EUROPEAN
COMMISSION

Brussels, XXX
[…](2021) XXX draft

REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

under Article 75 of Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012

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1. INTRODUCTION

The Regulation on improving securities settlement in the European Union and on central securities depositories[1] (CSDR) sought to improve the safety and efficiency of settlement as well as provide a set of common requirements for central securities depositories (CSDs) across the EU. It was adopted in 2014, however certain requirements started applying only after adoption of the relevant regulatory technical standards (RTSs) a few years later.

Article 75 of CSDR requires the Commission to review and prepare a general report on a wide range of issues by 19 September 2019. The report was postponed and its scope is narrower than prescribed in CSDR due to delays in the application of some measures, as well as the recent (re)authorisation of a sufficient number of CSDs under CSDR to allow a comprehensive assessment. Article 81(2c) of the European Securities and Markets Authority (ESMA) Regulation[2] also requires the Commission to assess the potential supervision of third-country CSDs by ESMA.

The Commission has engaged in a broad consultation process in the preparation of this report. In broad terms, CSDR is achieving its original objectives to enhance the efficiency of settlement in the EU and the soundness of CSDs. In some areas, the introduction of significant changes to CSDR would be premature considering the relatively recent application of requirements. Nevertheless, stakeholders have expressed concerns on the implementation of specific rules that already apply (i.e. on cross-border provision of services, access to commercial bank money, framework for third-country CSDs). The Final Report of the High Level Forum on the Capital Markets Union (CMU)[3] also recommended that the Commission conduct a targeted review of CSDR to strengthen the CSD passport and improve supervisory convergence among national competent authorities, to enhance the cross-border provision of settlement services in the EU, foster competition and generate cost savings. Concerns were also raised about the proportionality of the settlement discipline regime and its impact on financial stability. The pressure put on markets by the COVID-19 pandemic seems to shed light on some of those concerns.

[1] Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012, OJ L 257, 28.8.2014.

[2] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC, OJ L 331, 15.12.2010.

[3] https://ec.europa.eu/info/sites/default/files/business_economy_euro/growth_and_investment/documents/200610-cmu-high-level-forum-final-report_en.pdf.

The Commission acknowledged that some of these issues need to be addressed and in the new CMU Action Plan[4], adopted in September 2020, it announced that it will consider amending rules to improve the cross-border provision of services, to contribute to the development of a more integrated post-trading landscape in the EU.

This report summarises the main areas under review to ensure fulfilment of the objectives of CSDR in a more proportionate, efficient and effective manner. In light of the important issues identified, and as also announced in the 2021 Commission Work Programme,[5] the Commission considers presenting a legislative proposal to amend CSDR to improve its efficiency and effectiveness (CSDR REFIT), subject to an impact assessment that will consider the most appropriate solutions in more depth.

2. CENTRAL SECURITIES DEPOSITORIES REGULATION (CSDR)

CSDs[6] are financial institutions of systemic importance for financial markets. They play a crucial role in the primary market, by centralising the initial recording of newly issued securities ('notary service'). They operate the infrastructure ('securities settlement systems') that enables the completion of a securities transaction ('settlement'). They also maintain securities accounts that record how many securities have been issued by whom and each change in the holding of those securities ('central maintenance service'). According to the ECB, there were over EUR 53 trillion worth of securities in EU securities settlement systems at the end of 2019, which handled over 420 million delivery instructions for a total of turnover of over EUR 1,120 trillion that year.[7]

CSDs are essential for the financing of the economy. Apart from their role in the issuance process, securities collateral posted by companies, banks and other institutions to raise funds flows through securities settlement systems operated by CSDs. They are also integral for the implementation of monetary policy as they settle securities in central bank monetary policy operations.

CSDR played a pivotal role in the post-trade harmonisation efforts in the EU by introducing:

- shorter settlement periods;
- settlement discipline measures (mandatory cash penalties and 'buy-ins' for settlement fails, settlement fails reporting);
- strict organisational, conduct of business and prudential requirements for CSDs;
- increased prudential and supervisory requirements for CSDs and other institutions providing banking services that support securities settlement;
- a passport system allowing authorised CSDs to provide their services across the EU under a specific procedure.

[4] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions "A Capital Markets Union for people and businesses-new action plan", COM(2020) 590.

[5] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and The Committee of the Regions, 'Commission Work Programme 2021 A Union of vitality in a world of fragility', COM(2020) 690.

[6] References to CSDs in this document also cover the two International Central Securities Depositories (ICSDs), when applicable. The ICSDs are a sub-category of CSDs specialised in the issuance of international bonds (known as 'Eurobonds').

[7] European Central Bank Securities Holdings Statistics Database, https://sdw.ecb.europa.eu/browse.do?node=9691130 (accessed on 29.04.2021).

CSDR also sought to implement the international standards for financial markets infrastructures (CPMI-IOSCO Principles for Financial Markets Infrastructures (PFMIs)) in the EU.

3. STAKEHOLDER INPUT

In the preparation of this report:

- Member States' Expert Group meeting, where the European Central Bank (ECB), the European Parliament and ESMA were also invited (September 2020);
- ESMA submitted to the Commission its first two reports on CSDR implementation (i.e. on internalised settlement and cross-border provision of services) as required under Article 74 of CSDR (November 2020). Two additional reports (on the use of technological innovation by CSDs and the provision of banking-type ancillary services) are expected mid- 2021.
- targeted consultation on the implementation of CSDR between 8 December 2020 and 2 February 2021, to which 91 stakeholders responded. A detailed summary of the responses received is provided in the feedback statement[8]. The Commission also received confidential answers. In response to the Commission consultation on an EU framework for markets in crypto-assets[9], to which 198 respondents replied, some stakeholders also raised issues in relation to CSDR.

4. PRINCIPAL ISSUES IDENTIFIED

4.1. Clarifying and simplifying burdensome requirements related to the provision of services by CSDs domestically and cross-border

Domestically, EU CSDs are subject to the authorisation and ongoing supervision of their home Member State's authorities. A majority of respondents to the targeted consultation, public authorities and CSDs alike, argued that the annual review and evaluation of CSDs is disproportionate and of limited added value. They also expressed concerns as to the proportionality of the information required for these exercises.

Within the EU, passporting regimes allow businesses authorised in one Member State to provide their services throughout the single market, thereby enhancing competition. In other areas, in principle minimal additional requirements are required by host Member States' authorities for entities providing services cross-border. CSDs, however, may only provide services for financial instruments constituted under the law of another Member State under a special procedure requiring the agreement of the host Member State, based on the CSD's compliance with the host Member State's corporate laws and cooperation of the home and host authorities, before, and in some cases after, granting the passport.

Feedback shows there has been limited provision of cross-border CSD services.[10] For example, according to ESMA, the settlement of securities issued by issuers from other Member States represents for most CSDs less than 5% of their settlement activity, although it represents more than 80% of the activity of ICSDs.

[8] https://ec.europa.eu/info/consultations/finance-2020-csdr-review_en.

[9] https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12089-Directive-regulation-establishing-a-European-framework-for-markets-in-crypto-assets/public-consultation_en.

[10] ESMA Report 'Cross-border services and handling of applications under Article 23 of CSDR', 5.11.2020.

Stakeholders were therefore unanimous in their call for the Commission to clarify and simplify the passporting rules, in particular to reduce the administrative burden and costs**.** Different options were suggested, ranging from the more far reaching (replacing the existing procedure with a simple notification as for other financial institutions) to more technical (targeted modifications in the existing framework, e.g. allowing certain financial instruments (e.g. bonds) to be serviced cross-border without following the passporting procedure; clarification of the home and host authorities' assessment; standardisation of the procedure's content and format).

Based on this feedback, it is appropriate to evaluate the rules regarding CSDs' annual review and evaluation, in particular their frequency and content, as well as CSDR's passporting requirements.

4.2. Improving supervisory convergence amongst authorities involved in CSDs' supervision

While the (re)authorisation process has taken time, today almost all EU CSDs have been authorised pursuant to CSDR; the rest, provided they were authorised under the previously applicable national law, continue to operate under a grandfathering clause. As it is already seven years since CSDR was adopted, many stakeholders were in favour of introducing an end-date to that clause to ensure a level playing field amongst EU CSDs.

Furthermore, many stakeholders asked the Commission to enhance supervisory convergence in relation to CSDs operating both domestically and on a cross-border basis. For example, most respondents to the targeted consultation considered that there is need to improve cooperation among authorities and enhance convergence in the review and evaluation process due to different approaches. There were also suggestions to clarify the role of relevant authorities in the authorisation process and the review and evaluation procedure.

In addition, the divergent application of CSDR requirements and the insufficient cooperation between home and host authorities hinder the creation of a true single market for settlement. Therefore, many stakeholders, including ESMA and the CMU High Level Forum, advocated for additional supervisory convergence and enhanced cooperation amongst authorities. For example, the establishment of colleges of supervisors for CSDs making use of the passport, where such cooperation is more formalised and subject to specific rules, is voluntary and decided by the CSD's home authority; in practice, only one college has been set up to date.

Further consideration should therefore be given to ending the grandfathering clause for EU CSDs and to different ways to enhance the cooperation amongst authorities and strengthen supervisory convergence (e.g. through a requirement for mandatory colleges, empowerments to ESMA for RTSs) to ensure a true single market for CSDs.

4.3. Facilitating the provision of banking-type ancillary services

CSDR encourages settlement in central bank money; however, CSDs' access to non-domestic central banks is subject to strict conditions and, therefore, in practice quite limited. To address this difficulty, CSDR also allows settlement using commercial bank money under certain conditions. Commercial bank money can be provided by the CSD itself if it is licensed to provide banking-type ancillary services or from a credit institution. CSDs providing banking-type ancillary services need to comply with additional requirements due to significant credit and liquidity risks for the CSD and its participants**.** When using a bank, CSDs must use a designated credit institution (i.e. a limited-licence bank introduced by

CSDR that provides services only to CSDs and that has to comply with additional requirements to mitigate the risks) when their settlement activity exceeds certain thresholds; below those thresholds, they can use a commercial credit institution.

Certain stakeholders, mainly CSDs, argued that CSDR hinders settlement in foreign currencies, thereby making cross-border activity less likely and limiting competition. In particular, they observed that the requirements under which they can provide banking-type ancillary services are too restrictive and costly. This is evidenced by the fact that only four CSDs have been authorised under CSDR to provide such services to date. Furthermore, no designated credit institutions exist. Certain stakeholders also noted that the thresholds under which CSDs can use a commercial bank for settlement rather than a designated credit institution are too low. Some public authorities also expressed their openness to reviewing certain aspects of the rules without endangering financial stability. However, other stakeholders, including certain CSDs and CSDs' participants, noted that loosening the rules could endanger the level playing field between banks and CSDs or even possibly increase the risk of contagion.

It is appropriate to assess whether there is a need to simplify and make more proportionate certain requirements to address the challenges when settling in commercial bank money, while ensuring the resilience of the financial system. In view of facilitating access to settlement in EU currencies through accounts opened with a central bank, the Commission invites the European System of Central Banks to consider possibilities to facilitate the access by EU CSDs authorised in other Member States to their central bank services.

4.4. Reducing disproportionate burdens and costs related to settlement discipline

Settlement discipline is due to apply on 1 February 2022 when the relevant RTS[11] is set to enter into force. Its main elements are the introduction of cash penalties for CSD participants in case of settlement fails, and mandatory buy-ins where a CSD participant fails to deliver the security within a fixed extension period. Despite the absence of experience in applying the rules, the development and specification of the framework in the RTS has allowed all interested parties to better understand the regime and the challenges its application could give rise to, especially at times of crisis such as the COVID-19 crisis in spring 2020. Settlement discipline attracted the most attention in the targeted consultation, with almost all respondents providing feedback. The European Parliament in its resolution on further development of the Capital Markets Union[12] also invited the Commission to review the settlement discipline regime in view of the COVID-19 crisis and Brexit.

Almost all stakeholders noted that there is a **significant lack of clarity as to the scope of application of the mandatory buy-in rules**. This is also confirmed by the number of requests for clarifications to make the framework operational that have been submitted to ESMA and the Commission.

Furthermore, the vast majority of respondents to the targeted consultation indicated that **buy-in rules should be reviewed,** with a large majority in favour of **voluntary rather than**

[11] Commission Delegated Regulation (EU) 2018/1229 of 25 May 2018 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on settlement discipline, OJ L 230, 13.09.2018.

[12] European Parliament resolution of 8 October 2020 on further development of the Capital Markets Union (CMU): improving access to capital market finance, in particular by SMEs, and further enabling retail investor participation (2020/2036(INI)), para. 21.

mandatory buy-ins. It was argued that mandatory buy-ins will reduce liquidity in the market, increase costs for investors and place EU CSDs at a competitive disadvantage when competing with third-country CSDs that do not have to comply with similar rules.

Moreover, most respondents to the targeted consultation considered that **settlement discipline, in particular mandatory buy-ins, would have had a significant negative impact on the market during the market turmoil provoked by COVID-19**[13] as it would have: (i) increased liquidity pressure, (ii) increased the cost of securities at risk of being bought-in, and (iii) hampered the ability to hedge.

Nonetheless, few stakeholders were in **favour of mandatory buy-ins**, arguing that: voluntary buy-ins today do not incentivise the optimisation of back-office procedures that can also cause settlement fails; there will be significant hesitation to execute voluntary buy-ins against large market participants; and they have already made significant investments to comply with the framework.

The public consultation as well as questions to ESMA and the Commission have illustrated that clarifications on the **scope of the rules on cash penalties** might also be required. In addition, it seems that in certain Member States the current methodology for the calculation of cash penalties cannot be applied[14] due to the absence of an official interest rate for overnight credit.

In light of stakeholders' feedback, it is appropriate for the Commission to consider proposing certain amendments, subject to an impact assessment, to the settlement discipline framework, in particular the mandatory buy-in rules, to make it more proportionate and avoid potential undesired consequences.

4.5. Enhancing the framework for third-country CSDs

Article 81(2c) of the ESMA Regulation requires the conduct of a comprehensive assessment of the potential supervision of third-country CSDs by ESMA exploring certain aspects, including recognition based on systemic importance, ongoing compliance, fines and periodic penalty payments.

At present, third-country CSDs can only provide notary and central maintenance services after the Commission has adopted an equivalence decision with respect to the third-country legal framework and following recognition by ESMA. ESMA does not have direct supervisory powers over recognised third-country CSDs. However, in principle, third-country CSDs that provided their services in the EU before the entry into force of CSDR can continue to do so under a grandfathering clause that has no end date.

To date the Commission has adopted only one equivalence decision (for the UK) which is in force until 30 June 2021 and ESMA has recognised only the UK CSD. Limited practical experience exists therefore for the third-country regime.

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[13] According to ESMA (https://www.esma.europa.eu/sites/default/files/library/esma_50-165-1287_report_on_trends_risks_and_vulnerabilities_no.2_2020.pdf) in March 2020, settlement fails climbed to 14% for equities (vs 6% in 2019) and close to 6% for bonds (vs 3% in 2019); however they have since largely recovered to historical levels.

[14] Commission Delegated Regulation (EU) 2017/389 of 11 November 2016 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council as regards the parameters for the calculation of cash penalties for settlement fails and the operations of CSDs in host Member States, OJ L 65, 10.3.2017.

Against this background, the majority of stakeholders were not in favour of introducing at this stage a comprehensive framework for the recognition and supervision of third-country CSDs. Nevertheless, the consultation showed certain areas where further reflection may be needed to strengthen the applicable rules.

Concerning the **grandfathering clause**, first, it seems that there is insufficient information on which third-country CSDs currently provide services under that clause for financial instruments constituted under the law of a Member State. ESMA and many stakeholders were in favour of introducing a notification requirement to enhance transparency in the market. Second, some stakeholders questioned whether there is an unlevel playing field between EU CSDs and third-country CSDs that continue to operate under that clause.

Questions were also raised about the **scope** of the third-country provisions. First, **recognition by ESMA** is currently not required for **third-country CSDs providing settlement services for financial instruments constituted under the law of a Member State**. ESMA is in favour of expanding the scope of recognition to settlement services arguing that this could ensure financial stability and investor protection as well as a level playing field between EU and third-country CSDs. Little information is however available as to whether third-country CSDs engage in such activities. Second, certain stakeholders invited the Commission to **clarify the scope of financial instruments** for which recognition is required, taking into account the passporting rules where similar terminology is used.

It is therefore appropriate to assess whether further improvements are warranted in the framework for third-country CSDs (e.g. end-date to the grandfathering clause, introduction of a notification requirement) to ensure the financial stability of the EU and a level playing field between EU and third-country CSDs, taking into account the relevant internationally agreed PFMIs.

4.6. Use of technological innovation

Distributed ledger technology (DLT) and the tokenisation of securities may transform clearing and settlement by simplifying processes, reducing costs and increasing security. In September 2020, the Commission published a proposal[15] for a pilot regime for market infrastructures based on DLT.

Respondents to the targeted consultation noted that CSDR must remain technology neutral and ensure that emerging providers submit to the same rules as incumbents ('same service, same risk, same rules' principle). Most stakeholders argued that any changes to CSDR to realise the full potential of technology should be postponed until the Commission proposal for a pilot regime is adopted and lessons can be drawn from its implementation.

Further reflection will be given to the implications for CSDR of the use of technology by CSDs. The Commission also invites ESMA to consider whether supervisory convergence tools falling under its competence could be used or amendments to existing RTSs may be required to facilitate the use of technological innovation by CSDs.

4.7 Areas where stakeholders do not consider further action is necessary at this point in time

[15] Proposal for a Regulation of the European Parliament and the Council on a pilot regime for market infrastructures based on distributed ledger technology, COM(2020) 594.

Most stakeholders agreed that the data reported by settlement internalisers[16] is effective, efficient, coherent, relevant and provides EU added value, thereby increasing market transparency. Furthermore, stakeholders noted that the obligation has been in force for a limited period of time and it is too early for its review. However, increasing internalised settlement activity, a trend confirmed also by ESMA[17], warrants careful monitoring to prevent emerging risks to financial stability.

Regarding the introduction of measures to limit the impact of CSDs' failure on taxpayers, only few stakeholders provided input. Considering the limited feedback received, the Commission considers appropriate to examine this in more detail later, once public authorities and the industry will have had more experience with the implementation of CSDR and the recovery resolution framework applicable to other financial market infrastructures (namely CCPs[18]).

5. CONCLUSIONS

Stakeholders' feedback does not point to a need to make fundamental changes to most core requirements of CSDR, which are integral to ensuring transparency and mitigating systemic risks in settlement. Nevertheless, based on the input received, further consideration is needed for the issues identified in this report.

As announced in the 2020 CMU Action Plan and the 2021 Commission Work Programme, the Commission will therefore consider proposing a REFIT legislative review of CSDR, subject to an impact assessment. This initiative should support the Commission's Better Regulation agenda by eliminating unnecessary costs that are currently born by companies while making the EU financial market more integrated, efficient and safe to facilitate investment.

[16] Settlement internalisers are institutions that execute transfer orders on behalf of clients or on their own account other than through a securities settlement system.

[17] ESMA Report 'CSDR Internalised Settlement', 5.11.2020.

[18] Regulation (EU) 2021/23 of the European Parliament and of the Council of 16 December 2020 on a framework for the recovery and resolution of central counterparties and amending Regulations (EU) No 1095/2010, (EU) No 648/2012, (EU) No 600/2014, (EU) No 806/2014 and (EU) 2015/2365 and Directives 2002/47/EC, 2004/25/EC, 2007/36/EC, 2014/59/EU and (EU) 2017/1132, OJ L 22, 22.1.2021.