association of the
luxembourg fund industry

Luxembourg, 25 May 2022

Feedback to the European Commission
on a proposal for a CSDR Refit
COM(2022)120 final, 2022/0074 (COD)

Introduction

The Association of the Luxembourg Fund Industry (ALFI) represents the face and voice of the Luxembourg asset management and investment fund community. The Association is committed to the development of the Luxembourg fund industry by striving to create new business opportunities, and through the exchange of information and knowledge.

Created in 1988, the Association today represents over 1,500 Luxembourg domiciled investment funds, asset management companies and a wide range of business that serve the sector. These include depositary banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax advisory firms, auditors and accountants, specialised IT and communication companies. Luxembourg is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg domiciled investment funds are distributed in more than 70 countries around the world.

We thank the Commission for the opportunity to participate in this consultation on the CSDR Refit to which we will respond from the perspective of investment funds, that are net buyers of financial instruments.

I. General comments on the SDR

1. Background information

Investments funds belong to the buy-side sphere by opposition to the brokers that are on the sell side. Investment funds are net buyers of financial instruments, in line with the continuous growth of assets under management in the EU. Hence, investment funds are parties that suffer from late of failed delivery of securities. Therefore, investment funds are expected to be net receivers of cash penalties.

Before the entry into force of the Cash Penalties regime in February 2022, ALFI published for its members a guidance document regarding Settlement Discipline Regime (SDR), with a focus on the treatment and allocation of cash penalties.

2. Towards a simplified Settlement Discipline Regime (SDR)

We urge the Commission to allow the Refit initiative realize material simplification gains, both in terms pedagogy and relevancy.

In terms of pedagogy, for instance, the denomination of the "penalties" item in the Cash Penalties regime is often perceived as a sanction. Consequently, some jurisdictions consider this item as non-recordable or non-deductible in a fund's P&L, while it is only an ad valorem surcharge with a scale in basis points[1].
In light of ESMA June 2020 supervisory briefing on the supervision of costs in UCITS and AIFs[2], we considered this item can – if the asset manager and the CSD participant agree to pass on cash penalties - be charged to an investment fund, as the case may be. We expect to see such views confirmed by the outcomes of the common supervisory action (CSA)[3] that followed. We encourage the Commission to confirm that a CSD participant is not legally obligated to pass on cash penalties to its client (i.e. an asset manager or fund). The recitals of the CSDR currently allow for the passing on of penalties but do not require it. This status quo shall be maintained to enable all parties (custodians and asset managers) to adopt the most efficient approach to handling cash penalties.

In terms of relevancy, we think the Commission should also take into account the industry feedback based on the recent implementation of the cash penalty regime, as summarized in the next section.

3. Precisions on the scope excluded from the SDR

Besides, we would welcome precisions from the Commission through a delegated act or any other means on the transactions that should be excluded from the SDR, in line with Recital 4 of the Refit proposal[4]: *'In this regard, the scope of cash penalties and mandatory buy-ins set out in Article 7 of Regulation (EU) No 909/2014 should be clarified, in particular by specifying which categories of transactions are excluded.* ***Such exclusions should cover in particular transactions that failed for reasons not attributable to the participants and transactions that do not involve two trading parties, for which the application of cash penalties or mandatory buy-ins would not be practicable or could lead to detrimental consequences for the market, such as certain transactions from the primary market, corporate actions, reorganisations, creation and redemption of fund units and realignments.*** *The Commission should be empowered to supplement Regulation (EU) No 909/2014 by further specifying the details of such exclusions by means of a delegated act.'*

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[1] as stated in the annex of CDR (EU) 2017/389.
[2] (ESMA34-39-1042) §19 states: 'It should therefore be assessed whether the costs are necessary for the fund to operate in line with its investment objective (e.g.: the fund's investment strategy, portfolio management, transaction and settlement costs), or strictly functional to the ordinary activity of the fund or to fulfil regulatory requirements.'
[3] ESMA COMMON SUPERVISORY ACTION (CSA) WITH NCAS ON THE SUPERVISION OF COSTS AND FEES OF UCITS, 06 January 2021.
[4] 2022/0074 (COD).

4. Observation of the application of the cash penalty regime

a. From the monitoring that has been performed since the application of the cash penalty regime on 1 February, it appears - if cash penalties are to be passed on - that investment funds should receive a net credit balance, which is logical as they are net buyers of securities. Nevertheless, most of the time this credit is not material.

b. Besides, it appears that the cost of the corresponding operating process are often disproportionally high compared to the credit amount to be received. So far, we observed the following:

   i. Only Tier 1 asset managers have sufficient market exposure to receive material penalties and benefit from sufficient means to absorb the treatment of penalties in terms of human, contractual and IT costs.

   ii. Meanwhile, for Tier 2 asset managers (middle and small sized), the cost of the operating process outweighs the credit amount to be received. For this reason, it is frequent that such players decide in order to achieve a cost effective implementation to agree that the CSD participant (i.e. the custodian) shall bear all penalties (credits and debits).

c. Therefore, we might suggest the following remediations:

   i. Justify custodian price for the penalties service (filtering, pass-on, settlement reporting,…), - for the case that the parties agree to pass on penalties - with regard to the cost of doing business. It might be useful to define categories of service prices in light of CSDR purposes (ie. free of charge, cost of doing business, special price responding to a bespoke demand).

   ii. If the observation of the penalties regime implementation, -based on confirmed figures, in conjunction with point e. below- finally shows that this regime does not have a sufficiently positive impact on the buy side sector, an increase of the penalty rates[5] would represent one of the possible options to contemplate, with an appropriate calibration.

   iii. In the same vein, we are of the view that the Refit initiative should be the opportunity to clarify which of the following payment flows should prevail in light of the CSDR purposes. Is it the payment by the failing party[6], or the reception by the non-failing party[7]?

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[5] Op cit. Annex of CDR (EU) 2017/389.

[6] Recital 3 of CDR (EU) 2017/389 states: ‘To ensure that cash penalties imposed on failing participants act as an effective deterrent,…The level of cash penalties should provide incentives to failing participants to promptly settle transactions that failed to be settled’.

[7] Recital 16 of CSDR (EU) No 909/2014 states: ‘Cash penalties imposed on failing participants should, where possible, be credited to the non-failing clients as compensation’.

d. It would be helpful that ESMA shares with the industry a summary of the data received through the penalties reporting (type of failing counterparties, type of securities at issue, number of trades concerned). This would provide a qualitative complement to the figures circulated by the Commission in its impact assessment[8].

e. The timing of the present consultation is not ideal, as the production process is not yet stabilised. February was a short month (not representative) and its corresponding booking is unfortunately still ongoing at the time of the present drafting.

   For this reason, once the data are properly observable, ALFI will update its position on the CSDR SDR and will be happy to share it with the policy makers then.

5. Cash penalties production process

It is public information that CSDs are still encountering issues to properly book the penalties relating to the month of February 2022.

We may suggest that the Commission design measures to streamline the production process with the help of ESMA.

The target operating model may also take into account the potential introduction of new technologies (DLT) in the CSD operations, in light of the ESMA report on the topic[9].

II. On the Commission's proposals

In this section, we would like to provide feedback regarding the proposals contained in the consultation paper, in relation with the SDR.

1. Justification of Buy-in measures

Over the course of the last couple of years, while preparing the implementation of the SDR, a significant number of industry representatives have observed the following elements:

i. Since the entry into force of CSDR, the number of settlement fails has greatly diminished, despite the dramatic increase in trading through EU CSDs[10].
The regulation has had a deterrence effect. Moreover, CSDR was designed based on a rationale of the years 2000s with much more market participants. After the financial crisis, the industry has consolidated.

ii. Also, a review of the Securities Settlement Instructions static data (SSIs) has been beneficial.

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[8] SWD(2022) 75 final, Annex 8 (failed trades in % of turnover).
[9] ESMA, Report to the European Commission, Use of FinTech by CSDs, (ESMA70-156-4576), 2 August 2021.
[10] This is confirmed in SWD(2022) 75 final, p35.

iii. In the interim report issued by the Commission in July 2021[11], and in the impact assessment[12] annexed to the consultation, we noted an absence of official statistics to justify mandatory buy-in measures on top of cash penalties.

2. Triggering of the Buy-in

In light of the above elements, we support a 'differentiated approach' which calls for timely implementation of cash penalties, and only introducing buy-ins if settlement efficiency has not improved over time.

Nevertheless, should the buy-in regime needed to be implemented, we would recommend the following reforms.

A recalibration of the buy-in regime for the buy-side industry would be justified, in order to take into account its specificities. Indeed, Asset Managers structurally have long positions, thus are not representatives of the failing parties.

i. Possibility for a voluntary buy-in instead of mandatory one. This scenario would avoid the liquidity impacts of a mandatory regime. Cash penalties would remain.

We do not agree with the rationale contained in the impact assessment regarding voluntary buy-in[13] that describes disadvantages mostly from a broker's perspective, and not really from an asset manager's.

ii. Flexibility to appoint any suitable party as buy-in agent, e.g. a broker or the depositary bank of the fund, as long as the best execution requirement is ensured, in accordance with Rec. 33[14] and Art. 24[15] of the RTS (EU) 2018/1229. This would facilitate the performance of the buy-in for medium and small sized funds.

3. Scope of the Buy-in

The introduction of certain dimensions is interesting (certain financial instruments or categories of transactions) as it would calibrate the application of the buy-in to only relevant segments of the market.

Nevertheless, these dimensions are not described enough in the Commission's proposal. Moreover, the use of an implementing act would provide a lot of discretion to impose

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[11] On 1 July 2021, the EU Commission released an interim report on the review of CSDR, COM(2021) 348 final.
[12] SWD(2022) 75 final, in particular Annex 8 does not provide sufficient details on the reasons of the fails, p153-154.
[13] SWD(2022) 75 final, Section 6.4.3. Option 4 – Introduce voluntary buy-ins, p62.
[14] Rec. 33 RTS: 'Given that the buy-in agent should act upon request of a party that does not bear the costs related to the buy-in agent's intervention, the buy-in agent should act according to best execution requirements and protect the interest of the failing clearing member, trading venue member or trading party.
[15] Art. 24 RTS: 'A buy-in agent shall not have any conflict of interest in the execution of a buy-in and shall execute the buy-in on the terms most favourable to the failing clearing member, trading venue member or trading party, as applicable, in accordance with Article 27 of Directive 2014/65/EU.'

measures on which the industry would not have received sufficient information to get prepared.

Last, we recommend an exemption of the primary market transactions from the buy-in rules, in particular those underlying the creation of ETF shares. These transactions are already covered by long standing and well-established contractual arrangements between the issuer and its market makers/authorised participants. A buy-in would create a circular scheme.

4. Pass-on mechanism

If the CSD participant and the asset manager intend to pass on penalties, we agree with the implementation of a pass-on mechanism for such cases preventing a cascade of failed settlements each requiring a separate buy-in process by allowing each participant in the transaction chain to pass-on a buy-in notification to the failing participant such that only one buy-in is necessary to resolve the whole chain of transactions.