ESMA's Consultation Paper on Draft Technical Standards for the Regulation on improving securities settlement in the European Union and on central securities depositories (CSD) - AMAFI's response

Association française des marchés financiers (AMAFI) is the trade organisation working at national, European and international levels to represent financial market participants in France. It acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI has more than 120 members operating for their own account or for clients in different segments, particularly organised and over-the-counter markets for equities, fixed-income products and derivatives. Nearly one-third of its members are subsidiaries or branches of non-French institutions.

The Association has been following closely the preparation of the Regulation on improving securities settlement in the European Union and on central securities depositories (CSDR) and welcomes the opportunity to answer ESMA's consultation paper on Draft Technical Standards on CSDR (hereafter referred as to the CP), after having answered to the Discussion Paper last year.

AMAFI's members are involved in the settlement and clearing process and are therefore in the scope of CSD regulation. Given the activities of AMAFI's members, we have chosen to answer to two parts of the CP: **settlement discipline** and **internalised settlement**. The answer was elaborated in close relationship with the "Association Française des Professionnels du Titre" (**AFTI**) and AMAFI endorses its responses to the CP. The answer must be read taking into account the general following considerations:

Our answers concern matters dealt with by the CP regarding settlement discipline and not the others sections which treat subjects outside of AMAFI's core concerns.

Before answering the questions of the CP", AMAFI would like to emphasise some general comments.

I) GENERAL COMMENTS

Phase-in for settlement discipline

AMAFI considers that the date of application of the settlement discipline regime should be liaised to the timeframe of the "Target 2 securities" (T2S) project and that the regime should be developed once at the T2S level rather than at each CSD level. Given that, AMAFI welcomes the possibility to delay the entry into force of the RTS on settlement regime but really doubts that an 18-month period would be sufficient.

Cash penalties regime

AMAFI understands that ESMA has chosen to put in place a system based on the distribution of the amount of the penalty to the participant that suffers from the fail rather than a system aiming to cover the

costs of the penalty mechanism (with a remaining part that could be redistributed to the suffering party and/or be redistributed to the "virtuous" participants).

AMAFI is not opposed, on principle, to ESMA's proposal but considers that it has serious draw-backs. First of all, it is very difficult to put in place in an area where both gross and net settlement regimes are mixed (see our detailed answers below). But also, such a system supposes that there is a common view and understanding of the right level of the compensation of the suffering party when the securities have not be settled in due time. AMAFI regrets that ESMA has not elaborated on this subject which is closely related to the level of the cash penalty.

Buy-in Process

AMAFI considers that ESMA's proposal should be totally reconsidered on the basis of a clear definition yet to be determined of buy-in.

II) DETAILED COMMENTS ON SETTLEMENT DISCIPLINE

- **Q1: Do you think the proposed timeframes for allocations and confirmations under Article 2 of the RTS on Settlement Discipline are adequate?**

  If not, what would be feasible timeframes in your opinion?

  Please provide details and arguments in case you envisage any technical difficulties in complying with the proposed timeframes.

AMAFI supports the timing proposed by ESMA for allocations and confirmations which are in phase with the current market best practices.

But AMAFI disagrees with the fact to include **transaction type** in the confirmation/allocation process. Such data is not required today and will need technical adjustments for every party to a transaction. Besides that, adding this new field will probably delay the sending of the confirmations and may jeopardise the deadline considered. Moreover, AMAFI does not see the benefits of this new field from a regulatory purpose. It doesn't improve the settlement process and this type of information will be available to European supervisory bodies through the MiFID 2- MiFIR and Regulation on Securities and Financing Transactions (SFT) reporting mechanisms. This could, *a contrario*, creates discrepancy because of a lack of harmonisation on what a type of transaction means in each of the various European rules.

- **Q2: Do you agree with the cases when matching would not be necessary, as specified under Article 3(2) of the draft RTS?**

  Should other cases be included? Please provide details and evidence for any proposed case.

Yes, AMAFI agrees with this ESMA's approach.

However we would like to highlight that the already matched concept is a T2S concept and should be **precisely defined in the same way for the non T2S markets.**

- **Q3: What are your views on the proposed approach under Article 3(11) of the draft RTS included in Chapter II of Annex I?**

  Do you think that the 0.5% settlement fails threshold (i.e. 99.5% settlement efficiency rate) is adequate? If not, what would be an adequate threshold? Please provide details and arguments.

  Do you think that the 2,5 billion EUR/year in terms of the value of settlement fails for a securities settlement system operated by a CSD is adequate? If not, what would be an adequate threshold? Please provide details and arguments.

AMAFI does not share ESMA's approach.

We consider that CSDs should offer the same basic services to their clients and do not agree with the suggested exemptions nor the respective thresholds. T2S will provide this functionality and participating CSDs are encouraged to utilise this.

Moreover such exceptions would go against the harmonisation efforts the market is currently undergoing. We note that such rules could be seen beneficial for some CSDs. However, from a participant point of view with multiple market access point, having to build different settlement processes for certain markets is not desirable.

More specifically, we would like to point it out that:

- the hold and release function eases an early matching in the CSD and therefore contributes to a settlement on time (most of the instructions put on hold will have been released on ISD);

- partial settlement as well as recycling are essential to an efficient settlement;

- the penalty regime aims to penalise the real defaulters and that cannot be achieved if a participant is charged a penalty because the system operated by the CSD offer less functionalities than another.

- **Q4: What are your views on the proposed draft RTS included in Chapter II of Annex I?**

AMAFI broadly supports the proposed standards, but would like to raise the following comments:

We totally disagree with the introduction in Article 3.3 of a matching field "Transaction Type" introduced in Article 3.3 (*see our answer to Q1 above*). It is currently not widely used in the European securities settlement systems. Adding a new mandatory matching criteria will lead to important IT developments at every stage (from the party of the transaction to the CSD … and T2S) and may impede the matching efficiency. Therefore such change needs clear rationale. At the moment we do not see the purpose of this requirement.

Manual interventions by the CSDs should be restricted to the minimum possible: contingency for instance, i.e.: when a participant is not able to send/amend/cancel its settlement instructions. In such cases, the CSD manual intervention needs to be based on its participant instructions and be processed through GUI enabling a consistency check of settlement instructions. In addition, each CSD must validate this possibility with its local regulator. Therefore a clear procedure should be established between the CSD and its relevant regulator

We propose to add to the measures identified as facilitating the settlement, the auto collateralisation mechanism.

We also push for the wider adoption of the T2S features described below in the allegement period. This type of details allows us for a proper monitoring of our settlement fails.

Allegement delay periods
The allegement message is sent after a certain delay, following the first unsuccessful matching attempt. The delay depends on time of receipt of the instruction.

If the instruction was received…	The allegement delay period is…
Before 13:00 on the intended settlement date	1 hour
After 13:00 on the intended settlement date	The allegement message is sent in real time

The 13:00 timing is defined as a 5-hour delay period measured backward from the FOP cut-off time (18:00).

- **Q5: What are your views on the proposed draft RTS on the monitoring of settlement fails as included in Section 1 of Chapter III of Annex I?**

AMAFI broadly agrees with the draft RTS.

However some of the information to be published by the CSDs seems to be burdensome and we do not see their added value with respect with the original goal researched. (Report per asset classes for instance).

- **Q6: What are your views on the proposed draft RTS related to the penalty mechanism? Do you agree that when CSDs use a common settlement infrastructure, the procedures for cash penalties should be jointly managed?**

As we have stated in our answer to ESMA's DP on CSDR in may 2014 (*AMAFI / 14-20*) and have recalled in an AMAFI-AFTI letter to ESMA in December 2014 (*AMAFI / 14-52*), AMAFI is in favour of a penalty mechanism based on a net calculation regime. We are not convinced that ESMA's proposal is fair for intermediaries (brokers), often in the middle in a chain of settlement instructions on the same underlying security. We remain of the opinion that ESMA's regime will create an inflation of penalties to be paid and received and an important reconciliation workload to properly address and bill the relevant defaulting party. Indeed with this regime the main part of the collected amount will be used to offset the effect of a penalty, which should not have been paid. The proposed collection and redistribution mechanism aims to pass to the beginning of the chain the indemnity received by the "end of chain" participant (the defaulting one). Such a mechanism would be cumbersome and can easily be equivalent to a net system, which we favour, and be more or less equivalent.

We understand ESMA's preference is for a "gross model" (a calculation at the failing settlement instruction level) going with a full redistribution of penalties perceived in order to take into account the context of fail chains (a participant may be unable to deliver only because it didn't receive what it expected; so it will be charged and reciprocally indemnified) rather than a "net model" (a calculation on a net failing position) based on the assumption that taking into account settlement instructions is levelling the playing field between CSD operating on an omnibus basis and those who don't.

Therefore we would like to draw ESMA's attention on the fact that in many cases the proposed model would not work or not achieve its aim to penalise the real defaulting party. Some examples have been developed in relationship with AFTI and are provided in its response to the consultation. **We fully endorse the examples provided by AFTI in its response.**

- **Q7: What are your views on the proposed draft RTS related to the buy-in process? In particular, what are your views on applying partial settlement at the end of the extension period? Do you consider that the partialling of the settlement instruction would impact the rights and obligations of the participants?**

  What do you think about the proposed approach for limiting multiple buy-in and the timing for the participant to provide the information to the CSD?

AMAFI fully recognises and deeply regrets that CSDR provisions on mandatory buy-in (article 7) are particularly unclear, as such, and concretely very difficult to put in place.

Indeed, buy-in is a very costly process that has a profound impact on relationships, contracts, and the "economics" of trades and it must be noted that the level 1 text does not give any definition of buy-in with the exception of the reference made in the CSDR preamble (15) to the need to "*require failing participants to be subject to a compulsory enforcement of the original agreement".*

The lack of definition raises a number of fundamental questions and issues, such as:

Which agreement is to be compulsory enforced/subject to a buy-in:

- is it the trading agreement between trading counterparties?
- an agreement between settlement agents?
- or is something else?

Who are the failing participants?

CSDR defines failing participants as "*participants that cause settlement fails*" (CSDR Art 7.3), and participant as "*any participant... in a securities settlement system*"
In many (most) cases, trading counterparties use one or more levels of intermediaries such as, clearer, custodians and agent banks to settle securities and cash in the securities settlement system of any particular CSD. These custodians/banks act in the capacity of settlement agent[1], and do not assume responsibility for the performance of the trading contract obligations of their clients, of which they are often not aware. Moreover, these settlement agents do not have (nor need) any agreements with other settlement agents (hence the reference above to a non-existing agreement) which can be enforced.

Agents also do not usually 'cause settlement fails': it is their clients (or clients of clients) who due to a lack of securities (or cash for penalties) make their delivery instructions fail and they are often subject to a mandatory buy-in.

This creates a fundamental mismatch between:

- which contract needs to be enforced: trading contract between counterparties or settlement contract arrangements?
- who is held responsible for the fail and is charged with the buy-in; the settlement agent at CSD level or Settlement's agent client?

[1] Directive 98/26/EC defines 'settlement agent` shall mean an entity providing to institutions and/or a central counterparty participating in systems, settlement accounts through which transfer orders within such systems are settled and, as the case may be, extending credit to those institutions and/or central counterparties for settlement purposes;

- who has caused the fail; Settlement agent or the client?

ESMA does not provide further clarity on these fundamental questions and therefore has drafted proposals which will make the implementation of the regime extremely difficult and in a number of cases impossible. Most of these concerns stem from the approach taken by ESMA to have buy-ins purely applied at CSD settlement level.

Therefore, AMAFI considers that ESMA should work further in relation with the industry in order to elaborate a workable regime. This is a very important issue because if such a buy-in regime is enforced in the European capital markets this will have severe negative repercussions for market efficiency and liquidity.

Given that, AMAFI does not find it useful to answer the technical questions raised by ESMA in the CP or try to amend the Draft Technical Standard (article 16 to 19).

- **Q8: What are your views on the proposed draft RTS related to the buy-in timeframe and extension period?**

See our answer on Q7 above.

- **Q9: What are your views on the proposed draft RTS related to the type of operations and their timeframe that render buy-in ineffective?**

See our answer on Q7 above

- **Q10: What are your views on the proposed draft RTS related to the calculation of the cash compensation?**

See our answer on Q7 above

- **Q11: What are your views on the proposed draft RTS related to the conditions for a participant to consistently and systematically fail?**

See our answer on Q7 above.

- **Q12: What are your views on the proposed draft RTS related to the settlement information for CCPs and trading venues?**

See our answer on Q7 above.

- **Q13: What are your views on the proposed draft RTS related to the settlement information for CCPs and trading venues?**

See our answer on Q7 above.

- **Q14: Do you agree that 18 months would be an appropriate timeframe for the implementation of the settlement discipline regime under CSDR? If not, what would be an appropriate timeframe in your opinion? Please provide concrete data and evidence justifying a phase-in for the settlement discipline measures and supporting your proposals.**

AMAFI welcome the ESMA proposal to delay the entry in force of the RTS on settlement regime. As ESMA knows, the French market as well as 20 other European markets is in the process to migrate all its settlement in a common platform.

T2S is one the major and complex initiative European actors have to face with. This project which started almost 9 years ago is about to go live. CSDs and their participants will enter in the migration phases after a deep testing phase. They should focus their attention, resources on the migration. As for any project a black window should start where the only changes allowed should be to fix potential bugs. Moreover there should be a period after the migrations where no change should be made. This is of the upmost importance to state that T2S runs well.

Thus if it is clear that the RTS could not enter into force 20 days after its publication, AMAFI is of the view that a 18 months period is still not sufficient.

However, there are still some concerns to be raised with respect to the proposed timeline of 18 months after the publication of the RTS, which would practically-speaking point to an implementation deadline around mid-2017. The main concern relates to how this timeline would align with the migration activities for T2S, which will extend until February 2017 for the fourth migration wave, and possibly up to May 2017 in case an emergency migration wave will need to be adopted. Moreover it is foreseen that following completion of the T2S migration a phase of monitoring the system stability and performance will be conducted. This will allow all market participants to get used to the platform and revised settlement process.

AMAFI believes that T2S will be the logical place for the implementation of a central operational utility for the management of settlement discipline across all participating CSDs, it is very unlikely that the technical specifications, system development, testing, implementation and assessment of any operational impacts may all be completed within only 3-4 months after the end of the T2S migration period.

We would therefore recommend that a longer period of time may be allowed for the full implementation of the new settlement discipline measures, **at least up to one full year after the completion of the T2S migration (i.e. at least up to end of Q1 2018, or up to end of Q2 2018 in case of use of the emergency migration wave).**

In addition AMAFI suggests following the applicability of the new standards applying a monitoring period of 6 months where fines and other sanctions are reported but not ultimately charged. Such adaptation period allow competent authorities, CSDs and CSD participants to analyse the consequences of the new procedures and make necessary alignments to the processing. To this extend and in order to cater for a harmonised application of the above rules, the delayed implementation should be valid for all markets irrespective of their participation in T2S.

[**Q15 to Q31:** Not relevant for AMAFI.]

III) DETAILED COMMENTS ON INTERNALISED SETTLEMENT

- **Q32: What are your views on the proposed draft RTS on internalised settlement (Annex V) and draft ITS on internalised settlement (Annex IX)?**

AMAFI is of the opinion that the proposed regime is far too burdensome and that at least a *de minimis rule"* through thresholds and / or exemptions should be implemented. Besides that some information required are not available today and should therefore be asked to the trading party: e.g. client typology, assets classes.

Beyond that, we have several concerns due to ESMA's proposal.

Scope and level of granularity of the suggested requirements

Risk of misinterpreting

Article 9 states that "*Settlement internalisers shall report to the competent authorities of their place of establishment on a quarterly basis* ***the aggregated volume and value of all securities transactions*** *that they settle outside securities settlement systems*."

And the mandate says "*ESMA may, in close cooperation with the members of the ESCB, develop draft regulatory technical standards further specifying the content of such reporting*."

In no case it has been foreseen to require aggregated information split under different criteria.

Moreover such new requirement may introduce some confusion. Indeed, what is expected by the Commission is a reporting of **securities transactions** that are internally settled. Even if we can regret once again this mix between trading and settlement levels this will have no impact until reports are global.

Having the information split then things will be different. What would it mean and how would it be used if a participant declares that it settled mostly for credit institutions? Would it be understood as "most of the transactions are concluded by credit institutions"?

A settlement done internally doesn't mean that the transaction has been concluded internally too. Clients of a participant are not always final ones. It is likely that they have clients behind them and therefore instruct their custodian for an aggregated or even for a netted quantity.

Therefore we disagree for any split of aggregated data.

Type of client

Should the type of client be maintained then we ask ESMA to use the MiFID classification (retail, professional, eligible counterparty) rather than a too detailed one that will unlikely be useful and accurately populated (the client known by the participant is not always the final one and moreover may represent several types of underlying clients involved in the transactions).

Scope of financial instruments

We understand that the requirement is only for financial instruments admitted by a CSD regulated under the CSDR. Indeed information related to non EU ones will not be comparable to CSDs' figures.

To avoid any misinterpretation, we would appreciate that ESMA clarifies the point in its draft RTS.

Practical issues

We would appreciate some clarification on the requirements:

- does "failed transfer orders" means "failed matched transfer orders" (the definition doesn't mention it)?
- is it clear for ESMA that the settlement internaliser will report both legs? (a delivery for 10 by A and a receipt for 10 by B settle together will appear in the reporting as a settled quantity of 20)
- the volume of failed transfer orders is in the sub-column of "number of transfer orders" does it mean that only transfer orders that finally settle are to be reported?

Settlement fails' in the context of internalised settlement

Once again, we would like to highlight that neither the article 9 of level 2 nor the mandate given to ESMA require information beyond the "***aggregated volume and value of all securities transactions*** *that they settle outside securities settlement systems*".

So we ask ESMA to limit its requirements to an aggregated volume and value of all settlement instructions that settle outside a securities settlement system.

Regarding fails, ESMA considers that:
"*338. … it is important to cover the investor protection aspect. ESMA is aware of the fact that 'settlement fails' in the sense of the CSDR definition cannot be used in the context of internalised settlement, however ESMA believes that the technical standards may focus on whether the transfers made in the books of the settlement internalisers occur when intended (according to the settlement internalisers' clients instructions, and evidenced by settlement or payment confirmations, end-of-day statement of transactions). ESMA has included a template for the reporting of failed transfer orders by settlement internalisers, which is a simplified version of the template proposed in the RTS on the reporting of settlement fails by CSDs*" (page 95 of the CP on RTS)

If the protection of the investor is crucial and if we understand ESMA's intention, we are not convinced that such reporting on settlement instructions that failed to settle internally on ISD will cover this objective. As for external settlements, a failing instruction may be synonym of investor protection since it shows that no unintended use of financial instruments has been made by the participant.