



EUROPEAN COMMISSION TARGETED CONSULTATION DOCUMENT

REVIEW OF REGULATION ON IMPROVING SECURITIES SETTLEMENT IN THE EUROPEAN UNION AND ON CENTRAL SECURITIES DEPOSITORIES

General Comments

BlackRock welcomes the opportunity to provide feedback to the European Commission's targeted consultation on a possible review of the Central Securities Depository Regulation (CSDR). We recognise that CSDR plays a pivotal role in the post-trade harmonisation efforts in the EU, enhancing the legal and operational conditions for efficient cross-border settlement in the Union, while promoting cross-border competition within the single market. As such, the CSDR is a cornerstone legislative initiative underpinning Capital Markets Union (CMU) which drives the EU towards strategic autonomy in financial services.

Through this feedback BlackRock represents the interests of Europe's end-investors. End-investors are the Europeans, individuals and households, saving for life's events through UCITS for example, through to the most sophisticated financial institutions such as insurance companies and pension funds, demanding tailored investment solutions. Efficient and liquid markets are a pre-requisite for a functioning European capital market and only reinforce European's confidence to invest over a longer-term perspective.

Turning to the elements of the consultation, we limit our detailed comments to the sections of the consultation focused on scope and the Settlement Discipline Regime (SDR). BlackRock is fully supportive of the intention and objectives of CSDR to limit default risk, improve overall settlement efficiency and protect buyers against the risk of non-delivery from the seller. However, certain elements of the SDR have important unintended consequences, the impact of which would be borne by Europe's end-investors. The global market turmoil caused by the COVID pandemic of March 2020 underscored the importance of ensuring that Europe's regulatory framework provides a robust and clear framework but does no harm in terms of liquidity access, particularly in the less liquid asset classes, such as fixed income. With this perspective guiding our feedback, BlackRock is supportive of several recommendations set out in the consultation document. Our response is also generally aligned with several trade associations' responses including EFAMA, ICMA and ISLA.

First, it is important to clarify the scope of transactions in scope of the SDR. In our view, the SDR should be based on an appropriately calibrated penalty regime but it should not include a mandatory buy-in regime. We believe that this approach would sufficiently align incentives to improve settlement discipline in European capital markets and be fully consistent with the aims of the Regulation. If however a buy-in regime is to be implemented any regime should be voluntary and exclude the physical settlement of derivatives, corporate action settlement, collateral/margin transfers, and securities finance transactions (SFT) should all be clarified as being out of scope for the buy-in regime.

Second, we would encourage the publication of settlement failure rates by depositaries and where warranted, increase the penalty rates to support greater settlement discipline. A de minimis

threshold based on existing market practice below which a penalty will not be collected should also be established.

Third, exclude from the scope of the penalty regime a small number of technical trades, such as ETF creation and redemption trades in part because penalties would ordinarily apply to the failure to deliver the underlying securities.

Finally, we share the widespread concern amongst stakeholders that there will be insufficient time between agreeing the revised SDR framework and the go live date of 1 February 2022. Implementation requires time to develop and test IT and to establish dependencies between investment managers, custodians and brokers. Likewise, significant time is needed to re-paper agreements which include custodian documentation, master trading agreements (GMRA, GMSLAs, Terms of Business etc.). The process would typically take at least 12 months from the point at which the revised SDR rules are adopted. We urge the European Commission to factor into its planning the time that is necessary for the industry to adequately prepare for the transition to a revised SDR regime to avoid liquidity shocks and wider market disruption at a time when all sides are working collectively to build deep, liquid and open European capital markets that serve Europe's economy and its end-investors.

Consultation Questions

Section 6 - Scope

Question 31. Do you consider that certain requirements in CSDR would benefit from targeted measures in order to provide further legal certainty on their scope of application?

Yes

No

Don't know / no opinion

Question 31.1 If you answered "yes" to Question 31, please specify what clarifications/targeted measures could provide further legal certainty.

5000-character(s) maximum

Clarify that the SDR should be based on an appropriately calibrated penalties regime but it should not, at this time, include a mandatory buy-in regime.

Question 31.2 If you answered "yes" to Question 31, please specify which provisions could benefit from such clarification and provide concrete examples.

5000-character(s) maximum

Our suggestions in relation to where CSDR could warrant clarification all relate to the settlement discipline regime and we provide more detail on this in our response to question 34. In relation to the scope of the settlement regime, it should be made clear that ETF order/redemption leg should not fall within scope due to the inefficiencies that would be created by the imposition of penalties and mandatory buy-ins.

In the event that a buy-in regime is to be implemented (though please note the concerns raised to our responses to question 34) we have a concern on the potential application of mandatory buy-in to a number of settlement scenarios and believe that it should be made clear they are out of scope:

- Margin or collateral transfers relating to any transactions (e.g., derivatives, securities financing transactions etc.) [see ISDA response for further detail];
- settlements deriving from corporate actions,
- both legs of securities finance transactions (SFT) (see ICMA and ISLA responses for further details).

The physical settlement of derivatives (see ISDA response for further details).

Question 32. Do you consider that the scope of certain requirements, even where it is clear, could lead to unintended consequences on the efficiency of market operations?

Yes

No

Don't know / no opinion

Question 32.1 If you answered "yes" to Question 32, please specify which provisions are concerned.

5000-character(s) maximum

See the presentation of the International Capital Market Association (ICMA) (June 2020) [Mandatory buy in provision of the EU CSDR in the non-cleared bond & repo markets](#) which provides a comprehensive overview of the issues and unintended consequences of the scope of certain requirements on the efficiency of market operations.

Question 32.2 If you answered "yes" to Question 32, please specify what targeted measures could be implemented to avoid those unintended consequences while achieving the general objective of improving the efficiency of securities settlement in the Union?

5000-character(s) maximum

See above.

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

Question 33.1: If you answered yes to Question 33, please indicate which elements of the settlement discipline regime should be reviewed: (you may choose more than one options)

Rules relating to the buy-in

Rules on penalties

Rules on the reporting of settlement fails

Fails

Question 33.2: If you answered "Other" to Question 33.1, please specify to which elements you are referring.

5000-character(s) maximum

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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:

	1 (disagree)	2 (rather disagree)	3 (neutral)	4 (rather agree)	5 (fully agree)	No opinion
Buy-ins should be mandatory	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Buy-ins should be voluntary	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Rules on buy-ins should be differentiated, taking into account different markets, instruments and transaction types	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
A pass on mechanism should be introduced	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
The rules on the use of buy-in agents should be amended	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
The scope of the buy-in regime and the exemptions applicable should be clarified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
The asymmetry in the reimbursement for changes in market prices should be eliminated	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
The CSDR penalties framework can have procyclical effects	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
The penalty rates should be revised	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
The penalty regime should not apply to certain types of transactions (e.g. market claims in cash)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>

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

5000 character(s) maximum

Buy-ins should be voluntary, not mandatory

Imposing a one-size-fits-all buy-in framework across a range of different securities, markets, and transaction types is inherently sub-optimal, potentially undermining the very purpose and benefits of buy-ins or similar remedies and the broader effort to build deep and liquid European capital markets which serve the end-investor.

A uniform mandatory buy-in process will not always be an appropriate remedy for certain markets or transaction types. SFTs and derivative transactions for example, do not generally apply buy-ins as the outright purchase of a security is not necessarily consistent with the structure and economics of a short-term loan of securities. In most cases, buy-ins would not provide the non-failing party with a suitable outcome. In addition, industry standard agreements generally provide SFT-specific remedies, that have been developed to suit the underlying transactions, and which are designed to manage the specific risks arising from those transactions, whilst being consistent with the overall objectives of the CSDR.

Buy-in frameworks should therefore be designed with the underlying markets in mind, ideally by the relevant market participants who rely on those remedies and to whom they apply, as is currently the case with SFTs. Relevant trade associations are encouraged to issue guidance to market practitioners to set out the elements of a model buy-in process.

The SDR should be based on an appropriately calibrated penalties regime; it should not include a mandatory buy-in regime

The scope of application of the penalty and buy-in regimes should be differentiated, with buy-ins not being applied at all. Maintaining the approach of using buy-ins could lead to significant unintended consequences for European capital market efficiency in the related products and undermine efforts to build deep and liquid capital markets in Europe that best serve the end-investor.

A pass-on mechanism should be introduced

The optimal solution would be for pass-on to be provided for under market-based contractual arrangements, that reflect the underlying market structures and dynamics, rather than attempting to (re)introduce them through regulation. Any mandated pass on mechanism would need to be incorporated into contracts so such arrangements should be drafted by market participants bearing in mind existing contractual protections and risk associated with the product.

The mandatory requirement to appoint a buy-in agent should be removed

The optimal solution is for firms to be able to execute buy-ins at their own discretion under market-based contractual arrangements. We have strong concerns about there being a mandatory requirement to appoint buy-in agent since this does not necessarily reflect underlying market structures and dynamics, and which risks undermining the very purpose of a buy-in.

The requirement to appoint a buy-in agent creates significant challenges, particularly from the perspective of bond markets. Traditionally, buy-in agents were market-makers for the relevant securities, who were able to apply their product knowledge and experience and leverage their client franchise in order to fulfil the buy-in. In recent years, market-makers have withdrawn from providing buy-in services, largely due to the challenges, and risks, associated with acting in this capacity. Anecdotally, only one buy-in agent has come forward to fulfil the function

foreseen by the CSDR, which adds cost to trading for asset managers in terms of onboarding, connectivity, fees and burdensome collateral requirements as well as impacting best execution and adding concentration risk.

If more buy-in agents do not come forwards then there is a real risk that most buy-ins would not be successfully executed, resulting in a mandatory cash settlement mechanism that may also prove to be very challenging to implement given the requirement for the two trading parties to agree a mutually acceptable mark to market (cash compensation). We are particularly concerned about this outcome in the more illiquid asset classes such as High Yield debt where pricing is less transparent due to the lack of liquidity and therefore the agreement of a market to market would create friction.

Therefore, we recommend removing the requirement to appoint buy-in agents under the CSDR. This would be the cleanest way to alleviate this area of significant concern amongst market participants as regards the functioning of the CSDR. Firms should be able to execute buy-ins at their own discretion under market-based contractual arrangements, rather than being mandated by regulation that does not always reflect underlying market structures and dynamics, and which risks undermining the very purpose of a buy-in.

The asymmetry in the reimbursement for changes in market prices should be eliminated

The asymmetry in the reimbursement for changes in market prices creates an additional risk for all sellers of securities (who are effectively short this put option) and additional risks for intermediaries (counterparties who have matched purchases and sales), since they are effectively now short a put-spread.

In the case of symmetrical payments, intermediaries are protected by pass-on mechanisms but a pass-on cannot work in the case of asymmetrical payments. If the buy-in (or cash compensation/settlement) reference price is lower than the intermediary's original trade price, both transactions are effectively cancelled under CSDR, and any differences 'deemed paid'. In other words, the P&L generated by their sale and purchase will be lost, even where they are not the cause of the failure.

Hence the asymmetry inadvertently impacts not only the original failing party, but every party in a transaction chain, except for the final purchaser (who has the possibility of a windfall profit). Thus pass-ons become impossible in many circumstances.

Furthermore, it increases the incentive for all parties in a transaction chain to initiate a contractual buy-in as quickly as possible (i.e., immediately) as everybody scrambles at the same time to ensure delivery in order to protect their P&L from the regulatory asymmetry.

The penalty framework is unlikely to lead to pro-cyclical effects

We do not believe that the penalty framework will have a procyclical effect. Penalties are a stronger incentive mechanism than buy-ins and will improve overall hygiene of the ecosystem by forcing better behaviour of market participants. The application of the penalty regime will also generate investment into the infrastructure across all participants improving overall market efficiency.

The penalty rates should be subject to review by ESMA

Following the periodic disclosure of settlement failure rates by depositaries, ESMA should have the ability to tailor the regime to fully align with the objectives. Allowing targeted revisions to rates – up or down – and allowing for the rates to be tailored per instrument, would help to incentivise overall settlement efficiency.

We recommend that the cash penalty mechanism be implemented as soon as practicable. Once the regime has been allowed enough time to run, any possible recalibration of the penalty

fees should be based on an analysis of any impacts and considering its explicit objectives.

The penalty regime should not apply to certain types of transactions

The penalty regime should not apply to a small number of technical trades, such as ETF creation and redemption trades. In this case, penalty would ordinarily apply to the transactions on the purchase of the underlying securities, so the additional layer of penalty is not warranted to enforce market discipline.

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

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.

5000 character(s) maximum

BlackRock experienced slightly elevated settlement failure rates during the market turmoil of March 2020, which we can attribute to brokers being short a given security. Had the CSDR been in force during this time, executing buy-ins in addition to the increased workflow arising from settlement fails would have generated elevated levels of operational risk.

BlackRock estimates that during March and April of 2020 our buy-in volume would have potentially doubled that of an average two-month period. Had CSDR buy-in measures been in place during this period, they would have amplified pressure on European capital markets at a moment of intense market stress. The concern regarding these pro-cyclical effects of the buy-in regime underscore our recommendation to base the settlement discipline regime around an appropriately calibrated penalty regime rather than the additional proposed mandatory buy-in regime.

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.

5000 character(s) maximum

The settlement discipline framework can be improved by taking several targeted actions in the current Review. These actions would allow for broad adoption of a framework that incentivised a robust settlement discipline regime in European capital markets whilst minimising adverse market disruption and the significant operational challenges that would otherwise come to the fore under existing proposals.

Specifically, we recommend the European Commission makes the following changes:

- First, it is important to clarify the scope of transactions in scope of the CSDR settlement discipline regime (SDR). In our view, the SDR should be based on an appropriately calibrated penalty regime but it should not include a mandatory buy-in regime. We believe that this approach would sufficiently align incentives to improve settlement discipline in European capital markets and be fully consistent with the aims of the Regulation.
- Second, we would encourage the publication of settlement failure rates by depositaries and where warranted, increase the settlement rates to support greater settlement discipline. A de minimis threshold below which a penalty will not be collected should also be established.
- Third, exclude from the scope of the penalty regime a small number of technical trades, such as ETF creation and redemption trades as penalty would ordinarily apply to the transactions on the purchase of the underlying securities.
- Finally, we urge the European Commission to factor into its planning the time that is necessary – at least 12 months - for the industry to adequately prepare for the transition to a revised SDR regime. This is to avoid liquidity shocks and wider market disruption at a time when all sides are working collectively to build deep, liquid and open European capital markets that serve Europe’s economy and its end-investors.

Taken together we believe these recommendations represent a meaningful set of improvements to the SDR that fully align with the objectives of the CSDR, whilst ensuring there are no adverse and unintended impacts on the overall shared aim of building deep and liquid European capital markets at the service of European end-investors.