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# ICI Global[1] Response to European Commission Consultation on CSDR

## Section 7. Settlement Discipline

**Question 33. Do you consider that a revision of the settlement discipline regime of CSDR is necessary?**

- Yes
- No
- Don't know / no opinion / not relevant

**Question 33.1 If you answered yes to Question 33, please indicate which elements of the settlement discipline regime should be reviewed:**

you can select more than one option

- Rules relating to the buy-in Rules
- on penalties
- Rules on the reporting of settlement fails Other

**Question 34. The Commission has received input from various stakeholders concerning the settlement discipline framework.**

**Please indicate whether you agree (rating from 1 to 5) with the statements below:**

| | |
|---|---|
| Buy-ins should be mandatory | 1 (disagree) |
| Buy-ins should be voluntary | 5 (fully agree) |
| Rules on buy-ins should be differentiated, taking into account different markets, instruments and transaction types | 5 (fully agree) |
| A pass on mechanism should be introduced | 5 (fully agree) |
| The rules on the use of buy-in agents should be amended | 5 (fully agree) |
| The scope of the buy-in regime and the exemptions applicable should be clarified | 5 (fully agree) |
| The asymmetry in the reimbursement for changes in market prices should be eliminated | 5 (fully agree) |
| The CSDR penalties framework can have procyclical effects | 5 (fully agree) |
| The penalty rates should be revised | No opinion |
| The penalty regime should not apply to certain types of transactions (e.g. market claims in cash) | No opinion |

[1] ICI Global carries out the international work of the Investment Company Institute, the leading association representing regulated funds globally. ICI's membership includes regulated funds publicly offered to investors in jurisdictions worldwide, with total assets of US$36.0 trillion. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds, their managers, and investors. ICI Global has offices in London, Hong Kong, and Washington, DC.

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**Question 34.1 Please explain your answers to question 34, providing where possible quantitative evidence and concrete examples:**

ICI Global welcomes the opportunity to provide feedback on the European Commission's consultation document on the review of regulation on improving securities settlement in the European Union and Central Securities Depositories Regulation (CSDR).

We believe that a number of aspects of CSDR will contribute to the overall goal of increased settlement efficiency in EU capital markets, specifically improvement to the allocation and confirmation procedures and the introduction of matching and settlement failure penalties. ICI Global believes, however, that the mandatory nature of the buy-in regime will not serve its intended purpose but will in fact cause unintended harm to EU markets and investors. We therefore request that the EU Commission revoke the mandatory nature of the buy-in provisions in the CSDR settlement discipline regime.

With the introduction of a shorter settlement cycle (T2), the settlement efficiency in EU capital markets has improved substantially over the years, and the volume of failed trades has reduced and is in line with what we observe in other developed capital markets (e.g. US market). Given the efficiency of the EU settlement system, unless an extensive economic cost-benefit analysis demonstrates clear value to market participants and infrastructure, it would be imprudent to proceed with a mandatory buy-in regime. Furthermore, the mandatory buy-in rules as written in CSDR are not aligned with global practices for developed capital markets and therefore, will disadvantage EU markets.

## Cost & Liquidity Impact

- A mandatory buy-in regime will introduce an expensive and complex operational build for all participants involved in EU securities trading resulting in a significant compliance burden; this includes those involved in post trade, including brokers, custodians, and mutual funds. The ultimate cost in this scenario will be borne by investors. For example, as stipulated under the current version of CSDR, a failed buy-in will result in a cash compensation close out. For an investment fund, a cash compensation may impact corporate action eligibility, raise tax issues, and will have a direct impact on investment funds Net Asset Value (NAV) calculation. Such scenarios could trigger a NAV correction, subsequent adjustment of fund units or shares issued and redeemed, and a suboptimal result for investors and shareholders.

- A rigid mandatory buy-in regime will have an adverse impact on liquidity, particularly for less liquid securities. Dealers and market makers will naturally consider the potential cost of a mandatory buy-in. As a result, broker dealers may trade less of these instruments, or add a premium to the bid-ask spread to offset for the potential cost of a fail trade. Simply put, the greater the risk of a buy-in for a specific security the less inclined dealers and market makers will be to trade these securities. A similar consideration will apply for securities lending. We therefore conclude that a mandatory buy-in will negatively affect liquidity and the market trading mechanism that exists today; ultimately resulting in increasing risk and cost to investors.

- Under CSDR if the buy-in agent fails to source the securities, the transaction is replaced by a cash close out settlement in lieu of the purchaser receiving the contractually agreed securities. This is not an ideal method for trading parties to unwind a trade; furthermore, it assumes a simplistic one size fits all solution to various trading scenarios. To have efficient markets, participants should always have the flexibility and the option to resolve a failed trade bilaterally, in accordance with the non-failing party's best interest. For example, depending on the instrument and market conditions, parties may elect to extend the settlement cycle further, agree to a different security to replace the original one, trigger a discretionary buy- in, or agree on a partial cash settlement alternative. Contractual and service level agreements between parties facilitate such a process. These resolutions are scenario specific and further demonstrate that a broad-brush approach lacks the flexibility needed to maintain efficiency in varying markets, securities, and transaction types.

- The requirement to appoint a buy-in agent under CSDR is counterproductive and undermines the very purpose of a buy-in. This requirement will result in one or a few authorized buy-in agents in the marketplace, creating a monopoly or an oligopoly that will increase trading cost, introduce unnecessary operational complexity, and result in less efficient markets. It is evident that the economic incentive for a buy-in agent conflicts directly with the very goal of a settlement regime aspiring to achieve near perfect settlement efficiency. Moreover, the non-failing party should have the flexibility to execute the buy in with any dealer that provides the best terms possible, including cost and superior execution.

  Based on the above, ICI Global is certain that a mandatory buy-in regime will have an adverse impact on the European capital markets and will result in unintended consequences such as favoring the settlement of certain EU securities in non-EU CSDs. We urge the commission to consider changing this requirement to be voluntary and at the discretion of the non-failing party.

**Question 35. Would the application of the settlement discipline regime during the market turmoil provoked by COVID-19 in March and April 2020 have had a significant impact on the market?**

- ○ Yes
- ○ No
- ○ Don't know / no opinion / not relevant

**Question 35.1 Please explain your answer to Question 35, describing all the potential impacts (e.g. liquidity, financial stability, etc.) and providing quantitative evidence and/ or examples where possible:**

During the unprecedented market conditions in March and April of 2020 caused by the COVID-19 health crisis, global markets witnessed an increase in securities fail trades across all asset classes. During this time period based on sample data we collected from members, the increase in fail rate was generally around 5- 10% above the average fail rate during regular market conditions. This fail rate was not specific to an asset class but applied to both equities and fixed income to varying degrees. The top three reasons for fail trades were attributed to brokers shorting positions, followed by missing counterparty instructions, and finally shares being on loan. Based on members' feedback most of the trades settled within 5 days, however there was a higher than usual number of trades that settled beyond 8 days or more.

If a settlement discipline regime was effective during this time period, market participants would have certainly experienced a significant volume of cash penalties on late matched trades and failed trades. Market conditions would have worsened had mandatory buy-ins kicked in, contributing to a chain effect

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of failed trades and buy-ins across the value chain, accumulation of penalties and worsening market liquidity. Please see our response above to Question 34.1.

To better understand the situation during this period, it is worth putting in perspective what caused this spike in trade failures. This was a global pandemic that caused a sudden economic shutdown and impacted everyone almost at the same time. Following stay at home orders across various jurisdictions broker dealers, investment managers, and essentially all market participants globally had to work from home. This transition happened in a matter of a day or two for most, and this new reality was tested for the first time in a complex global capital market system. Many participants rushed to adjust workflows, service levels, communications to operate in this new environment.

In addition, this new operational model of remote work was put to test immediately with unprecedented market volatility and trading volumes. It was abundantly clear that operational limitations and capacity constrains due to sudden remote work contributed to this higher than average level of settlement failure during this period. Looking at the magnitude of events and the timing, we conclude that the market infrastructure weathered the storm quite well. Within a few weeks all trades were resolved, and participants were able to minimize the impact of failed trades during this time.

**Question 36. Which suggestions do you have for the improvement of the settlement discipline framework in CSDR? Where possible, for each suggestion indicate which costs and benefits you and other market participants would incur:**

ICI Global recommends that only cash penalties are implemented as part of CSDR's settlement discipline. Cash penalty provisions are adequate to provide incentives for market participants to match and settle trades in a timely fashion, ultimately improving settlement efficiency for EU markets overall. We further propose that the Commission consider a Euro threshold for cash penalties, for example, only penalties above a specific EUR amount (e.g. 100 or 200) are enforced. We believe that this approach will achieve greater operational efficacy.

To measure effectiveness, we further recommend that the Commission monitor and perform periodic analysis to review the impact of cash penalties on overall EU settlement efficiency. After doing so, the Commission can adjust settlement discipline policy goals as needed. Conversely, we strongly believe that the currently proposed mandatory buy-in rules are inherently flawed and will have significant and potentially irreversible impacts on markets if implemented in their current form. We urge the Commission to consider waiving the mandatory buy-in requirement from the CSDR framework; instead we recommend that any buy-in mechanism be voluntary and at the discretion of counterparties.