EU SECURITIES POST TRADING: PRIORITIES AHEAD

1. Evolution of securities cross-border post-trading activities in the EU

1.1 Progress made in EU cross-border post-trading activities

An official considered it vital to use the current situation to determine further improvements. Well-functioning cross-border settlement is key for post-trade financial market integration, and much has been achieved since the Giovannini reports on post-trade barriers to integration, although some points are still pending. TARGET2-Securities (T2S) provides seamless central bank money settlement through a common platform and will increase coverage by adding new central securities depositories (CSDs) and markets in the coming years. The question is how much this facilitates cross-border settlement and what more can be done.

Measuring cross-border settlement directly is difficult as it occurs via a multitude of channels. The ECB's high-level indicators suggest that in quantitative terms the increase has not been significant. T2S cross-CSD settlement data as a proxy seems to be stagnating at around 3% of T2S's total turnover recently. Data on CSD links shows a similar picture to general ECB security settlements. Holdings via CSD links seem stable at around 21% of securities outstanding with no increase since the Central Securities Depositories Regulation's (CSDR) introduction or the T2S go-live. When looking at the cross-border issuance of securities, quantitative data from the eligible asset database suggests that securities' cross-border issuance across national CSDs is stable at relatively low absolute levels, the official explained.

The numbers would, however, not be likely to show the full picture. Qualitative feedback suggests that settlements and holdings often take place via custodians and are not captured, and says that their task has been made easier by what is on offer. There is more to do however to overcome a lack of harmonised procedures in corporate actions and withholding tax in particular, as they are key for improving European post-trade integration. The Single Collateral Rulebook for Europe (SCoRE) initiative on the collateral domain, which also indirectly contributes to better awareness and compliance with high-level market standards for corporate actions, should be highlighted in this context. This, together with the T2S corporate action standards covering pending settlement transactions, forms a single corporate actions rulebook which should be implemented by all stakeholders: custodians, CSD issuers and investors, the official suggested.

An industry representative considered that major global custodians see the benefits of T2S. These have materialised to a large extent, and it is important that settlement in Europe is now largely harmonised. With regard to statistics, cross-CSD settlement alone is not a good measure of the foreign investment flowing into Europe, as much of it comes via custodians or investment banks. Analysis on the proportion of the client base outside Europe investing in Europe shows it is more than half. That indicates that Europe is an attractive place for foreign investors, provided that the regulatory regime and market infrastructure are efficient and do not lead to prohibitive costs. Tax is also one element. Concerning the remaining barriers to investing into Europe for non-European investors, reducing them aligns with the objectives of the capital markets union (CMU). The CSD Regulation (CSDR) is generating many benefits and also some difficulties for getting CSD licences. It has largely made Europe a safer and more interactive place from a post-trade perspective.

Another industry representative stated that fragmentation is a problem not fully solved yet therefore more action is needed on that front. Another industry representative advised that the experience of dealing with multiple regulators and supervisors shows that progress in supervisory convergence and coordination would be beneficial. This includes the use of the passporting system in CSDR.

A third industry representative agreed that further supervisory convergence is needed, as it can be hard at present to deal with different supervisors on one matter. The Commission's CSDR review consultation touches on the most relevant aspects, including passporting regimes and other issues such as withholding tax and corporate actions, where there is evidence and experience as to needed adaptations.

1.2 Main actions underway at the Eurosystem level

An official stressed that the Eurosystem has helped to reshape the payments and settlement systems infrastructure, aiming to establish a single financial market across Europe where payments, securities and collateral can move safely without friction between participants. The Eurosystem has been working over the last few years with market participants to increase the harmonisation and integration of European securities markets, notably addressing the European Post-Trade Forum (EPTF) recommendations. A key project is the Eurosystem Collateral Management System (ECMS), with a go-live for November 2023. It is vital for collateral management harmonisation and will foster a level playing field among market participants. This will replace the existing system of 19 national central banks with one system to mobilise collateral for assisting credit operations and bring operational and cost-efficiency benefits.

In May 2019, at the front end of the securities process chain, the Eurosystem launched a public consultation on a potential European mechanism for the issuance and initial distribution of debt securities in the EU, the European Distribution of Debt Instruments Initiative (EDDI). EDDI would be a pan-European gateway for debt securities aiming to support integration and harmonisation in the EU's issuance and initial distribution ecosystem. Work is needed to support the pan-European issuance process of the future European benchmark with a common regulatory environment, underpinning market infrastructure that promotes security, stability and transparency. By fostering more integration in the European securities market these different Eurosystem initiatives will facilitate the achievement of the CMU.

1.3 Issues related to the CSDR settlement discipline regime

An industry representative noted that the last stage of the CSDR implementation rollout concerns settlement discipline. A key objective of the CSDR is improving settlement rates in Europe by preventing fails, obtaining better matching rates, or ensuring that partial hold and release and other technical features which may affect delivery are implemented. The industry has invested a great deal of effort either internally or via T2S or CSDs for achieving these objectives before the February 2022 deadline.

There are other so-called 'ex-post' measures aiming to motivate players financially to improve settlement rates via penalties for late settlements or mandatory buy-ins. Industry and public authorities learned in 2020 that liquidity is not a stable phenomenon, as the upheaval in the markets made it clear that bid offer spreads and the ability to find or sell securities is not a given. That led to debates about the need to implement mandatory buy-ins by buyers as an ultimate measure if fails persist beyond a certain date. The Commission's consultation, which closed in February, included the topic of settlement discipline. The feedback published shows that although many of the measures proposed are welcomed by a majority of stakeholders including industry participants, strong concerns are expressed regarding a possible mandatory buy-in regime.

Firms both on the buy and sell side are concerned that the cost of mandatory buy-ins will be detrimental to the ability of buyers and investors to buy and sell securities and will hinder the issuance of new ones into the market, which is the opposite of the regulation's aim of making Europe a better place to invest. Internal calculations of potential costs show dramatic impacts for investors, so regulators and market authorities must reconsider in the perspective of the CSDR review proposal due to be published in Q3 or Q4 2021 if this is really the best tool for achieving settlement efficiency, the speaker believed. It is hoped that an appropriate settlement discipline regime (including discretionary buy-ins) will be included in this proposal in order to maintain the attractiveness of Europe because many non-European investors who are not accustomed to all the details of EU regulations will be impacted. Reviewing the current regime and making it futureproof is a pressing concern and an opportunity for the future.

Another industry representative agreed that the settlement discipline regime is an issue that needs to be carefully addressed. Work on the framework has been underway for a long time and there have been many delays in its preparation, demonstrating the magnitude of the challenge of its preparation. However it is essential to take into account the broader context of the EU market concerning settlement fails. The Eurosystem sees significantly higher fail rates than other leading jurisdictions at present, so the time spent on making sure the settlement discipline regime is right is justified.

The majority of settlement fails relate to the non-delivery of securities, so more discipline should be ensured on that end of the market. The buy-in regime which intends to strengthen integrity could contribute to this. It may reduce liquidity, but this is 'ghost liquidity,' which would not have been delivered upon anyway. Another observation is that this proposal concerns the uncleared space. In the cleared space, buy-ins are already part of the system.

1.4 Other areas of improvement concerning post-trading rules

Corporate actions management

An industry representative stated that one of the recommendations of the CMU High-Level Forum (HLF) was to harmonize the definition of 'shareholders' and the management of corporate actions across the EU. That requires common rules governing the interaction between investors, intermediaries and issuers to facilitate shareholder engagement. Many efforts have been made during the last few years by different industry and market working groups for defining corporate action standards. In addition, the new SWIFT ISO 20022 is a useful tool for increasing harmonisation.

The implementation of the Shareholder Rights Directive II (SRDII) and the ECB ECMS project have also contributed to reaching agreement on common rules based on current market practices materialised by the single collateral management rulebook for Europe. Work must however continue to reach a common understanding among the different stakeholders of the content and format of corporate action messages and communications and of entitlement rules and also an agreement on key dates and deadlines across markets.

Withholding tax refunds

An industry representative noted that there is room for improvement on the common procedures and practices for withholding tax refunds, which is in the CMU action plan. The 2017 code of conduct is a good foundation, although non-binding. The goal is improving the current withholding tax procedures' efficiency and leaving the standard tax reclaim as a contingency procedure. Tax topics are difficult, and progress will be complex, but harmonisation is essential to achieve CMU.

An official welcomed this being an explicit action point in the CMU action plan. Concrete proposals are anticipated, and the ECB is ready to help with fact-finding and impact assessment.

2. Prospects of the DLT Pilot Regime

The Chair stated that the core idea of the distributed ledger technology (DLT) Pilot Regime is that an infrastructure provider using DLT technology can apply for exemptions from the MiFID, MiFIR and CSDR legislations when these are not compatible with DLT.

2.1 Potential benefits of DLT technology and other new technologies in the post-trading area

An industry representative explained that work is progressing to achieve efficiency gains with DLT particularly in the settlement area. DLT reduces by nature the need for reconciliation and potentially brings other operational efficiency benefits, but more importantly it can change the conduct of financial transactions more broadly. First it supports peer-to-peer, which is an ongoing trend that is already happening independently from DLT. Work is progressing e.g. on allowing peer-to-peer collateral management and repo trading whereby counterparties no longer have to go through a bank but can trade with each other, which improves the process and the risk profile of the transaction. Secondly, the true benefit of DLT is that it allows the creation of a distributed marketplace, moving away from the single point of failure that existing infrastruc-

tures represent. Further thought about the implications of that change is however needed. A further aspect is the potential for deconstruction of asset risk-reward profiles. With assets such as stablecoins the interest of cash and payment capacity can be processed separately, which is not the case today.

An official stated that DLT has the potential to improve the efficiency of the securities market and support the CMU, while preserving its resilience and safety, but there is a long way to run for implementing it at scale. The direction of travel at the European level is the right one, with the recent proposal for regulating the crypto assets market (MiCA) and the DLT pilot regime proposal. These may be important drivers for the use of DLT in securities markets in the future.

Another industry representative emphasized that technology has been a key driver of efficiency and stability in the securities market since the 90's and this applies particularly well to post-trading. The change from manual and paper-based processes to electronic trading significantly improved market integrity at the time and the same should be true going forward. The adaptations in the 90's were however made without regulatory relief, the speaker pointed out.

A third industry representative mentioned that new technologies can also help to tackle some of the problems that exist with corporate actions and withholding tax procedures. This could allow a step change in terms of safety and efficiency in these areas in the coming years.

2.2 Challenges associated with the use of DLT in the post-trading area

Scalability, security and privacy

An industry representative emphasized that while DLT has many potential benefits in terms of efficiency and safety, its deployment remains challenging. When implementing DLT there is a trade-off between the scalability of the technology and therefore its performance, and the level of security and data privacy that can achieved. In a distributed system, an institutional market participant will have to consider whether it wants to distribute all the data including client data across the system, which is the essence of a DLT system. This causes a data privacy issue, because the organisation's client data would be accessible in the distributed databases or ledgers by peers or even competitors. This can be resolved with strict and robust privacy measures and cryptography, but doing so can reduce the performance of the process, which requires defining the optimal configuration.

Another industry representative commended the European authorities for proposing a regulation for this new market. Europe is one of the most advanced jurisdictions in this regard and the lack of regulation in some other major markets prohibits market growth in these markets. There are however challenges to overcome. Firms want improvements and competition but at the same time do not want this to happen at the expense of system stability and safety.

Finality

An official observed that a key point to the use of DLT systems in the securities market is legal soundness. That means ensuring the compliance of the technical system with applicable regulation, especially concerning the finality of transfer orders. In the absence of a specific regulatory framework for a token economy, all actors must ensure that token activities comply with the traditional rules and regulations. This entails complying with several European regulations, such as the CSDR, the Settlement Finality Directive (SFD) and EMIR, which are not fully adequate in this new paradigm. Changes need to be made to these regulations and to SFD in particular, in order to adapt them to the new reality of DLT-based systems, but doing so with rules designed for traditional assets is not easy. It brings cost for market players and it may not be as safe or efficient as expected.

2.3 Regulatory implications of the use of DLT in the settlement space

An industry representative considered that DLT may allow traditional service providers to provide new services in the crypto space. The review of CSDR is also an opportunity to make CSDR fit for digital.

An official stated that the Eurosystem is supportive of the adoption of new technologies like DLT as they may open up new possibilities for financial markets.

Another official considered that it is vital to emphasise that, for regulation, the status of an asset should not be affected by tokenisation, provided that there are no changes in the underlying assets' legal status. The technology and methodology do not affect the status of assets, but the nature and the structure of the DLT cost system in which the token exists may change the extent to which regulations are applicable. Some aspects of the European securities regulation must be adapted to the new reality of DLT-based systems. First, there is currently no legal European framework around safekeeping and service cost for the DLT environment, and jurisdictions have different legal frameworks. Second, there are different interpretations of services (i.e. asset services, custody and safekeeping) in a DLT environment. New roles, functions and responsibilities will emerge in a DLT environment and must be defined in the revised regulatory framework. Third, the concept and definition of settlement, plus the moment of settlement finality, must be assessed and clarified within a DLT environment. In addition, if a securities token qualifies as a transferable security in a regulated market, it must be recorded with an authorised official CSD. Interoperability and standardisation across DLT platforms and the ability to provide delivery versus payment and settlement in the central banks' money are further questions that must be addressed.

An industry representative believed that the Markets in Crypto-Assets (MiCA) proposal on cryptoassets is a good starting point for the DLT pilot regime. An important and welcome fundamental base principle in MiCA is that crypto assets will be regulated under financial regulation.

2.4 Potential level playing field and fragmentation issues raised by the DLT Pilot Regime

An industry representative noted that traditional settlement providers like CSDs should be authorised to offer settlement services on crypto-assets, thus avoiding the thinking that settlement for crypto-assets should be only for entities under the DLT pilot regime and traditional assets only for traditional CSDs. There is an opportunity to make slight modifications to CSDR to make it fit for digital moving forward.

Another industry representative suggested that the pilot regime is possibly being considered too theoretically. The market is not yet mature enough when it comes to security tokens and other financial instruments operating and being issued on DLT, therefore we need to be open to these new developments. The pilot regime fosters innovation and a review of current regulation to adapt it to the new DLT environment, but it is not certain that it goes far enough, because it is largely based on the existing market structure (e.g. market infrastructures in the form of CSDs), but banks operating MTFs also want to participate in those market evolutions. The true benefits of DLT materialize in a decentralised marketplace, which would mean allowing more players to participate in that evolution.

A third industry representative stressed the conflicts of interest raised by the DLT pilot regime. Allowing the same entity to do trading, risk management and settlement could mean a return, philosophically at least, to the situation before the G20 reforms. There is a need to be careful when providing exemptions from EMIR and CSDR as to what is wished for, especially on the clearing and risk management side. Concerning trading, MiFID II reforms brought 670-plus trading venues into the EU's landscape, so there is no fear by incumbents of new competition.

A fourth representative agreed that the DLT pilot regime must find the right balance between innovation and security and not compromise safety and stability, for which post-trading is essential. The objective should not be to develop DLT as such, but as a catalyst for a more integrated and safer CMU. The legislative framework must also remain technology neutral. This is important to avoid market fragmentation or conflicts of interest.

The first industry representative agreed that the DLT Pilot Regime must serve primarily the CMU objective, rather than focusing on the development of the DLT technology. A potential concern is a pilot regime that would end up reducing harmonisation and integration in the EU securities market, with exemptions for MTFs using DLT granted by each national competent authority and with only limited coordination by ESMA. This may lead to an unlevel playing field between MTFs and incumbent infrastructures and to regulatory arbitrage. It may also increase fragmentation if a large number of MTFs provide settlement services in silos with no open access and no interoperability, going against the integration objectives of the CMU. Ensuring a level playing field requires applying the principle of 'same activities, same risks and same rules'. Some changes to the regulatory framework might also need to be considered. Generally speaking, when adjustments are being considered for fostering technological development, these should have the CMU objectives in mind. There should be an evaluation of whether these changes are likely to foster more cross-border investment and help connect investors and issuers.

Another industry representative stressed the importance of technology-neutrality, which requires a convergence of the traditional regime and of the DLT Pilot Regime with regard to CSDR, SFD, CFD and AIFMD and so on, all of which are based on existing technology. This would ensure that regulation does not inhibit innovation when DLT becomes more a mainstream technology.

2.5 Issues related to the possible winding down of the DLT Pilot Regime

An industry representative suggested that the exit strategy from the DLT pilot regime must be clear before starting.

Another industry representative agreed that the exit strategy must be spelled out beforehand, because it must be possible to stop it or modify it if it is inadequate and the entities entering the pilot regime should know what to expect if the regime does not work out the way it should. The speaker noted that the current proposal limits the scope of the regime to five years, but it is not necessary to wait that long because most of the benefits and issues will emerge before then. The regime could be limited to three years for example, because the longer it lasts the more difficult it will be to wind it down. In addition, winding down is different from a trading or CSD perspective. Winding down a trading venue (i.e. shifting trading onto another venue) is easy and can be done quickly. This is much more difficult for a CSD, especially for instruments that do not have a redemption date, like equities and bonds. Those would have to be limited to three to five years.

A third industry representative mentioned the importance of thresholds, especially concerning shares, in the winding-down perspective. The € 200 million market cap threshold for shares admitted into the regime seems low but can quickly develop into significant volumes and the rule can be bypassed if issuers construct several issuances that never break the threshold individually. This needs to be considered in the context of a possible exit or winding-down strategy, because if a great number of citizens are locked into a system based on the DLT pilot regime, the winding-down will be a challenge. Greater granularity is required in the Commission's proposal on how projects can be discontinued or wound down and also how projects may transition from the pilot regime into the 'real world'.

An official considered the pilot regime to be the right way to gain experience with DLT, allow structured, safe implementation and assess developments. It must be created and used with an understanding by stakeholders that it is a pilot with a foreseen end, and it must not be confused with a potential review of the mainstream regulatory framework, based on experiences eventually gained from the pilot. If the pilot regime gains traction, stakeholders must understand that its generalisation can only be based on careful analysis afterwards of that experience and a review of the mainstream framework, while avoiding regulatory arbitrage and parallel regulatory regimes.

It is also important to highlight the strict thresholds imposed in the Commission's proposed DLT Pilot Regime regulation, which are essential for keeping this a pilot regime and preventing it from becoming a parallel regime and a regulatory loophole to the CSDR. The draft Commission proposal also states that operators of DLT under the pilot regime must have in place an exit strategy. However if permissions or exemptions are revoked or if the market valuation of DLT-transferrable securities exceeds thresholds, the DLT market infrastructure operator may have to undertake substantial changes, which might require a significant period of time. Pilots should be allowed only if they can potentially be wound down afterwards, if needed. This should be the base assumption that should be sufficiently elaborate and prominent in the final regulation, the official believed.