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ICI Global Recommendations on the Central Securities Depositories Regulation REFIT

ICI Global's members manage about €39 trillion in regulated investment funds around the world, and we have a strong interest in a well-functioning securities market in the EU.

The Central Securities Depositories Regulation (CSDR) should aim to increase the safety and efficiency of securities settlement and settlement infrastructures, but the mandatory buy-in regime (MBR) is not consistent with this and will not be able to achieve its intended purpose. Therefore, the MBR should be removed or substantively reformed to avoid unintended harm to markets and fund investors.

European Commission's REFIT proposal

The European Commission acknowledges that mandatory buy-ins may increase costs for investors, reduce liquidity and negatively impact the attractiveness of EU markets. Despite these concerns, in its REFIT proposal for the CSDR the Commission has retained the possibility of introducing the MBR if settlement failure rates are too high. ESMA has highlighted the imperative role that settlement fails reporting and cash penalties can play in improving settlement efficiency and has called for "urgent changes" to the MBR.

Removing the Mandatory Buy-in Regime

EU settlement efficiency has improved substantially over the years, reducing the volume of failed trades to internationally consistent levels – a trend that will be supported by the CSDR's matching and settlement failure procedures. The MBR will do the opposite. 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. A MBR will thus negatively impair liquidity, increasing costs, disadvantaging investors, and reducing the EU's competitiveness. It should be removed.

Cash penalties should be the primary mechanism to reduce settlement failures in the EU. 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.

Liquidity and cost implications from the mandatory buy-in regime

The introduction of a MBR may have the following negative consequences for market participants, including fund investors:

- **Reducing liquidity, particularly for less liquid securities, thereby increasing risk and cost for investors** as dealers and market makers trade less and add a premium to bid-ask spreads to cover the cost of a failed trade.
- **Forcing non-failing counterparties to accept cash in lieu of securities even if this is not in their best interest**, rather than allowing a failed trade to be resolved bilaterally such as by extending the settlement cycle, agreeing a different replacement security or a partial cash settlement etc.
- **Adversely impacting fund investors** as accepting cash compensation for a failed buy-in may impact corporate action eligibility, create tax liabilities, require NAV correction, and ultimately reduced investment performance and increase cost.
- **Reducing market efficiency** as the requirement to appoint a buy-in agent may create incentives for a counterparty to fail on a trade if they can achieve better terms than settling it, thereby conflicting with the goal to enhance settlement efficiency
- **Increasing trading costs** as the small number of authorised buy-in agents risks creating a monopoly or oligopoly.

Reforming the mandatory buy-in regime

While we believe EU policymakers should remove the MBR from the CSDR, if a buy-in regime is retained then it should be made voluntary, giving the non-failing party the ability to use the buy-in rule if in their best interest – this provides a guaranteed layer of investor protection and safety in the settlement system and is consistent with international best practices.

The MBR should be framed in a predictable and proportionate manner. The vagueness of the criteria and of the examination procedure in the current proposal could result in implementing the MBR in scenarios that would hamper investors and capital markets. The MBR should only be implemented under the following conditions – building on those in the Commission's proposal:

- As a last resort measure when other possibilities (e.g., recalibrating cash penalty levels) have not sufficiently increased the settlement efficiency as measured over a timeframe which takes account of pre-CSDR settlement failure levels;
- Based on a comparison assessment of only those third-country markets which have introduced MBRs to reduce the level of settlement failures;
- Only if it can be demonstrated that mandatory buy-ins will not have a negative impact on fund investors, including in, but not limited to, stress scenarios.

In any case, the MBR should retain sufficient flexibility for the non-failing party to determine how best to resolve a failed trade in their best interest (e.g., through sourcing securities or cash compensation.) Such an approach retains the possibility, when a buy-in is not possible, for the receiving party to choose the alternative of cash compensation or to defer the execution of the buy-in to a later stage.

Other aspects of the REFIT proposal

We support the following reforms proposed by the Commission in the REFIT proposal, subject to the following clarifications:

- **Payment symmetry** – the REFIT proposal should be amended to clarify that in all cases where the price of financial instruments agreed at the time of the trade is different from the price used to determine cash compensation, the corresponding difference shall be paid by the participant benefitting from such price difference to the other participant within the timescales proposed by the Commission.
- **Cash penalties** – the REFIT proposals to exclude from the scope of cash penalties instances where settlement fails are caused by factors not attributable to the participants to the transaction or for operations that do not involve two trading parties, should be further clarified by ESMA to provide certainty to investment funds and other market participants as to how the penalty regime will be applied.