy-in regime. Carmella Haswell reports

The European Securities and Markets Authority (ESMA) has postponed the application of the Central Securities Depository Regulation (CSDR) mandatory buy-in regime for a further three years. Market participants have conveyed concerns over "serious difficulties" to implement the mandatory buy-in regime on the scheduled date — which has been postponed on several occasions since 13 September 2020.

These difficulties referred to "the absence of clarity regarding some open questions necessary for the implementation of the buy-in requirements". This is in addition to "the uncertainty as to whether the European Commission's legislative proposals on amending regulation of the European Parliament and of the Council would include amendments to the mandatory buy-in rules and the extent of any potential amendments."

Speaking to SFT on the recent news, Karan Kapoor, head of regulatory change and technology at Delta Capita, says: "The securities finance and lending industry was going to feel a significant impact of the buy-in regime, should it have gone ahead as planned — given there are numerous instances where lenders and borrowers would find themselves foul of the CSDR timelines, due to no fault of theirs, resulting in a chain reaction of 'onward' buy ins."

In July 2021, the Joint Trade Associations — a group of 16 industry bodies — wrote to the European Commission (EC) and ESMA advising against the introduction of the proposed mandatory buy-in component of the CSDR settlement discipline rules and encouraged amendments to the mandatory buy-in component. The letter followed on from earlier recommendations by the Joint Associations on the CSDR settlement discipline regime in letters addressed to both the EC and ESMA on 22 January 2020 and 11 March 2021.

The much anticipated delay of the buy-in rules — which refer to a mandatory obligation for trading parties to execute buy-ins against counterparties who fail to settle their trades within a required period — has been welcomed by a number of market participants.

Paul Baybutt, director for middle office product, securities services, at HSBC, comments: "The industry has welcomed the decision by ESMA as it is seen to provide sufficient time for the legislators to determine how best to improve settlement efficiency without having a detrimental impact on the market. It also provides time to measure how effective other aspects of the Settlement Discipline Regime are — including penalties — at improving settlement efficiency without mandatory buy-ins."

> *"The industry has welcomed the decision by ESMA as it is seen to provide sufficient time for the legislators to determine how best to improve settlement efficiency without having a detrimental impact on the market"*

Also in favour of the announcement, Delta Capita's Kapoor suggests that the move will allow participants additional time to test out their newly implemented processes in a live environment, ensure that all controls are acting according to expectations, and put in place remediations where necessary.

He adds: "The firms that have been disadvantaged in this process are organisations that were standing up 'buy-in agent' services – but for the rest of the industry this has been a positive outcome."

Mandatory buy-ins had previously been scheduled for implementation when the settlement discipline regime went live on 1 February 2022, but instead European policymakers took the decision to postpone the mandatory buy-in element for further consideration. The legislation enacted in February requires impacted European CSDs to automatically apply financial penalties to market participants that fail to complete transactions on the contractual settlement date and subsequently report those failed trades.

Redirecting attention

After a long period of ambiguity, the delay has continued to steal energy and focus in forums and market conversations. According to AccessFintech's head of financial products Pardeep Cassells, the industry is now able to free up resources to redirect attention to the current penalty regime, implement it fully and work to drive down fails.

Similarly, Daniel Carpenter, CEO of Cognizant company Meritsoft, says the postponement will allow for planned resources to be allocated to ensuring automation of penalties handling, processing the increasing partial settlements needs, and performing daily and monthly reconciliations.

Carpenter continues: "In conjunction, firms can work towards digitising and centralising their settlement fails data, which can be utilised for predictive analytics purposes, leveraging artificial intelligence and machine learning. All of the above will give market participants a strong footing from which to tackle the buy-in rules, should they ultimately be introduced."

Despite the additional three years for the securities finance industry to ready themselves for the possible change, Camille McKelvey, head of post trade STP business at MarketAxess, advises market participants must use this extra time wisely.

A step in the right direction would be to work towards improving settlement rates across securities, says McKelvey. "Next-day or T+1 settlement of fixed income trades "might seem a pipe dream", but there are few insurmountable operational or technology reasons why such a move cannot happen – this is already happening in the US, and I predict it will likely follow in Europe."

Although post-trade automation adoption is improving, McKelvey believes there is still a long way to go before 100 per cent post-trade straight-through-processing (STP) is achieved. Furthermore, she suggests that if this is achieved and this has a positive impact on settlement rates, this could mean that mandatory buy-ins will not be on the regulators' radar.

"When operational efficiencies and financial stability are at stake, the industry's resolve and propensity to change should not be underestimated – there are now three years to make a positive change, we must not waste them," says McKelvey.

A final report by ESMA has seen amendments to the regulatory technical standards (RTS) on settlement discipline, based on the expected changes to the CSDR buy-in regime presented in the commission's legislative proposal for the CSDR Review and amendments to the Distributed Ledger Technology Pilot Regulation.

This draft RTS has been sent to the EC for endorsement in the form of a Commission Delegated Regulation. Following the endorsement by the EC, the Commission Delegated Regulation will then be subject to the non-objection of the European Parliament and of the Council.

Analysing the impact the delay will have on the industry, AccessFintech's Cassells explains: "It was widely anticipated that stock lending volumes would increase significantly under a mandatory buy-in regime, where borrows to cover would have grown to minimise execution of mandatory buy-ins.

"However, given the huge value of penalties that we are seeing across the market — with AccessFintech having seen €77 million in the first two months since the regulation went live — I expect we will see activity pick up for lending agents as organisations look for ways to minimise penalties against longer-standing fails."

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