Friday, 7th May 2021

EBF Discussion Paper on the Settlement Finality Directive

INTRODUCTION

This paper sets out at a high level the views of the European Banking Federation as to why and how SFD should be improved and adapted.

This paper gives the context and the underlying rationale for the views set out in the EBF responses to the European Commission public consultation on the Settlement Finality Directive (SFD).

This paper relates to SFD as a whole and does not specifically cover the question of how SFD should be updated to reflect technological developments. The EBF believes that the approach and views set out in this paper are of general validity.

Objectives of a review of SFD

The EBF believes that the review of SFD should be undertaken with four key objectives in mind:

1. Development of a Capital Markets Union

Rules on settlement finality relate to the core infrastructure of financial markets. The review of SFD should play an important role in building a Capital Markets Union and should be closely associated with European Commission initiatives relating to Action 11 (Insolvency Procedures) and Action 13 (Settlement services).

2. Extending SFD protections

There are gaps and inconsistencies in the existing scope of SFD protections. SFD protections should have a more complete and more consistent range of applicability.

3. Updating SFD

Significant recent regulatory developments, such as the introduction of EMIR and CSD Regulation, have not been sufficiently reflected in the text of SFD. The same goes for the evolution of CCP business on the one hand and for the migration of many EU-CSDs to TARGET2-Securities on the other. SFD should be appropriately updated.

4. Improving the structure and definitions of SFD

The structure and definitions of SFD do not easily correspond to the business activities covered, and the protections offered, by SFD. There is scope to rationalise the structure of SFD.

History and further context

The Settlement Finality Directive (SFD) is a successful piece of EU legislation that has sound core principles, has contributed to systemic stability, and has delivered benefits to all market participants. It is, in particular, a targeted set of rules harmonising specific EU-insolvency law, which is of utmost importance for financial markets.

SFD dates back to 1998, and the main part of its text was drafted and passed in a market, regulatory and technical environment that is very different from that of today. Especially the development of the business involving CCPs and its regulation by the Regulation (EU) No. 684/2012 (EMIR) as well as the progress in cross-border securities settlement – both in actual perspective through the migration onto TARGET2-Securities and in regulatory perspective by the introduction of the Regulation (EU) No. 909/2014 (CSDR) – have not been fully reflected in SFD.

The SFD was introduced as a central piece of EU law removing barriers for cross-border financial services by harmonising national insolvency law rules within the EU regarding transfers of cash (payments) and securities (settlement). However, since the SFD is a directive, its transposition into national law took place differently. Moreover, the SFD left the actual determination and transposition of several concepts and rules under the SFD explicitly to the discretion of the member states.

Key elements of SFD

SFD arranges for specific rules regarding the insolvency of certain intermediaries when using a SFD-designated system. SFD imposed an obligation on the member states to change their national insolvency laws so that the rules of a SFD-designated system (regarding finality of transfers and enforceability of collateral) are respected by all member states national insolvency laws.

There are two types of systems that can be designated under the SFD, namely:

- Payment systems and
- Securities settlement systems.

These two types of system can be operated by three different types of market infrastructures, namely:

- Central Securities Depositories (CSDs)
- Central Counterparties (CCPs)
- Operators of payment systems.

Although there are only two types of systems, the functions and the business of the three types of system operators are very distinct.

SFD provides two types of protection:

- finality of settlement of transfer orders or of netting (cash or securities)
- the enforceability of collateral security (including cash and securities).

SFD protections benefit the market infrastructure that operates the system that has been designated under SFD, some (or all) of its participants, as well as (to some extent) all the market participants involved in the transaction that has been "settled" or "processed" on the market infrastructure.

In its current form, the protections offered by SFD are restricted in scope.

SFD is a directive, and how the SFD rules apply in the context of an insolvency is dependent, amongst other things, on the national transposition of SFD. Particularly in a cross-border context, this may lead to a different application of insolvency rules involved and therefore to unjust results.

Therefore, a more comprehensive and harmonised approach is desirable for the EU. This approach should include the option that several member states have incorporated already (recital 7) that the SFD is also applicable on European participants to third country systems which meet certain quality standards (for example, in the Netherlands BIS membership).

Structure of this paper

This paper contains three main sections, each section relating to one type of market infrastructure (CSDs, CCPs, and payment systems).

In each section, there is an analysis of how the SFD protections currently apply to the activity in that type of infrastructure. Each section contains a set of proposals as to how SFD protections for that type of infrastructure should be updated and expanded. Each section also contains proposals on how there can be increased harmonisation of the effects of SFD.

This paper ends with a section setting out broader, higher-level conclusions and a proposal for another review in three years' time.

1. Central Securities Depositories – Analysis of SFD Protections

This section analyses separately each of the two SFD protections (settlement finality and enforceability of collateral security) with reference to the SFD-designated systems operated by CSDs.

1A. SFD protections - settlement finality

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Article 3 SFD

1. Transfer orders and netting shall be legally enforceable and binding on third parties even in the event of insolvency proceedings against a participant, provided that transfer orders were entered into the system before the moment of opening of such insolvency proceedings as defined in Article 6(1). This shall apply even in the event of insolvency proceedings against a participant (in the system concerned or in an interoperable system) or against the system operator of an interoperable system which is not a participant.

Where transfer orders are entered into a system after the moment of opening of insolvency proceedings and are carried out within the business day, as defined by the rules of the system, during which the opening of such proceedings occur, they shall be legally enforceable and binding on third parties only if the system operator can prove that, at the time that such transfer orders become irrevocable, it was neither aware, nor should have been aware, of the opening of such proceedings.

[...]

Article 4 SFD

member states may provide that the opening of insolvency proceedings against a participant or a system operator of an interoperable system shall not prevent funds or

securities available on the settlement account of that participant from being used to fulfil that participant's obligations in the system or in an interoperable system on the business day of the opening of the insolvency proceedings. member states may also provide that such a participant's credit facility connected to the system be used against available, existing collateral security to fulfil that participant's obligations in the system or in an interoperable system.

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Gap in protections

SFD protects the finality of the settlement of securities and cash transfers carried out in the system. They are legally enforceable and binding on all third parties. However, this protection applies just to transfer orders that are carried out between two CSD participants that meet the SFD definition of a "participant".

The SFD definition of a participant is limited, so that it is possible that not all holders of securities and cash accounts at a CSD meet this definition, and there can be questions as to the applicability of SFD protection in the case of the insolvency of indirect participants, especially where the national transpositions of the SFD differ from each other.

This is a potential source of risk and legal uncertainty.

In order to minimise risk, for the CSD and for other parties, it is necessary that SFD finality protections apply for all transfers settling at a CSD. If SFD protections do not apply comprehensively, then there is risk for the CSD, and for the participants in the CSD; this risk applies both for CSD participants that fall within the SFD definition of a participant, and for CSD participants that do not fall within this definition).

This can be achieved by adding a clarification in Art. 3 SFD that the insolvency of any party which is not the system operator or a (direct) participant, is irrelevant. Such clarification would underline that it is the transfer order in the SFD system which has a decisive role and that the insolvency of parties outside the system are insignificant.

If a transaction settles at a CSD, and benefits from the protection of the SFD, then the settlement of that transaction is final. The finality of settlement benefits all parties associated with the transaction, including the two trading parties, as well as all the intermediaries acting on their behalf along the custody chains.

Definitional issues

In addition to the problems arising out of the different national transpositions of Art. 3 SFD, the current wording of SFD has other definitional issues.

Three notable ambiguities in SFD are:

(i) the lack of recognition under SFD of the concept of delivery versus payment; SFD treats a securities transfer as being a separate transfer from the associated cash transfer;

(ii) the possibility that national laws and system operators can define different rules on the moments of entry and irrevocability in each system; and

(iii) the lack of the concepts of matching and of settlement of a securities transfer and the lack of a definition of the concept of "irrevocability".

This creates the possibility both of legal risk, and of different national transpositions of the SFD rules, and, in consequence, in different rules of several SFD-designated systems. This is also particularly problematic in cases where different CSDs agree to operate their respective settlement systems through outsourcing to a common technical platform (such as in the case of Target2-Securities, where a bespoke "collective agreement" [1] had to be put in place).

1 Accessible at: https://www.ecb.europa.eu/paym/target/t2s/profuse/shared/pdf/collective_agreement.pdf

Furthermore, the opt-in possibilities of Art. 4 SFD lead to an unharmonized application by different national transpositions and, especially in the case of cross-border settlements, to a different treatment of the same insolvent parties throughout member states. Furthermore, Art. 4 SFD only addresses the continuation of the settlement process of pending transfer orders with respect to the insolvency proceedings of a system operator or of a (direct) participant, but not regarding the insolvency of parties outside these defined categories.

The Final Report of the European Post Trade Forum[2] gives some more information on some of these definitional issues (see the text covering Barrier 10).

1B. SFD protections – enforceability of collateral security

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Article 9 SFD

1. The rights of a system operator or of a participant to collateral security provided to them in connection with a system or any interoperable system, and the rights of central banks of the member states or the European Central Bank to collateral security provided to them, shall not be affected by insolvency proceedings against:

(a) the participant (in the system concerned or in an interoperable system);

(b) the system operator of an interoperable system which is not a participant;

(c) a counterparty to central banks of the member states or the European Central Bank; or

(d) any third party which provided the collateral security.

Such collateral security may be realised for the satisfaction of those rights.

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With relation to settlement at a CSD, the SFD protection on enforceability of collateral security deal with the relationship between a CSD and its participants (as collateral givers), and between a CSD participant and its clients (as collateral givers).

This SFD structure creates a twofold discrimination:

(i) between intermediaries at the top of the chain (who can benefit from protections), and lower-level intermediaries (who can't);

(ii) between different types of activity that an intermediary performs on behalf of the same client; for some securities held on a single securities account, the intermediary may be a direct participant in a CSD (and may benefit from SFD protections), while for other securities it may use a sub-custodian (and thus does not benefit from the SFD protections).

Furthermore, SFD remains ambiguous on the enforceability of collateral security with respect to system participants and their clients when they receive collateral (i.e. as collateral takers). Again, this is due to the differences in national transposition laws.

Protection of the collateral taker

With relation to enforceability of collateral securities, SFD protection is given to the system operator (the CSD) and to the participant in the system, as takers of collateral.

For a participant to benefit from this protection, the participant has to meet a threefold test: (i) the claims against another party resulting from the transfer order processed in

2 Accessible at: https://ec.europa.eu/info/publications/170515-eptf-report_en

the system are due and allow for the realisation of collateral security, (ii) it has to meet the SFD definition of a participant, and (iii) it has to be a direct participant in the CSD. SFD also creates the possibility, that under restrictive circumstances an "indirect" participant, namely, a client of a direct CSD participant, can be treated as a direct participant, and thus can benefit from the SFD protection. This is the case when national law includes such indirect participants in the term "participant" following transposition of the SFD (see former definition of "participant" in Art. 2 (f)[3], which however was removed in the 2019 amendment). While some jurisdictions include indirect participants as participants and their systems have notified them, so that they benefit from the SFD protection, others do not. This creates uneven levels of protection across the EU.

EPTF Barrier 8 ("Uncertainty as to the legal soundness of risk mitigation techniques used by intermediaries") identifies "custody pledges" as a vital component of the post-trade market. They are important as they mitigate risk for intermediaries in providing access to CSDs. Without the ability to take collateral, and to enforce rights to that collateral, intermediaries will find it difficult to provide services (access to a CSD) to some categories of clients, especially clients that are in a pre-insolvency or in a "recovery" phase.

The EPTF Barrier 8 suggests changes to FCD to deal with the legal uncertainties relating to "custody pledges" problem.

SFD offers a complementary solution. Compared to an FCD solution, an SFD solution would be more limited in the scope of securities covered (just securities held in European CSDs) but would be broader in the scope of categories of clients covered (all clients).

An SFD solution relating to the enforceability of collateral security should have the following features:

- All intermediaries along the custody chain granting access to the system through the custody chain should be able to benefit from SFD protections in connection with transfer orders and netting carried out in the system.
- The SFD definition of indirect participant should be extended to all intermediaries.
- No specific operational requirements should be placed on the intermediaries (so that, specifically, intermediaries can continue to use omnibus accounts, in line with CSDR Article 38).
- Securities that are covered will include all securities held at CSDs designated under SFD (including third-country CSDs).

Specifically, this protection should be extended to clients of all intermediaries that provide access services to all SFD-designated systems, no matter where those intermediaries are located in the chain of intermediaries. This protection should apply to all collateral that is linked to the activity at the system and that is held by the intermediary, including collateral placed by the client with the intermediary ("on stock"), as well as collateral that the intermediary receives in the system through the execution of the client's transfer orders ("on flow"). A high degree of harmonisation of SFD protections across all EU member states would have the benefit of legal certainty in all cross-border scenarios.

For example, these provisions are explicitly included in the Italian transposition law, *D.Lgs. nr. 210 of 12/04/2001, Art. 6*, insofar it states that, in the event of the opening of insolvency proceedings against the intermediary on whose behalf a participant executes transfer orders , the relevant contracts between the participant and the intermediary shall not be terminated and the participant may be satisfied for the capital, interest and expenses on the sums or price of the financial instrument received as counterpart to the orders executed in good faith and to which it has the right to retain as collateral.

Similarly, in Germany Sec. 116 sentence 3 insolvency regime (InsO) declares that the opening of the insolvency proceedings does not have the effect of cancellation of any

[3] "A Member State may decide that for the purposes of this Directive an indirect participant may be considered a participant if it is warranted on the grounds of systemic risk and on condition that the indirect participant is known to the system;"

transfer order. All parties along the custody chain are therefore protected and would be entitled to use securities as collateral (provided this was previously contractually agreed between the relevant parties which is usually the business case.

In other cases, these specific provisions do not exist. Hence, we would propose that these provisions should be fully harmonised across the EU (preferably to the highest possible level of collateral enforceability, both on stock and on flow), so as to ensure equal treatment and equal legal certainty for all participants and all their clients that are accessing an SFD-designated system.

Limiting this protection just to some type of activities creates both gaps in the protection, and operational complexity. For example, limiting the protection just to clients of direct participants would mean that an individual investor providing collateral relating to activity on a single securities account across multiple SFD-designated systems may be protected for part of that collateral, but not for all, given that the protections would depend on the different operational set-ups between the intermediary and the different SFD-designated systems.

Protection of the collateral giver

Currently, SFD does not provide protections (ring-fencing of the collateral) for the collateral giver in the event of the insolvency of the collateral taker.

Section 4 of the SFD consultation paper asks whether SFD should provide such protections.

Where a client is a collateral giver and places collateral with a participant to secure, for example, a credit line, the client is not protected pursuant to the SFD in the event of the insolvency of a participant. Although other protections may apply (such as the client assets rules set out in MiFID), we agree that the SFD should be extended to protect clients who are collateral givers in the event of the insolvency of a participant.

Nonetheless, collateral givers should be protected, so that it does make sense to extend the SFD protections to the collateral giver for all three types of market infrastructure.

1C. SFD protections – harmonisation needs

The proposals set out in the two sections above, "1A/ SFD protections – settlement finality" and "1B/ SFD protections – enforceability of collateral security", will contribute to increased harmonisation, will provide a higher degree of legal certainty and will reduce systemic risks and financial costs, ultimately facilitating the provision of access to CSDs for all market participants that are solvent.

There is the question of whether this is enough, or whether there is a need for increased harmonisation. The question arises because there are many aspects of SFD that create the possibility for unharmonized outcomes. These include different national transpositions of SFD, different rules in member states regarding legal relationships outside the system, different national practices regarding recognition of third-country systems, differences in inclusion of indirect participants, and the national discretions specifically mentioned in Article 4.

This question is important, in particular with relation the procedures that should be followed once a market participant becomes insolvent. In a well-functioning Capital Markets Union, insolvency procedures should follow best practices, and should be harmonised to the greatest extent possible.

To make progress on this topic, it must be recognised that the basic structure of SFD does create the possibility for unharmonized practices. One important principle of SFD is that it defers to the rules of the designated systems. This creates the possibility that different systems have different rules.

In consequence, steps to increase harmonisation of outcomes need to have legal, market practice and technical components.

From a legal perspective, it is, for example, very important that there is uniformity across member states in the meanings in national law of the terms used in Article 3, and that the possibility for divergence in Article 4 be eliminated.

From a market practice perspective, the question of the procedures to be followed in the case of an insolvency is both broad and complex.

This is because a market participant subject to insolvency procedures may be an intermediary, a trading party, or both, and may be a direct CSD participant in some CSDs but use one or more intermediaries to access other CSDs.

There are two main approaches that can be taken to handle an insolvency:

1. To freeze all settlement activity as soon as possible.
2. To try and minimise the disruption caused by insolvency by allowing as much settlement as possible, within the limits of the available resources (cash and securities), and within the constraints of the SFD protections.

The role of a market participant (trading party or intermediary) may have an effect on the desirability of a particular approach.

Compliance with best practice in insolvency procedures may depend on the existence of appropriate technical functionalities at the level of market infrastructures and of intermediaries.

To achieve an objective of as great a harmonisation of insolvency procedures as possible, the following steps should be taken:

- Creation of common definitions of key SFD concepts, including harmonisation of rules relating to point of entry (validation) and irrevocability (matching).
- Elimination of SFD opt-in possibility of article 4; instead, harmonised rule is needed.
- Definition of expectations as to procedures in the event of insolvency (that apply no matter what the custody arrangements are); such expectations may vary depending on the role of the market participant
- Provision of a set of appropriate technical functionalities (for example, hold/release mechanisms, late settlement penalty mechanisms that no longer impose fines once a trading party has become insolvent, removal of pending transfer orders that remain unsettled after close of business on the day of the insolvency declaration, etc.), which allow intermediaries to manage the insolvency of their clients.

The EBF believes that many of these steps could be achieved by converting the SFD into a regulation.

2. CCPs – Analysis of SFD Protections

2A. SFD protections - settlement finality

Gap in protections

The business activity of a CCP is more complex, more diverse and involves other types and potentially systemically relevant risks than the business activity of a CSD. A CCP interposes itself between the parties to a financial contract, effects a netting of obligations, manages collateral during the life cycle of a financial contract, manages the settlement of obligations at the end of the contract, and, in the event of a default/insolvency of a (direct) participant (clearing member), resolves outstanding positions and transfers positions of clients under their default management procedures and in line with existing regulatory

requirements. One key characteristic of CCPs is that many parties relying on CCP clearing (including parties under a regulatory clearing obligation) cannot become a direct participant (clearing member) and thus have to rely on access as a client via a clearing member, or even via a client of a clearing member ("indirect clearing").

It is important that SFD finality protections apply to the full range of activities linked to the business role of a CCP.

As in the case of CSDs, there is the risk that not all the participants in a CCP fall within the SFD definition of participant. Therefore, it should be ensured that SFD finality protections apply to the activity of all participants in a CCP.

For CCPs, there is also the risk of a much broader gap that derives from the limited applicability of SFD terminology to the full range of CCP activities, in particular regarding the protection of clients and indirect clients.

Definitional issues

The definitions contained in SFD were not drafted with CCPs in mind, and in several cases, it is difficult to link the details of the activity of a CCP to the current SFD definitions.

One notable example is the SFD concept, and definition, of "transfer order", which is tailored very much to the business activity of a CSD and of a payment system, but remains vague in the case of business flowing through CCPs.

The inadequacy of SFD definitions with relation to CCP activity is a source of risk and has been analysed in more detail in the EPTF Report in relation to EPTF Barrier 10.

2B. SFD protections – enforceability of collateral security

Protection of the collateral taker

As with CSD activity, SFD provides protection to a party that takes in collateral linked to the process of a CCP interposing itself between the counterparties to a trading contract.

As with CSD activity, the SFD protections are limited to the CCP itself and to direct participants in the system.

As with CSD activity, the SFD protections linked to enforceability of collateral security should be extended to all parties that are in the contractual chain, and that provide a service of facilitating the use of a CCP.

Given that it is possible to tie the amount of protected collateral to the specific contract cleared by a CCP, the SFD protections should not be subject to additional contractual or operational requirements.

Protection of the collateral giver

In the same way that all collateral takers in the contractual chain should be protected when they receive collateral in relation to CCP activity, all collateral givers should be protected when they provide collateral to other intermediaries (e.g. clearing members) in relation to their use of CCP services.

3. PAYMENT SYSTEMS – ANALYSIS OF SFD PROTECTIONS

The SFD aims at facilitating the smooth operation of payment systems, reducing systemic risk and ensuring stability of payment systems by minimising disruption caused by insolvency proceedings against one of its participants.

We believe that scope should be restricted to systems which meet the requirements of the CPMI – IOSCO Principles for Financial Market Infrastructures (or any future version) in order to protect the integrity of the SFD in protecting against systemic risk.

SFD protections – harmonisation needs

As is clearly indicated by the Recitals to the SFD, particularly 1, 2, 3 and 9, the Directive was originally designed to reduce systemic risk in payment and securities settlement systems and improve the enforceability of collateral security. Such risk is likely to arise primarily from wholesale systems and we believe that it is important that the original focus is maintained. We recognise that since 1998 non-credit institutions effecting payments have become far more prevalent, but their impact on systemic risk and collateral enforceability is much lower than for credit institutions and particularly major credit institutions.

Payment systems provide a vital component of the EU's infrastructure, which relies on a complex network of collaborative relationships. The existing rules of direct participation of banks and not payment or e-money institutions do not hinder innovation or have the effect to be an obstacle for market access. Art. 35 (2) PSD ensures that banks offer services to payment institutions and e-money institutions and therefore guarantee access to such systems. If however the Commission would consider granting non-bank PSPs access to payment infrastructures, then this should take into account any possible additional systemic risks on Clearing and Settlement Mechanisms(CSMs) and the payments sector in general. Payment and e-money institutions are not subject to the same stringent regulations as banks with the effect of possible differences in risk governance and depth. Therefore, objective measures that are on par with those imposed on credit institutions - including the instruments of providing adequate guarantees or collateral and appropriate prudential controls and oversight arrangements- should be in place and applied to ensure that any broader direct access does not create systemic impacts in terms of risk and resilience of payment systems or an unlevel playing field with credit institutions. Otherwise, higher risks could be carried into the system, eventually posing costs on CSM providers and their participants. This requires a careful configuration of access criteria to mitigate any potential financial, operational, and reputational risks to other direct participants and to protect users' trust in payments.

Since the systems concerned are likely to be FMIs for regulatory purposes, we consider it to be essential that payment and e-money institutions comply with the requirements arising from the BIS Principles for Financial market infrastructures drafted by the CPMI and IOSCO before being allowed to be participants.

We note points made in the Committee on Payments and Market Infrastructures (CPMI) report to the G20 on enhancing cross-border payments - under building block 10 ('Improving (direct) access to payment systems by banks, non-banks and payment infrastructures') - which highlight the importance of having appropriate levels of oversight and supervision as well as the need to address any underlying legal obstacles.

Furthermore, if the Commission would consider amending the respective personal scope, it should at the same time aim at further reducing the different national rules and discretions which are in effect prevalent today and cause regulatory complexity, fragmentation and uneven competitive conditions.

4. CONCLUSIONS

The harmonised application of the SFD protections should be achieved to the widest extent possible.

The EBF therefore believes that:

- The SFD should be converted into a regulation.
- Uniform and directly applicable rules should be developed in relation to the application of the SFD protections regarding third-country systems (Recital 7).
- The SFD should broaden the range of parties protected under the SFD and should clarify the *modus operandi* of such protections.
- The SFD should clarify the destiny of an irrevocable but not yet finally settled transfer order (Art. 4).
- The SFD should be reviewed again after three years in order to assess its compatibility with new processes and the application of new technologies, such as the DLT. This should go hand in hand with an assessment of Art. 18(2) CSDR according to which "*Securities settlement systems may be operated only by authorised CSDs, including central banks acting as CSDs*."
- The protection of settlement finality should apply to all activity processed by the system (whether CSD, CCP or payment system), independent of the regulatory status of the participant in the system. In case of CCPs this protection should also cover clients and indirect clients (also in the interest of safeguarding the default management procedures of CCPs, in particular the transfer of client positions in the event of a default of a clearing member).
- The protection of enforceability of collateral security should apply – with relation to CSD and CCP activity - to all participants in the intermediary chain (from infrastructure to end investor), both as collateral giver, and as collateral taker.
- The structure of SFD should be modified, so that it describes separately, by type of infrastructure, how the relevant protections operate.
- The terminology used by SFD should be modified, so that it matches more closely the business activities of each type of infrastructure.