

Where we are with CSDR

In this eighth episode, *flow* editorial director Janet Du Chenne hears from John Siena, Associate General Counsel at Brown Brothers Harriman (BBH) and Chair of the European Committee of the Association of Global Custodians, and Emma Johnson, Director in the Deutsche Bank Securities Services Market Advocacy team about the Central Securities Depository Regulation (CSDR) and why it affects all securities market participants

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CSDR and the securities value chain

Janet Du Chenne: Could you tell us a bit about your roles in the industry and the work that you've both been involved in on CSDR?

John Siena: As chair of the European Committee of the Association of Global Custodians (AGC), we've obviously had to engage with CSDR on the global custodian industry segment. And that role was brought in to effect with what eventually became an ad hoc steering group of different representatives of different industry segments to try to facilitate coordination and collaboration across industry segments. It became clear early on when CSDR emerged (in July 2014¹) that it's a very complex, broad and wide ranging piece of legislation that required a great deal of collaboration and coordination, not just among intermediaries and custodian banks but also with other affected industry segments. Because of that, I was asked to represent the custodian segment of the steering group that that was trying to achieve that coordination. So that included the market infrastructures, the brokers across Europe as well as other stakeholders.

Emma Johnson: My role is very much looking at CSDR primarily from the custodian angle which is the division that I'm responsible for in Deutsche Bank. But more broadly I look at CSDR across the Deutsche Bank Group of businesses, so I'm trying to look at the regulation from every angle. So we're very active in the AGC as John mentioned, but also in AFME, who are relied heavily on as a great source of collaboration. We should also acknowledge the CSDs through ECSDA (the European Central Securities Depositories Association), who are a great partner to the AGC and AFME (Association for Financial Markets in Europe) and have played a key role in the CSDR journey. From the CSD community, the CSDs have also been on this journey from day 1 with the majority of the articles focused on the CSDs and their various regulatory requirements.

John Siena: It's probably worth emphasising that because I happen to be a lawyer at the steering group I was asked at the AGC to focus on the so called legal aspects of the legislation. So the AGC has been asked to play a leading role on the legal requirements that are imposed by CSDR. And a lot of those requirements relate to mandatory buy in, which is what I've been mainly focused on. That contrasts with what Emma has been focusing on which has been the penalty mechanism, which is the other big area of the Settlement Discipline Regime. And as a result in some respects I think Emma probably plays more of a critical role because the cash penalty mechanism involves

intermediaries and custodians in a way that the buy in requirements don't. So that's where the focus and attention is and where Emma and I are required to work closely together as a result.

Emma Johnson: From the cash penalty point of view there's a true provider and consumer dependency, and as custodians we're really in the thick of it. We have a dependency on the CSDs where we're general clearing members. And we have a responsibility to enable our clients on the implementation and to go above and beyond and think ahead of what we need to need to implement on a client's behalf and take that information back into the various committees and back to the CSD community who thankfully listen to us and respond to our requirements. So I think we're in a good place.

John Siena: If we take a step back I have thought about what we've been doing across a few broad fronts. The first is that we are discussing and trying to align expectations and readiness across all these different industry segments. The second, involves engaging with regulatory authorities because this involves ongoing interaction with ESMA as well as the European Commission, among others, and the member state level across how we deal with the Settlement Discipline Regime. That's involved a very, deep effort, partly because the regulation is so complex, broad and deep. By that I mean it impacts a wide variety of different financial services firms and infrastructures (the CSDs who are very much in the middle of all this). But then I think what a lot of people haven't fully appreciated is the extent to which it also impacts the vertical chain of custody which means there's a wide range of intermediaries that might connect the end investor to the ultimate investments, and the security in which they're investing in through the chain for multiple intermediaries in that chain. And what people came to realise starting a year or two ago was that the extent to which it impacts every player in that chain one way or the other, wherever they're located anywhere in the world. So the extraterritorial impacts of CSDR are quite significant as well. And I think that's just by definition required a strong collaboration and coordination to do that which is why, to some extent, the engagement of public authorities became so important. Public authorities relied on us to come up with market standards and to deal with the complexity as well as all of the gaps that were quite evident as we moved through representations.

The passage of CSDR

Janet Du Chenne: Tell us a more about the regulatory passage of CSDR and where we are right now?

Emma Johnson: CSDR has had long life cycle. It's very much the Peter Pan of regulation. It's been around for a decade now, and counting. There are more than 70 articles in CSDR and the original ambition of the regulation is to enhance securities settlement in Europe with a particular focus on cross border transactions. Also, it crucially recognises the systemic importance of CSDs, by introducing single rule standards, prudential risk and supervisory requirements. So it's very similar to how the CCPs were regulated under EMIR and the tsunami of regulations that were imposed on the banks post global financial crisis. Then there's also the consistent regulatory approach to the settlement systems, and the settlement processes. This really brings us forward to where we are today and where we've seen a number of different requirements implemented through the CSDR journey. So we've had, from a custodial point of view, the implementation of internalised settlement reporting which was hugely impactful. Then there's the reconciliation requirements which we do today anyway, but also the segregation and disclosure aspects of the regime. So we've had a period where we've been constantly engaged and having to constantly implement over the lifecycle. But we're now reaching the pivotal moment with the settlement discipline regime, which for all actors in the settlement lifecycle is the most impactful.

John Siena: In terms of the state of play, CSDR has been postponed from its initial implementation date of 1st of February 2021. Through the Covid-19 crisis, the realisation dawned that that deadline was unrealistic. As of the 22 October 2020, the European Commission formally endorsed a proposed postponement of one year, to 1 February 2022. This is something that fortunately was expected, and something that the industry has been pushing for some time. It's not quite formally decided upon yet because the delay is still subject to approval over a three month period by the European Parliament /European Council. So once those three months have passed we'll know for certain that that delay will actually take effect. The focus is on the Capital Markets Union action planⁱⁱ, which the European Commission also announced in late October. One of the key elements of the action plan is what we collectively refer to as the CSDR review. So we're hoping to see the commission address many of the industry concerns and questions around CSDR. Hopefully by the end of December we'll have a better sense of the extent to which the current regulation may change or not change.

Emma Johnson: On the topic of the review, with SDR being on the tip of everyone's tongue, the expectation is that that the review will just be on the SDR but it's going to be the whole regulation. I think it's going to be quite a big undertaking to turn around in a relatively short period of time for all industry associations and national competent authorities. So it's going to be interesting to see how it all pans out. In many respects we're going to be focusing on implementation while we are also subject to a review. The natural question is are we implementing something that might change? I think that does unsteady the ship to a certain extent with budgets, internal projects, change requests, the Q&A's that have been raised to the regulatory authorities and best practices across the industry. So we're trying not to be in a holding game and I think we're very dynamic as an industry and we're trying to keep the wheels moving but we are at a crossroads now.

What's next?

John Siena: In terms of the AGC, as I mentioned earlier, we've been focused on mandatory buy-ins. Assuming that the buy in regime continues in its current form, what a lot of industry participants have been pushing for is discretionary buy-in rather than mandatory buy in. But, nevertheless, there are provisions of the regulations that require all intermediaries in the chain to facilitate buy in, including in legal agreements. So what we've been focused on probably more than anything is the regulation as it relates to buy in and then how to comply with those requirements. This has been difficult, mainly because intermediaries are not the trading counterparties and not the ones that are typically expected to buy in if the trade were to fail. The party that's expected to do that is in fact the counterparty. So we've had to work with the language as it's currently written in the regulation. With that in mind, to obviously comply and at the same time try to place intermediaries in the role that they actually play in the process, as post trade providers, the obligation obviously does apply to the counterparty. There's been a bit of a struggle to provide the necessary clarity for peers and for others that might be affected by all of this, but I think we accomplished that. Now we're looking at potential change to the legislation which frankly I think everyone would welcome. If it does happen. Again, there are no guarantees as to whether the EC would have appetite to reverse to discretionary buy in but if that were to happen then obviously we would need to revisit other work we've already done, and we've already expanded resources. But that's just the buy in regime and we're probably less impacted. On the penalty mechanism I should let Emma speak to that because it would be really interesting to hear your thoughts in terms of all the work we've done to date, as well as what your expectations are around the extent to which we can use that work.

Emma Johnson: I think it will be interesting to see what is proposed, if anything, on the cash penalties. When you think about the cash penalty mechanism, it's administered by the CSDs and there is a huge investment on their part to build the infrastructure. T2S is a common platform, and a common penalty mechanism. So it's a huge piece of work. And as intermediaries we've had to make significant developments in our systems and services and messaging, to be able to achieve that. So it's going to be worth staying close to. I think the CSDs are going to be pivotal in the review and in the feedback that they give, and the AGC in that regards. I think what I'd like to see is crispness in the language and true clarity. Although we have transparency of the penalty rates to be used and the penalty calculation algorithms, what we're still missing is a succinctness in the scope: what transactions are in scope with a penalty regime. That's a precarious place to be right now because again implementing something that's based on assumptions to me just feels at odds with a regulation which is meant to provide steady foundations for the industry. So I think the CSDs need clarity on the transaction scope and the CSDs and CCPs need clarity in terms of who is going to be operating the penalty mechanism in respect of cleared transactions. There's been a debate going on for a couple of years now on that. So I think there's so many question marks and I think that extra year just gives us that chance to really lock down what we're trying to achieve here. We're supportive of the regime. We just need to dot the I's and cross the T's to get it over the line.

John Siena: I think we've made all these points, quite clearly along with other industry associations such as AFME and ICMA about specific concerns and areas we would like to see improvement on. ESMA and the European Commission have those recommendations now since the early summer and we've seen some acknowledgement of that. We hope they will be addressed and reviewed. The scope and impact is a major issue. There are questions around where certain requirements of CSDR apply and where they don't. One issue we haven't focussed on is ETFs, particularly the sharpe ratio with respect to the buy in requirements. Are they in scope or are they are not in the scope? But that definitely represents significant changes to the process by which ETF shares are redeemed. It's a bit of a complex process and it varies between the US and Europe. So there's a lot of healthy discussion across all segments supporting ETFs. It's all very healthy and very good but it just demonstrates the need for more time to develop a view and to ensure that public authorities take into account the complexities that arise. That's just one example, and many other examples around scope and impact.

Janet Du Chenne: Thank you for sharing your insights on this topic. That's all for this episode. But stay tuned for the next one, where we will take a look at how Covid-19 has impacted CSDR, and how the regulation can be seen as helpful to the post trade industry. Remember, if you have any suggestions for future podcast guests, why not get in touch and let us know. And don't forget to register for more regulatory insights at db.com/flow.

ⁱ <https://www.esma.europa.eu/regulation/post-trading/settlement>

ⁱⁱ https://ec.europa.eu/info/publications/200924-capital-markets-union-action-plan_en