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La dynamique du post-marché

Amafi > Association française des marchés financiers
FINANCIAL MARKET PROFESSIONALS

EXECUTIVE SUMMARY

AFTI and AMAFI representing the French Market welcome the publication of CSDR as this is an important milestone to promote market efficiency, transactions secured and settled on time.

AFTI (French Association of Securities Professionals) is the leading Association in France and in the European Union representing the post-trade businesses. AFTI gathers more than 100 members all market players in the post-trade industry: custodians/depositaries, investment firms, market infrastructures, issuers.

AMAFI (Association Française des Marchés Financiers**)** is the trade organization 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 organized 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.

With roughly 20% of the European market shares both in terms of Assets kept in custody at the national CSD or daily turnover the French market is an important actor of the post trade industry.

Our support was indeed already outlined in the French Market answer to the ESMA discussion paper back in spring 2014.

However, in the frame of the establishment of the level 2 measures by ESMA, we would like to voice our concerns on the 3 main components of the so-called future market discipline.

Penalty system

- **Should be harmonized within the EU**
- **Should be as simple and understandable as possible**
- **Should be built with the only aim to penalize the “originating” defaulting party**
- **Should be based on an ad valorem fee principle for failing transactions**
- **Should be adapted per asset classes, specificities of actors (brokers, custodians…) and potentially per types of transactions (cash market, repos….**)
- **Should be based on a Net model: penalize the participant only for the missing portion of securities per ISIN at the end of each day– and therefore incentivize the partial delivery.**

Buy-In

- **Must be different per asset classes (fixed income/equities/funds) and per types of transactions (cash market, repos….**.)
- **Duplication must be avoided**

Confirmations

- **Necessary but not sufficient condition: confirmations only limit the uncertainty risk but do not remove the risk of settlement not occurring.**

Detailed answer

A/Penalty system

1/ Its target does not appear obvious to us. Whether it aims to penalize the defaulting party or to compensate their counterparties for the costs of fails makes a big difference in the approach to be retained.

First we believe it might be useful to define clearly the meaning of compensation in a CSDR context. In our view it should only be about how CSDs can "use" the collected amount rather than a right of the non-failing client to be compensated by its trading counterparty due to the fact it has not been in a position to dispose from the cash or the securities. The evaluation of such prejudice and the way to compensate it has to be determined and settled bilaterally by the two counterparties without the implication of a CSD. The TMPG regime (for US Treasury Securities) works since it applies to specific financial instruments between specific trading actors. Having such a compensation scheme applied at the CSD level on segments (cash equities for example) representing high volumes and involving numerous intermediaries won't simply be workable for both the CSDs and their participants.

Indeed according to our knowledge of the markets, today the vast majority of fails - representing less than 2 % of settlement instructions both in value and quantity for each (see EOC ESES statistics) ESES CSDs- results from a long and complex chain of transactions from the seller to the buyer on a given ISIN and not always comes from any bad voluntary behavior from a participant (actually from one of its clients) at each step of the chain.

Thus, we recommend to avoid any compensation mechanism and that the penalty system should be built as to only penalize the "originating" defaulting party (meaning its representative in the CSD) , bearing in mind that this concept is not an easy one especially when speaking on a chain of transactions including cross-border settlements and be valid for all types of financial instruments (fixed income, equities as well as funds). A penalty fee that would be paid from the failing party to the failed party, based on a simple calculation principle, though it will not compensate the parties, may incentivize the failing party and would benefit to the failed party.

2/The penalty system should not jeopardize the business and volume of transactions. On one hand, it must be disincentive enough to promote good settlement and good behavior, but on the other hand, its level in terms of fees amount should not be too prohibitive and expensive, as it may prevent the parties to instruct.

The French Market community advocates therefore an ad valorem fee principle for failing transactions but with a cap. – In this case, the collected penalty fee may in certain instances be different from the penalty fee that is distributed, and thus this principle favors the adoption of a penalty regime based on a the net position rather than on the gross model **-**

3/ **If the area of application should be the same - matched instructions that are not settled at the end of the intended settlement date (should the instruction be on Hold or not, should the participant be a custodian or another CSD) –the penalty system must be adapted to the asset classes, specificities of actors (brokers, custodians…) and potentially by types of transactions**.

For instance the Fixed Income market is a wholesale market, with transactions with very high amounts, mainly OTC and with liquidity provided by market makers.

Should the penalty system be not adapted to this particular situation these market makers would not play their role of provider of liquidity and as secondary market key contributor.

4/ **We strongly believe that a fair penalty system must not penalize "innocent" parties.**

This means that somehow the future regime should take into account the global situation of a participant (this could be done at an account level) to decide if the latter is innocent or guilty – and therefore compensate the penalties to be paid and received.

A participant that behaves badly would therefore be penalized, a participant that acts evenly would not be penalized, and a party that does not trigger fails but is being failed would receive penalties-

Roughly there are two main ways to achieve this at the end of the day:

- by taking a picture of the participant's account (i.e. failing deliveries minus failing receipts and minus end of day position if there is no "on hold" transactions) -as a whole and after penalizing the real missing quantity (by calculating the fine on a net position per ISIN)
- by charging each single failing delivery and after mitigating the amount in order to take into account the personal situation of the participant; this second part could be done either through a unitary distribution of a compensation or by the use of a threshold

Some CSDs currently use a threshold per participant (a minimum rate above which to be in order to not be penalized at all) as a mean to drive the regime fair. Such a principle will go against the idea to incentivize defaulters to better work. – Instead, the participant's clients that fail may be balanced with participant's client that do not fail and therefore not incentivize to pass on the penalties - Participants are rarely the seller (most of the time there is a client behind them). Therefore avoiding failing settlements means for a participant to be able to pass them on fines. Should there be fines or

not depending on the global level of settlements there would be no way for a participant to make its clients realize that they have to improve their settlement performance.

The unitary compensation is not a universal solution at least in two cases of the "real life": when there is a CCP in the chain (because it benefits from an exemption) or when a party opts out from partial delivery.

Accordingly our proposal would be to base the penalty on an end of day position per ISIN of each participant (or participant's account), and to penalize the participant only for the missing portion of securities – and therefore incentivize the partial delivery.

Following this principle would remove the complexity for the CSD to identify the chain of transactions in order to penalize only the real defaulting party (which would have been quite complicated for the CSDs given the limited information they have at their disposal) and would clearly alleviate the workload of the CSD as redistribution of the penalties fees would be done differently (not on a one by one basis). In this model, each participant is viewed by the CSD independently (what it should have delivered, what it should have received, what it has). It doesn't matter if stock should come from X or Y and be delivered to C or D.

Such model is utmost relevant in case of cross CSD settlements; no more need to worry about who is the other CSD and about how to pass on the unitary compensation. Although the settlement chain involves several CSDs, as each CSD focuses on participant rather than on a chain, the regime applies domestically on all the participants (custodians as well as other CSDs which, acting as custodians represent cross border participants). It is the same for redistribution. The compensation process will be handled by each CSD irrespective of the nature (custodian or CSD) of the participant.

5/ **We are convinced that whatever the future regime will be it would entail IT developments at the participant level in order to find the real defaulter within its clients**

It is obvious for everyone that in case of a net model, participants will have to build their own system by duplicating the CSD's one. Conversely it may be concluded that in case of a gross model a participant will just need to get the reference of the failing instruction, find the name of the related client and pass on the fine to the latter.

Considering that the gross model is simplest than the net model in terms of operations and systems for CSDs and participants is an illusion .We believe that even in a gross model (per failing instruction) it is simply not true that participants will easily pass on the fines. So this could not be seen as an argument in favor of this model. Moreover having a regime where each intermediary in the chain may be penalized will be synonym of high running costs for all the participants and also CSDs:

On the participant's side

- the participant will have to analyse each fine and each compensation to ensure that at the end it is only the defaulting party that is fined:

. Is the client linked to the failing instruction the real defaulter? Was it waiting the shares from someone else? If yes was it from an external settlement (in this case the participant should receive compensation)? …

. As there is not always a 1 to 1 link between a failing delivery and a failing reception ,fine and compensation may not concern the same client.

- participants will have to check **on a daily basis** that fines and compensations are correctly and totally allocated

On the CSD's side

- a "gross model" to be fair must combine both the fine and the compensation at the same level, i.e. per instruction; It means that CSDs will be able to handle **the unitary redistribution of compensation all along the settlement chain**
- since CCPs benefit from an exemption, CSDs will need to build a system able to spread unitary penalty and unitary compensation "skipping" any CCP
- the opt-out option allows a participant to avoid any partial delivery; CSDs should take into account such case where any intermediary may be charged for the whole quantity and indemnified for the only quantity that remains missing

For both (CSDs and participants) and for both models (net or gross), it might be worth to recall that the use of a reference price is required when evaluating the cash consideration for a penalty's ad valorem calculation:

- to cover the case of instruction with no cash
- in a net model to be multiplied by the net quantity
- in a gross model since intermediaries in the chain apply fees so that for receptions/deliveries of the same quantity cash amounts won't be identical

In other words, in both models the participant should handle its own analysis with its own clients and fine if justified the right client. In fact there are however differences between net and gross models:

- no need of a reconstitution of the whole settlement chain in a net model
- in a gross model fines and redistributions of compensation should follow the same mechanism in order to be fair

It shall be noticed that the above differentiation of net and gross model is based on their operational aspects and does not imply a difference on the amount of penalties, given that both models are based on failing instructions which are in one case penalized one by one, and in the other penalized on their aggregation.

6/ **The penalty system should be as simple and understandable as possible**. It must also be easy to replicate the system at each level of the transactions to be able to cascade down to the relevant actor the penalties fees,

Moreover when making its recommendations for the design of the regime ESMA should pay attention on the fact that fines will be passed on: **the features of the regime should be clear, undisputable.** If not there will be room for claims from the client. This will be time consuming and at the end just uselessly costly. And eventually the regulation will fail in its objective to improve the global settlement efficiency.

7/ **There should be an harmonization within the EU**

Letting CSDs choose their own way to manage this requirement and set-up their own regime will just lead to penalty arbitrages between countries on multi-listed securities, inventories will first be used to cover fails where the penalties are the more stringent … Therefore ESMA should be very prescriptive in its recommendations..

Saying that and since a participant may have to deal with several CSDs for the same purpose, we advocate for a central penalty system which would for instance makes a lot of sense at least for the T2S markets.

This central system is a key element and condition to achieve the global objective of European harmonization.

It would also create a virtuous circle for T2S as we believe that as many markets, CSDs, participants work on T2S, and since only one system will exist, fails will be less numerous and then less expensive.

8/In terms of application date of this penalty system, ESMA should consider the workload to set up such system, not only for the CSDs but also for the custodians, brokers….

In this respect, we believe that 1 year after the freeze of the technical specifications is necessary to have time to build such system per market.

It is also a key factor to promote a central system for the penalty system because the industry will have only to pay once for such system.

9/ **The regime doesn't need to take into account the way securities are held at the CSD level (direct holding versus indirect holding that allows omnibus account structure**)

A direct holding means that at the CSD's level the account is opened on the name (on behalf?) of the final owner and holds only its assets. Therefore should there be a "per instruction" or a "position" regime, it simply works, may be with a slight difference regarding the workload.

Indeed, in a per instruction model and in a case where the beneficial owner could not deliver since it didn't receive, both the beneficial owner and the CSD will have to handle a penalty fee that may be paid and received within the same entity. For CSDs with huge volumes of individual final owners this may entail high running costs for nothing.

As mentioned, direct holding models and indirect holding model would be treated evenly. The difference between direct holding and omnibus account in terms of settlement discipline regime stays at the participant's level. Should it be the final owner then it just has to pay the fines, should it be the custodian (or another CSD) then it needs to find the real defaulter(s).

B/Buy-Ins Régime

The French community overall supports the proposal with 3 main caveats:

1/**Buy in must be different per asset classes (fixed income/equities/funds).**

Indeed as opposed to a plain vanilla market like the equity one, the other markets bear some specificity (OTC, illiquid securities) that should imply specific buy in treatment.

2/**Buy In must be different per types of transactions**

For instance, repos transactions must be considered differently, in particular its duration is too short to trigger a buy in.

Some exemptions must even been authorized in this situation as such transactions are used precisely to cover a short position

3/**ESMA must fix the date for the buy in triggering.**

For the time being, buy in may be launched between 4 to 7 days. We recommend that this parameter is definitively fixed.

Level 1 states "where a failing participant does not deliver the financial instruments referred to in Article 5(1) to the receiving participant within 4 business days after the intended settlement date ('extension period') a buy-in process shall be initiated". We have some concerns with the words "within 4 business days". Should it mean that the buy-in can be triggered before the 4 days period? Today some countries do not allow such extension period. Likewise CCPs may today trigger the buy-in before the 4 days period required by the Short Selling Regulation.

Fixing this parameter will favor the European harmonization and will also avoid arbitrage between countries.

4/**ESMA should avoid any buy-in duplication**

Indeed in most of the case a single transaction will involve several actors at both the trading level and the settlement level (pure isolate bilateral transactions are quite unusual). Settlement will follow a chain of intermediaries from the custodian of the seller to the custodian of the buyer sometimes going through a CCP. Thus a single lack of shares (for example) may lead to several unitary failing settlements. Should the buy-in process apply for each unitary failing settlement then the shares will be bought in several times uselessly with the risk that the terms of the buy-ins vary. Thus we recommend ESMA to design the buy-in process in such a way that there will be one buy-in triggered which consequences should be passed on all along the chain or starting from a CCP (should there be one).

5/**Buy-in should be clearly defined**

It is not clear on our view if the cash compensation is part or not of the buy-in process. We believe that buy-in will deserve a clear and harmonized definition or at least what it aims (to put an end to a failing settlement by delivering what was agreed at the confirmation level preferably and cash if not). According to Article 7.7 of the CSDR, cash compensation is not included in the buy-in process since cash compensation should be applied when the buy-in failed, whereas, in article 15 of the SSR, cash compensation is part of the buy-in process.

C/Confirmations

The French community recognizes the importance to confirm as early as possible the economic details of the transactions.

- **confirmations only limit the uncertainty risk**

First we would like to recall that there are different types of confirmations. The confirmation process could be done at the same moment with each party sending a message to a confirmation / affirmation platform, the latter being in charge of the matching and the statement of the agreement. Or this could be done bilaterally with one party sending a confirmation to the other, the latter having to answer. In this case the process is a two steps one and if the first confirmation could be sent immediately the second one may take more time (the receiver should control the terms of the execution and do the reconciliation giving that it might not be in the same time zone).

However, confirmation should be done as soon as possible (and this is the case most of the time); thus only information directly linked to the execution itself should need to be agreed. Information used for the settlement should be exchanged slightly after (since with a T+2 settlement cycle, the time for preparing the settlement comes swiftly).

- **but do not remove the risk of settlement not occurring.**

All though confirmation is the first step for any post trade process we should keep in mind that confirmation and settlement are two separate processes with different actors and different roles. Should the seller and the buyer agree immediately after the execution, agreement between the delivering party and the receiving party is still needed. This agreement is the real first step of a settlement process (on a “penalty regime” point of view since it should apply only on failing matched instructions).

A timely confirmation doesn’t mean a timely settlement as well as a late confirmation doesn’t mean a late settlement.

Should a late confirmation have an impact on the settlement on the intended settlement date then the CSD will apply a fine on the failing instruction. This will be the incentive for an earlier confirmation. A way forward would be to link the confirmation system (upon agreement of the participants) to the settlement system to avoid double workload and to promote STP and efficiency. In any case we believe there is no need for measures on confirmation.

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The French community thanks in advance the ESMA for the time taken to read our proposals and we would be glad to meet you to further expose these positions and help the discussion.

Yours sincerely

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