

Consultation Paper

Technical Advice on CSDR Penalty Mechanism

Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex I. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale;
- provide evidence (including relevant data, where applicable) to support the views expressed;
- describe any alternative approaches ESMA should consider.

ESMA will consider all comments received by **29 February 2024**.

All contributions should be submitted online by using the response form available at [ESMA Consultation list | European Securities and Markets Authority \(europa.eu\)](#).

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading '[Data protection](#)'.

Who should read this paper?

All interested stakeholders are invited to respond to this consultation paper. In particular, ESMA invites CSDs and CSD participants, as well as other stakeholders that may be impacted by the CSDR cash penalties regime to respond to this consultation paper

Legislative References

CSDR¹	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
ESMAR²	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
Regulation (EU) No 600/2014³	Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012
Regulation (EU) No 575/2013⁴	Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012
Directive 2014/65/EU⁵	Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast)
Commission Delegated Regulation (EU) 2017/389⁶	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

¹ OJ L 257, 28.8.2014, p. 1

² OJ L 331, 15.12.2010, p. 84

³ OJ L 173, 12.6.2014, p. 84

⁴ OJ L 176, 27.6.2013, p. 1

⁵ OJ L 173, 12.6.2014, p. 349

⁶ OJ L 65, 10.3.2017, p. 1

penalties for settlement fails and the operations of CSDs in host Member States

Commission Delegated Regulation (EU) 2017/583⁷ (RTS 2)

Commission Delegated Regulation (EU) 2017/583 of 14 July 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on transparency requirements for trading venues and investment firms in respect of bonds, structured finance products, emission allowances and derivatives

RTS on Settlement Discipline⁸

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

Commission Delegated Regulation (EU) 2021/70⁹

Commission Delegated Regulation (EU) 2021/70 of 23 October 2020 amending Delegated Regulation (EU) 2018/1229 concerning the regulatory technical standards on settlement discipline, as regards its entry into force

⁷ OJ L 87, 31.3.2017, p. 229

⁸ OJ L 230, 13.9.2018, p.1

⁹ OJ L 27, 27.1.2021, p. 1

List of acronyms

BD	Business day
CP	Consultation Paper
CSD	Central Securities Depository
ESMA	European Securities and Markets Authority
EC	European Commission
EEA	European Economic Area
ETF	Exchange traded fund
EU	European Union
DvP	Delivery versus Payment
FoP	Free of Payment
ISD	Intended settlement date
ITS	Implementing Technical Standards
LMFPs	Late Matching Fail Penalties
MBI	Mandatory buy-in
NCA	National Competent Authority
RTS	Regulatory Technical Standards
SSS	Securities Settlement System
TA	Technical Advice
T2S	TARGET2-Securities

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1 Executive Summary

Reasons for publication

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 (CSDR) was published in the Official Journal on 28 August 2014, and entered into force on 17 September 2014.

CSDR (Articles 6 and 7) includes a set of measures to prevent and address failures in the settlement of securities transactions (settlement fails), commonly referred to as settlement discipline measures. They consist of reporting requirements, 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.

Although settlement fails cannot be totally eliminated, persistent settlement fails negatively affect the functioning and competitiveness of the capital market and contradict the objectives of the Capital Markets Union, which aims to improve the functioning of market infrastructures across the EU. A fully functioning and integrated market for capital will allow the EU's economy to grow in a sustainable way and be more competitive.

Cash penalties should not only deter participants from causing settlement fails, but also incentivise the failing party to rapidly resolve the settlement fail: according to the third subparagraph of Article 7(2) of CSDR, the failing party is charged a daily penalty for each business day that a transaction fails to settle after the intended settlement date (ISD).

Article 7(14) of CSDR provides that cash penalties shall ensure a high degree of settlement discipline and the smooth and orderly functioning of the financial markets concerned. In order to achieve this aim, the same Article empowers the European Commission (EC) to adopt delegated acts in accordance with Article 67 CSDR to specify parameters for the calculation of a deterrent and proportionate level of cash penalties.

According to Commission Delegated Regulation (EU) 2021/70, amending the RTS on Settlement Discipline, cash penalties are being applied to failing settlement instructions in securities settlement systems operated by EU CSDs as of 1 February 2022. The effect of cash penalties on settlement rates on the EU capital market is currently being assessed.

In the context of the application of cash penalties in case of settlement fails caused by a lack of cash under CSDR, on 13 December 2022, ESMA received a request from the EC for technical advice on alternative parameters, when the official interest rate for overnight credit charged by the central bank issuing the settlement currency is not available.

In addition, on 15 May 2023, ESMA received a second request for technical advice on specifying the treatment of historical reference data for the calculation of late matching fail penalties (LMFPs).

The co-legislators have concluded negotiations on the review of the CSDR¹⁰. The provisional agreement on CSDR maintains mandatory buy-ins as part of the settlement discipline toolkit. However, they will only apply as a measure of last resort where the rate of settlement fails in the EU is not improving and is presenting a threat to financial stability.

Hence, to ensure that mandatory buy-ins are a necessary, appropriate and proportionate means to address the level of settlement fails on the EU capital market, the full potential of other measures, in particular cash penalties, to address settlement fails must be explored. In addition, a low level of settlement fails is essential in light of the ongoing discussions about a potential shortening of the settlement cycle in the EU. This indicates that cash penalties will play an even greater role in ensuring settlement discipline in the future and points to the need to reassess the current framework.

In light of the above, the EC has sent ESMA a third request for technical advice on a possible amendment to Commission Delegated Regulation (EU) 2017/389. ESMA should assess the effectiveness and proportionality of the current penalty mechanism and propose, if justified, changes to the structure or severity of the mechanism and consider alternative methods for calculating cash penalties, including by introducing progressive penalty rates. In drafting its technical advice, ESMA should consider how the changing interest rate environment, including negative interest rates, affect a participant's incentive to fail and how this could be mitigated. Furthermore, ESMA should reflect on the need for further flexibility with regards to penalties for settlement fails imposed on illiquid financial instruments. The proposed amendments to the structure and severity of the mechanism should effectively discourage settlement fails, incentivise their rapid resolution and improve settlement efficiency.

The aim of this Consultation Paper (CP) is to collect views, comments and opinions, as well as data and evidence from stakeholders and market participants on the effectiveness of the current penalty mechanism in discouraging settlement fails and incentivising their rapid resolution, and on ESMA's preliminary proposals on the following topics:

- a) alternative parameters, when the official interest rate for overnight credit charged by the central bank issuing the settlement currency is not available;
- b) the treatment of historical reference data for the calculation of late matching fail penalties;

¹⁰ [Central Securities Depositories: Council and Parliament reach agreement - Consilium \(europa.eu\)](#)

- c) alternative methods for calculating cash penalties, including progressive penalty rates.

Given the overlapping scope the three requests for technical advice, ESMA will combine them in one document.

Contents

This CP contains three main sections on the topics mentioned above. It covers the matters to be included in the technical advice that ESMA intends to provide to the EC on penalties for settlement fails, as further specified in the Annexes.

ESMA has prepared this CP in order to consult interested parties for the purpose of producing its technical advice to the EC. Respondents to this consultation are encouraged to provide the relevant background information and qualitative and quantitative data on costs and benefits, as well as a concrete redrafting proposals, to support their arguments where alternative ways forward are called for.

Next Steps

ESMA will consider the feedback received to this consultation and expect to publish a final report and submit its technical advice to the EC by 30 September 2024.

ESMA will finalise the impact assessment regarding the proposed measures, which will be included in the Final Report to be submitted to the EC. One essential element in the development of technical advice is the analysis of the costs and benefits that the proposed measures would imply. The limited information available did not allow ESMA to produce a quantitative impact study for the purpose of this CP. The input from stakeholders will help ESMA in finalising the technical advice and the relevant impact assessment. Therefore, respondents to this consultation are encouraged to provide the relevant data to support their arguments or proposals.

2 Introduction

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 (CSDR) was published in the Official Journal on 28 August 2014, and entered into force on 17 September 2014.
2. CSDR includes a set of measures to prevent and address failures in the settlement of securities transactions (settlement fails), commonly referred to as settlement discipline measures. They consist of reporting requirements, 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.
3. In view of the preparation of an amendment of Commission Delegated Regulation (EU) 2017/389, the European Commission (EC) has submitted three requests for technical advice to ESMA covering the following topics on cash penalties:
 - a) alternative parameters, when the official interest rate for overnight credit charged by the central bank issuing the settlement currency is not available (request submitted on 13 December 2022);
 - b) treatment of historical reference data for the calculation of late matching fail penalties (request submitted on 15 May 2023);
 - c) alternative methods for calculating cash penalties, including progressive penalty rates (request submitted on 28 August 2023).
4. The technical advice on the three topics should be submitted by ESMA to the EC by 30 September 2024.
5. The mandates mentioned above set out the principles which ESMA is invited to take account of when developing its advice, including proportionality and coherence within the regulatory framework of the Union. ESMA is invited to widely consult market participants in an open and transparent manner and to take into account the resulting opinions in its advice. ESMA is also invited to justify its advice by providing a quantitative and qualitative cost-benefit analysis of all the options considered and proposed.
6. The limited information available did not allow ESMA to produce a cost-benefit analysis for the purpose of this CP. While this CP does not include a draft cost-benefit analysis, ESMA has developed its draft technical advice having due regard to the principle of proportionality and being mindful about the possible costs the obligations they contain

would create for market participants. The input from stakeholders will help ESMA in finalising the technical advice and the relevant impact assessment. Therefore, respondents to this consultation are encouraged to provide the relevant data to support their arguments or proposals.

3 Alternative parameters, when the official interest rate for overnight credit charged by the central bank issuing the settlement currency is not available

3.1 Background

EC request for ESMA technical advice (13 December 2022)

ESMA is invited to provide technical advice to assist the Commission in amending Delegated Regulation (EU) 2017/389. In particular, this advice should specify which alternative rate or methodology should be applied in the calculation of cash penalties for settlement fails caused by a lack of cash where no overnight credit rate charged by the central bank issuing the settlement currency exists.

In order to ensure a deterrent effect of cash penalties and incentivise timely settlement by failing participants, the penalty rate should reflect the borrowing costs for that currency. ESMA should ensure that the applicable interest rate is set such that the level of cash penalties provides incentives to failing participants to promptly settle failed transactions, without endangering the integrity of the EU capital market. Simultaneously when defining the alternatives their impact on the level of penalties and on the market should be considered. In particular, the proposed rate should not lead to further fragmentation of the single market for capital. Moreover, considering the automation of calculation of cash penalties the proposed alternative rate should be easy to source and compute.

The Delegated Regulation notes that the most appropriate benchmark of borrowing costs in the calculation of a penalty rate is the official interest rate of the central bank issuing the settlement currency. Other potential substitute interest rates exist on the national and EU capital markets. Although some of them are set without the involvement of a central bank, they reflect the borrowing costs on the commercial inter-bank market and are used in several securities settlement systems. The technical advice should reflect upon the relevance of these proxy rates for the calculation of cash penalties in case of settlement fails caused by a lack of cash in light of the requirements of the Delegated Regulation (in particular Recital 12 and point 8 of the Annex).

7. Commission Delegated Regulation (EU) 2017/389¹¹ specifies the parameters and methodology for the calculation of the level of cash penalties that CSDs will impose on and collect from the failing participants in their securities settlement systems.

¹¹ 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

Specifically, Article 2 states that “...the level of cash penalties referred to in the third subparagraph of Article 7(2) of Regulation (EU) No 909/2014 for settlement fails of transactions in a given financial instrument shall be calculated by applying the relevant penalty rate set out in the Annex to this Regulation to the reference price of the transaction determined in accordance with Article 3 of this Regulation...”. Accordingly, the Annex to the Delegated Regulation specifies penalty rates applicable to settlement fails. In the case of settlement fails due to a lack of cash (point 8 of the Annex) the applicable rate should be the official interest rate for overnight credit charged by the central bank issuing the settlement with a floor of 0 (“zero”). For instance, in the case of Euro-settled transactions this would be the rate on the marginal lending facility, which is the interest rate banks pay when they borrow money overnight from the European Central Bank (ECB).

8. CSDR or the relevant Delegated Regulation do not provide a common definition of the overnight credit rate to be applied by CSDs or an alternative proxy interest rate for calculating the cost of borrowing in case a central bank overnight lending facility does not exist for the settlement currency. This appears to be the case in Bulgaria and Denmark.
9. The current Delegated Regulation (EU) 2017/389 was based on the related ESMA Technical Advice¹². It should be mentioned that, when ESMA consulted on the draft Technical Advice, the fact that some central banks do not have an overnight lending facility was not raised.
10. Alternative calculation methodologies or rates have been proposed, as evidenced by the ECSDA CSDR Penalties Framework¹³. Please see the table¹⁴ published by ECSDA with the cash penalty rates.
11. At the same time, ESMA would like to point out that, according to the upcoming review of CSDR (CSDR Refit), for which a political agreement was reached by the European Parliament and the Council on 28 June 2023, the Commission will be empowered to supplement CSDR by adopting delegated acts specifying parameters for the calculation of a deterrent and proportionate level of the cash penalties based on all of the following:
 - (a) asset type;
 - (b) liquidity of the financial instrument;

¹² https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1219_-_final_report_csd_r_ta_incl_cba_for_ec.pdf

¹³ https://ecsda.eu/wp-content/uploads/2021/10/2021_10_05_ECSDA_CSDR_Penalties_Framework.pdf

¹⁴ [2021_10_05_ECSDA_Currencies_Discount_rates_26_08_20.xlsx \(live.com\)](https://ecsda.eu/wp-content/uploads/2021/10/2021_10_05_ECSDA_Currencies_Discount_rates_26_08_20.xlsx)

(c) type of transaction;

(d) duration of the settlement fail.

12. According to the above-mentioned agreement, when specifying these parameters, the Commission will need to take into account the level of settlement fails per class of financial instruments and the effect that low or negative interest rates could have on the incentives of counterparties and on settlement fails. The parameters used for the calculation of cash penalties will need to ensure a high degree of settlement discipline and the smooth and orderly functioning of the financial markets concerned.
13. The Commission will also have to review the parameters for the calculation of the level of the cash penalties on a regular basis and at least every four years in order to reassess the appropriateness and effectiveness of the cash penalties in achieving a level of settlement fails in the Union deemed to be acceptable having regard to the impact on the financial stability of the Union.

3.2 Assessment

14. No common calculation method or agreement on the variables used to calculate an alternative rate has been developed, when the official interest rate for overnight credit charged by the central bank issuing the settlement currency is not available. Currently different settlement currencies use different domestic rates or a combination of a domestic benchmark rate and spread of key ECB interest rates. Please see the examples below.
15. It should be mentioned that Bulgaria is expected to join the Eurozone in 2024/2025 (exact date to be confirmed), therefore it appears that the only EEA jurisdiction without an official interest rate for overnight credit for the national currency will be Denmark.
 - A) Bulgaria
16. BG FSC has confirmed the following approach which the Bulgarian Central Depository AD (CDAD) and the Bulgarian National Bank (BNB) implement due to the lack of an official interest rate for overnight credit in Bulgarian Leva.
17. The penalty rate (PR) is determined as the base interest rate (BIR) published monthly by the BNB, plus the spread calculated as difference between ECB marginal lending facility rate (MLFR) and the ECB Main refinancing operations rate (MROR). Thus, the applicable formula is: $PR = BIR + (MLFR - MROR)$.
18. The PR in January 2023 was 1.67 %. This figure is calculated by: BIR – 1.42% (as of 1 January 2023; it was zero up to 1 October 2022) and MLFR = 2.75 % and MROR =

2.50% 9 as of 21 December 2022. Thus: $PR = 1.42 + (2.75 - 2.50) = 1.42 + 0.25 = 1.67\%$ per year.

19. The method described above was proposed as an interim solution by the BNB and afterwards discussed with EC representatives, BNB, the Bulgarian Ministry of Finance and FSC. As a follow-up of the above-mentioned discussion, the method was adopted by both BG CSDs: BNB (in Ordinance No. 31 of BNB) and CDAD (in Article 30 of CDAD Rules and Regulations).
20. Furthermore, the determination of the domestic rate BIR is completely market-based. BNB calculates and publishes the LEONIA Plus index – LEV Overnight Index Average, which is determined as the average-weighted interest rate on all uncollateralized overnight deposits in Bulgarian Leva provided on the interbank market in Bulgaria. LEONIA Plus is calculated and published on a daily basis. The BIR is the average of all daily values of LEONIA Plus for the previous month. BIR is determined and published on the first day of each month and applies for the same month.

B) Denmark

21. DK FSA has confirmed the approach used by VP Securities, the Danish CSD, in the absence of an official interest rate for overnight credit Denmark conducts a fixed exchange rate policy against the euro. This means that the value of the Danish krone is to be kept stable against the euro which Danmarks Nationalbank does by way of monetary policy. In a fixed exchange rate regime monetary-policy interest rates are reserved for managing the exchange rate. The interest rates are kept relative to those of the ECB.
22. For the Euro, the ECB's "marginal lending facility rate" is used to calculate penalties. Since Danmarks Nationalbank does not offer an overnight credit facility there is no interest rate for overnight credit. Instead, there is an interest rate for weekly credit which is the same as the ECB's "main refinancing operations" (MROs). According to DK FSA, the interest rate of Danmarks Nationalbank would be too low compared to the ECB's marginal lending facility rate since it is weekly instead of overnight. A proxy used until now is based on Danmarks Nationalbank's weekly lending rate plus the spread calculated as the difference between the ECB marginal lending facility rate (MLFR) and the ECB deposit facility rate. The calculation method is this proxy rate divided by 360 with a floor of zero. The approach is linked to the fixed exchange rate policy.
23. An example of the proxy which the Danish CSD uses to calculate the penalties is:
 $\text{Weekly lending rate} + (\text{ECB marginal lending facility interest rate} - \text{ECB deposit facility rate}) = 3.10\% \text{ per year} + (4.25\% \text{ per year} - 3.50\% \text{ per year}) = 3.85\% \text{ per year}.$

3.3 Proposal

24. ESMA believes that the penalty rate applied for a settlement fail due to lack of cash should ensure that it is cheaper to borrow cash to settle the transaction than to pay the penalties and obtain interest on the unpaid cash.
25. ESMA is considering the four options mentioned below (with a preference for Option 4) when calculating cash penalties for settlement fails due to lack of cash, for the currency/currencies without an official interest rate for overnight credit. Option 4 would apply across currencies. Even if the cost of borrowing cash may vary depending on the underlying currency, ESMA believes a single, high enough, penalty rate for settlement fails due to lack of cash would achieve the main objective of penalising those that cause the settlement fails in question.
26. The three options take into account the proportionality principle, as they do not go beyond what is necessary to achieve the objective of the cash penalties regime under CSDR. They are simple and avoid excessive financial, administrative or procedural burdens for CSDs.

Option 1

STEP 1: converting the respective cash amount subject to penalties into EUR (using the official exchange rate - the conversion rate should be from the same day as the reference data for the calculation of penalties for a given business day)

STEP 2: applying the ECB marginal lending facility rate (interest rate for overnight credit from the Eurosystem) to the converted cash amount

STEP 3: where needed, converting the result back into the original currency (using the official exchange rate - the conversion rate should be from the same day as the reference data for the calculation of penalties for a given business day)

Option 2

STEP 1: calculating the spread on the shortest maturity (e.g. 1 month) market rates available for EUR and currency X (currency without an official interest rate for overnight credit)

STEP 2: adding the ECB marginal lending facility rate (interest rate for overnight credit from the Eurosystem) to calculate the penalty rate to be applied for the other currency

Example:

EUR 1 month 4.75%, currency X 1 month 6.2% -> spread 1.45%

EUR marginal lending facility rate 4.75%

Penalty rate for currency X -> $1.45\% + 4.75\% = 6,2\%$

(Note: Day count conventions and other adjustments may be needed before calculating the spread.)

Option 3

Short description: In the absence of an overnight interest credit rate due to the monetary policy of the central bank issuing the settlement currency, other comparable interest rates of the ECB and the relevant central bank could be used to calculate a proxy which a CSD can use to calculate the cash penalties due to lack of cash. The alternative method must always ensure that the cash penalty rate costs more than it would cost to borrow the cash and pay for the securities on time. It is a precondition for this alternative method that the interest rates of the ECB and the relevant central bank are comparable. The proxy is calculated by the central bank issuing the settlement currency and must be recalculated whenever either the interest rates of the ECB and/or the interest rates of the central bank issuing the settlement currency are subject to changes.

An example of the alternative calculation is:

A rate corresponding to the ECB's "main refinancing operations" (MROs) could be used to calculate a proxy.

STEP 1:

Identification of comparable interest rates of the ECB and the central bank. In the example those interest rates are ECB's "main refinancing operations" (MROs) and the corresponding interest rate for weekly credit of the central bank.

STEP 2:

The comparable interest rate of the central bank (the interest rate for weekly credit) is added the spread between the ECBs deposit facility rate and the ECBs marginal lending rate. The spread is added because a weekly credit rate will typically be lower than an overnight credit rate. Adding the spread will compensate for this difference in order for the interest rate used to calculate the cash penalties is as close to the official interest rate for overnight credit of the ECB.

Option 4

Another option could be considered, which goes further than addressing the situation when the official interest rate for overnight credit charged by the central bank issuing the settlement currency is not available. This option is described in Section 5 of this CP as part of a potential general review of the cash penalties regime under CSDR Refit. Under this option, higher fixed

rates for settlement fails due to lack of cash, irrespective of the currency, would apply depending on the length of the settlement fail.

Daily penalty rates for settlement fails due to lack of cash

10 basis points - 1st BD of fail

15 basis points – 2nd BD of fail

20 basis points – 3rd BD of fail

25 basis points – 4th BD of fail

30 basis points – starting with 5th BD of fail

Q1: Do you agree with ESMA’s proposal? Which Option is preferable in your view? Please also state the reasons for your answer.

Q2: Do you have other suggestions? If yes, please specify and provide arguments.

Q3: Do you agree with the approach followed for the Option you support to incorporate proportionality in the Technical Advice? If not, please provide an indication of further proportionality considerations, detailed justifications and alternative wording as needed.

Q4: What costs and benefits do you envisage related to the implementation of each Option? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Option		
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

4 Treatment of historical reference data for the calculation of late matching fail penalties

4.1 Background

EC request for ESMA technical advice (15 May 2023)

ESMA is invited to provide technical advice to assist the Commission in amending Delegated Regulation (EU) 2017/389. This advice should specify how to deal with reference data accumulation caused by the need to calculate LMFPs, in particular by suggesting appropriate methods to calculate settlement fails penalties and handle reference data underlying transactions that are matched after the ISD.

27. Article 7(2) of CSDR requires CSDs to apply cash penalties to participants that cause settlement fails, which shall be calculated on a daily basis for each business day that a transaction fails to be settled after its intended settlement date, but no longer than the actual settlement day.

CSDR Article 7

2. *For each securities settlement system it operates, a CSD shall establish procedures that facilitate settlement of transactions in financial instruments referred to in Article 5(1) that are not settled on the intended settlement date. These procedures shall provide for a penalty mechanism which will serve as an effective deterrent for participants that cause settlement fails.*

Before establishing the procedures referred to in the first subparagraph, a CSD shall consult the relevant trading venues and CCPs in respect of which it provides settlement services.

The penalty mechanism referred to in the first subparagraph shall include cash penalties for participants that cause settlement fails ('failing participants'). Cash penalties shall be calculated on a daily basis for each business day that a transaction fails to be settled after its intended settlement date until the end of a buy-in process referred to in paragraph 3, but no longer than the actual settlement day. The cash penalties shall not be configured as a revenue source for the CSD.

28. The parameters for the calculation of cash penalties are defined in the Commission Delegated Regulation (EU) 2017/389:

Article 2 - Calculation of cash penalties

The level of cash penalties referred to in the third subparagraph of Article 7(2) of Regulation (EU) No 909/2014 for settlement fails of transactions in a given financial instrument shall be calculated by applying the relevant penalty rate set out in the Annex to this Regulation to the reference price of the transaction determined in accordance with Article 3 of this Regulation.

Article 3 - Reference price of the transaction

1. The reference price referred to in Article 2 shall be equal to the aggregated market value of the financial instruments determined in accordance with Article 7 for each business day that the transaction fails to be settled.

2. The reference price referred to in paragraph 1 shall be used to calculate the level of cash penalties for all settlement fails, irrespective of whether the settlement fail is due to a lack of securities or cash.

29. CSDR settlement discipline regime provisions imply that LMFPs must be calculated for settlement fails with an ISD for any point in time in the past as of 1 February 2022 onwards. This poses a challenge for any IT system with finite resources: to calculate settlement fails for any given day in the past means that the related historical reference data must be kept available and made use of by the system where the amount of reference data is gradually increasing every business day (with no possibility for historical reference data deletion/removal).

30. This accumulation of historical reference data may have an impact on all EU CSDs as well as, most notably, on TARGET2-Securities (T2S) where the accumulation of past data over time will degrade the functioning of the system.

31. In light of the above, the EC has asked ESMA to suggest a possible amendment to Commission Delegated Regulation (EU) 2017/389. Such amendment should clarify the calculation method for LMFPs that prevents the accumulation of reference data over time and ensures the efficient operation of securities settlement systems.

4.2 Assessment

32. ESMA supports the objective to ensure a proportionate approach by not requiring CSDs to accumulate unlimited reference data in respect of LFMPs in the systems they use, to prevent the degradation of the performance of the systems used by CSDs.

33. As such, ESMA believes that the efficient and smooth operation of securities settlement systems should take precedence over the use of daily reference data for the calculation of LMFPs beyond a certain date in the past. ESMA also acknowledges the importance

for CSDs to have predictability regarding the amount of data they need to manage, so that they can plan and develop the capacity of the systems they use accordingly.

34. At the same time, ESMA considers it is important to ensure that the number and value of settlement fails for which the calculation of penalties may be impacted are very low, and that this should be a criterion for setting the threshold beyond which recent reference data (last available data) may be used for the calculation of the related cash penalties. Based on an overview of the number and share of LMFPs in T2S across July-October 2023: an average of less than 300 LMFPs monthly (<0.03% of total penalties) apply for business days older than 40 days, and an average of less than 100 LMFPs monthly (<0.008% of total penalties) apply for business days older than 92 days. To be precise, the July-October 2023 monthly average in T2S for 92+ days was 77 penalties. As a comparison, the monthly average in T2S for 40+ days was 279 penalties.
35. ESMA also believes it is important that, for each financial instrument, there is one CSD (the Issuer CSD) that should be responsible for determining the relevant reference data to be used for the related penalties calculation.
36. Last but not least, ESMA would like to highlight that CSDs would still need to archive the reference data related to the calculation of penalties to ensure compliance with the relevant record keeping requirements under Article 29(1) of CSDR, according to which a CSD shall maintain, for a period of at least 10 years, all its records on the services and activities.

4.3 Proposal

37. ESMA suggests including in the technical advice the proposed amendments to Commission Delegated Regulation (EU) 2017/389 included below (please see in particular the added paragraph 3 in Article 3).
38. In addition, ESMA would like to ask for stakeholders' views on where to set the threshold beyond which more recent reference data could be used for the calculation of cash penalties, bearing in mind the proportionality principle, in order not to go beyond what is necessary to achieve the objective of preventing the accumulation of reference data over time and ensuring the efficient operation of securities settlement systems, while also enabling the application of effective and deterrent penalties.

Article 2 - Calculation of cash penalties

The level of cash penalties referred to in the third subparagraph of Article 7(2) of Regulation (EU) No 909/2014 for settlement fails of transactions in a given financial instrument shall be calculated by applying the relevant penalty rate set out in the Annex to this Regulation to the reference price of the transaction determined in accordance with Article 3 of this Regulation.

Article 3 – Reference ~~data price of the transaction~~

1. *The reference price referred to in Article 2 shall be equal to the aggregated market value of the financial instruments determined in accordance with Article 7 for each business day that the transaction fails to be settled.*

2. *The reference price referred to in paragraph 1 shall be used to calculate the level of cash penalties for all settlement fails, irrespective of whether the settlement fail is due to a lack of securities or cash.*

3. *Where settlement instructions have been matched after the intended settlement date, and that intended settlement date is beyond [92 or 40] business days in the past, more recent reference data (last available data), such as reference prices and exchange rates, shall be used for the calculation of the related cash penalties.*

In the cases mentioned in the first subparagraph, the issuer CSD for each financial instrument shall be responsible for determining the relevant reference data to be used for the related penalties calculation.

Q5: As a CSD, do you face the issue of accumulation of reference data related to Late Matching Fail Penalties (LMFPs), that may degrade the functioning of the securities settlement system you operate? If yes, please provide details, including data where available, in particular regarding the number and value of late matching instructions, as well as for how many business days they go in the past from the moment they are entered into the securities settlement system, and the percentage they represent compared to the overall number and value of settlement fails on a monthly basis (please use as a reference the period June 2022 – June 2023).

Q6. What are the causes of late matching? How can you explain that there are so many late matching instructions? What measures could be envisaged in order to reduce the number of late matching instructions?

Q7: Do you agree with ESMA's proposal to establish a threshold beyond which more recent reference data shall be used for the calculation of the related cash penalties to

prevent the degradation of the performance of the systems used by CSDs? Please also state the reasons for your answer.

Q8: Do you agree with the threshold of 92 business days or 40 business days in order to prevent the degradation of the performance of the systems used by CSDs? Please specify which threshold would be more relevant in your view:

a)92 business days;

b)40 business days;

c)other (please specify).

Please also state the reasons for your answer and provide data where available, in particular regarding the number and value of late matching instructions that go beyond 92 business days, 40 business days in the past or another threshold you think would be more relevant, and the percentage they represent compared to the overall number and value of settlement fails on a monthly basis (please use as a reference the period June 2022 – December 2023).

Q9: Do you agree that the issuer CSD for each financial instrument shall be responsible for confirming the relevant reference data to be used for the related penalties calculation? Please also state the reasons for your answer.

Q10: In your view, where settlement instructions have been matched after the intended settlement date, and that intended settlement date is beyond the agreed number of business days in the past, the use of more recent reference data (last available data) for the calculation of the related cash penalties should be optional or compulsory? Please also state the reasons for your answer.

Q11: Do you have other suggestions? If yes, please specify, provide drafting suggestions and provide arguments including data where available.

Q12: Do you agree with the approach followed to incorporate proportionality in the Technical Advice? If not, please provide an indication of further proportionality considerations, detailed justifications and alternative wording as needed.

Q13: What costs and benefits do you envisage related to the implementation of the approach proposed by ESMA? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Approach proposed by ESMA		
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

Q14: If applicable (if you have suggested a different approach than the one proposed by ESMA), please specify the costs and benefits you envisage related to the implementation of the respective approach. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Approach proposed by respondent (if applicable)		
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

5 Alternative methods for calculating cash penalties, including progressive penalty rates

5.1 Background

EC request for ESMA technical advice (28 August 2023)

The Commission asks ESMA to suggest a possible amendment to Commission Delegated Regulation (EU) 2017/389. The Agency should assess the effectiveness and proportionality of the current penalty mechanism and propose, if justified, changes to the structure or severity of the mechanism and consider alternative methods for calculating cash penalties, including by introducing progressive penalty rates. In drafting its technical advice, ESMA should consider how the changing interest rate environment, including negative interest rates, affect a participant's incentive to fail and how this could be mitigated. Furthermore, ESMA should reflect on the need for further flexibility with regards to penalties for settlement fails imposed on illiquid financial instruments. The proposed amendments to the structure and severity of the mechanism should effectively discourage settlement fails, incentivise their rapid resolution and improve settlement efficiency.

39. ESMA would like to point out that, according to the political agreement on CSDR Refit, cash penalties will need to be calculated for each business day for as long as the fail persists. The calculation will need to take into account the possibility of a negative interest rate environment. Furthermore, the EC will be mandated to review, on a regular basis, the parameters used to calculate cash penalties and will, as a result, need to consider potential changes to the method used for the calculation of those penalties, such as setting progressive rates.
40. Finally, based on the political agreement on CSDR Refit, the EC will be empowered to supplement CSDR by adopting delegated acts specifying parameters for the calculation of a deterrent and proportionate level of the cash penalties based on all of the following:
- (a) asset type;
 - (b) liquidity of the financial instrument;
 - (c) type of transaction;
 - (d) duration of the settlement fail.

When specifying these parameters, the EC will need to take into account the level of settlement fails per class of financial instruments and the effect that low or negative interest rates could have on the incentives of counterparties and on settlement fails. The parameters used for the calculation of cash penalties will need to ensure a high degree of settlement discipline and the smooth and orderly functioning of the financial markets concerned.

41. The EC will also be mandated to review the parameters for the calculation of the level of the cash penalties on a regular basis and at least every four years in order to reassess the appropriateness of the cash penalties and effectiveness in achieving a level of settlement fails in the Union deemed to be acceptable, having regard to the impact on the financial stability of the Union.
42. In light of the above, the EC has asked ESMA to assess the effectiveness and proportionality of the current penalty mechanism and propose, if justified, changes to the structure or severity of the mechanism and consider alternative methods for calculating cash penalties, including by introducing progressive penalty rates.

5.2 Assessment

5.2.1 Effectiveness and proportionality of the current penalty mechanism

43. According to Article 7(1) of CSDR, CSDs have to establish a system that monitors settlement fails and provide regular reports to the Competent Authorities and the Relevant Authorities regarding the number and details of settlement fails as well as any other relevant information, including the measures envisaged by CSDs and their participants to improve settlement efficiency to fulfil their respective duties and mandates. This provision further requires CSD National Competent Authorities (NCAs) to share with ESMA the relevant settlement fails reports they receive from CSDs.
44. The settlement fails reporting requirements have become applicable upon the entry into force of the RTS on Settlement Discipline (i.e. 1 February 2022), which further specifies the content of settlement fails reporting.
45. Given the need to have a longer observation period since the start of the application of cash penalties to have a meaningful assessment of the impact of cash penalties on settlement efficiency, as well as to allow for sufficient time to ensure an adequate level of data quality regarding the settlement fails reports submitted under Article 7(1) of CSDR, ESMA aims to publish a more detailed impact analysis at a later stage.
46. As a preliminary assessment, ESMA notes that settlement fail rates at the level of securities settlement systems operated by EEA CSDs seem to have been somehow

reduced after the application of the CSDR penalty mechanism. However, settlement fail rates remain high for some CSDs across all asset classes, and in particular for ETFs.

47. ESMA would also like to ask for input from CSDs' and CSD participants as well as any other interested stakeholders on the effectiveness of the CSDR penalty mechanism so far, given the trends of the levels of settlement fails by asset class since February 2022.
48. In addition, ESMA would like to invite stakeholders to express their views on the level(s) of settlement efficiency they consider appropriate, both at CSD/SSS level and by asset type.
49. Regarding the proportionality of the application of the penalty mechanism at the level of CSDs, even if some CSDs have lower settlement fail rates than others, ESMA does not consider that applying the penalty mechanism at individual CSD level (based on the CSD settlement fail rates) would be the right approach at this stage. The main reason for this is that the interconnectedness of securities markets and among CSDs in the EEA (cross-CSD transactions) would not allow for penalties to be passed on in case of a chain of transactions.
50. Nevertheless, ESMA would like to ask for input from CSDs' and CSD participants as well as any other interested stakeholders on the proportionality of the application of the penalty mechanism at the level of CSDs.
51. Regarding the proportionality of the penalty rates by asset type as foreseen by the Annex to Commission Delegated Regulation (EU) 2017/389, ESMA does not have data on the breakdown of cash penalties (by number and value) applied by CSDs by asset type. Therefore, ESMA would like to use this CP to ask for data from all EEA CSDs on this breakdown, including on the duration of settlement fails by asset type.
52. ESMA would also like to ask for input from CSDs' and CSD participants as well as any other interested stakeholders on the proportionality of the penalty rates by asset type as foreseen by the Annex to Commission Delegated Regulation (EU) 2017/389.
53. In addition, ESMA understands based on information provided by an NCA that it seems that penalties paid or received are treated inconsistently by CSD participants. Some CSD participants do not pass on penalties to clients, while others do pass penalties to the respective clients. According to the respective NCA, some CSD participants have referred to Recitals no. 18 et seq. of the RTS on Settlement Discipline as the legal basis for passing on penalties to clients, while others have argued that Article 7 of CSDR does not provide for a clear legal basis on this.

54. ESMA considers that, if penalties are not passed on to clients, this would reduce the effectiveness of the penalty mechanism and would also lead to a different application of CSDR across the Union. Therefore, ESMA would like to ask for input from CSD participants as well as any other interested stakeholders regarding the current market practices as well as data, examples and reasons, if any, which may impede the passing on of penalties to clients.

5.2.2 Progressive penalty rates

55. According to the political agreement on CSDR Refit, cash penalties will need to be calculated on a daily basis for as long as the fail persists. The EC should reassess on a regular basis the parameters used to calculate cash penalties and should further consider possible changes to the method used for the calculation of those penalties, such as setting progressive rates.

56. First of all, ESMA believes that not all settlement fails are the same and that a one-day settlement fail is not as impacting as a 20-day settlement fail. This is true both in terms of impact but also in terms of the underlying causes, and therefore in terms of measures to address them. As such, there may be merit in considering setting progressive penalty rates.

57. Secondly, not all settlement fails are equally avoidable. This means that 100% settlement efficiency may not be a realistic target, and that some flexibility in the penalty mechanism should be tolerated.

58. Last but not least, the cash penalty mechanism is the first line of defence whereas the MBI is the second. This means that, if the penalty mechanism works, there is no need for an MBI. In ESMA's view, the aim should be to build a cash penalty mechanism that reduces the need for more drastic measures.

59. Having regard to the above, one may conclude that an effective disincentive to "actionably avoidable" settlement fails, i.e. those for which participants have some form of agency to avoid them, is one that removes the economic incentives to letting the trade fail, without unduly burdening the settlement process.

60. The operational intuition is that the scope for "actionably avoidable" fails is quite broad, provided investments are poured into the process (in terms of automation, controls, and staff). Therefore, on the one hand, meaningful, persistent costs in the form of penalties can trigger meaningful investments to avoid them. On the other hand, costs on un-avoidable fails will only make the system less efficient and at a competitive disadvantage. As mentioned above, according to the political agreement on CSDR Refit, an additional criterion which the penalty system should potentially take into account will be introduced, i.e. the duration of the fail. Thus, it seems appropriate to

consider amending the penalty mechanism by introducing progressive cash penalties that increase with the length of the settlement fail.

61. Another potential approach to progressive penalty rates could be based not only on the length of the settlement fail but also on the value of the settlement fail, provided that this is feasible from an operational and technical perspective. A settlement instruction with a lower value could be charged a higher penalty rate than those with a higher value, thus potentially creating an incentive for participants in settling smaller value instructions at their intended settlement date (ISD). Alternatively, settlement instructions with a higher value could be charged a higher penalty rate than those with a lower value. In the same vein, introducing a minimum amount of cash penalty per type of fail could also be considered. ESMA would like to ask for the stakeholders' views on the operational and technical implications and the related implementation costs of such measures.
62. To be effective and efficient, the cash penalty should be:
- unequivocally more expensive than remedial action, like borrowing the securities or funding the cash;
 - certain in terms of calculation and forecasting, to facilitate cost/benefit calculations in terms of remedial investments.
63. Considering that securities borrowing is usually the easier way to prevent or resolve a settlement fail caused by the lack of securities, it could be argued that the level of penalties on fails due to a lack of securities should take into account the cost for borrowing securities plus a mark-up in order to incentivise the prevention of the fails. On the other side, it is also worth noting that stock lending is carried out mostly in a bilateral way, therefore, even if some data providers collect data on stock lending fee, the data quality may be lacking. Thus, ESMA would welcome input from stakeholders in response to this CP regarding the: i) opportunity to revise the penalty rates to link them to the average stock lending fee of the corresponding asset class; ii) the data quality of stock lending fees available at data vendors; iii) data on the average stock lending fees for the 8 categories of asset class depicted in Option 1 below (i.e. revised penalty rates without convexity based on the existing types of fails, and introducing a new type of settlement fail for lack of ETFs).
64. Last but not least, ESMA would like to ask for stakeholders' views on the risk that underlying parties that end up with "net long" cash payments may not have incentives to manage their fails or bilaterally cancel failing instructions as they may "earn" cash from penalties and how this risk could be addressed.

5.2.3 Impact of changing interest rates, including negative interest rates

65. ESMA suggests introducing higher penalty rates for settlement fails due to a lack of cash, which should apply irrespective of the currency, and should increase depending on the length of the settlement fail. This solution should be both easy to manage and predict, as well as very highly punitive for long-dated settlement fails.
66. According to the political agreement on CSDR Refit, the EC will be mandated to review the parameters for the calculation of the level of the cash penalties on a regular basis and at least every four years in order to reassess its appropriateness and effectiveness in achieving a level of settlement fails in the Union deemed to be acceptable, having regard to the impact on the financial stability of the Union.

5.2.4 Further flexibility with regard to penalties for settlement fails imposed on illiquid financial instruments

67. Even if the settlement efficiency rate per type of financial instruments may not necessarily be correlated with the liquidity of the financial instruments across asset classes, as settlement fail rates for government bonds and money market instruments are lower than for equities, ESMA believes it is important to consider the liquidity of different securities within each asset class, in order not to disincentivise trading in illiquid securities.
68. ESMA suggests taking further into account the liquidity of financial instruments when setting the penalty rates. In addition to the categories of financial instruments that already have lower penalty rates under the current penalty regime (shares that do not have a liquid market within the meaning of Article 2(1)(17), point (b) of Regulation (EU) No 600/2014¹⁵, and financial instruments traded on SME growth markets), ESMA is considering the feasibility of identifying another asset class subject to lower penalty rates: “bonds for which there is not a liquid market in accordance with the methodology specified in Article 13(1), point (b) of Commission Delegated Regulation (EU) 2017/583 (RTS 2)”.
69. ESMA currently publishes a quarterly liquidity assessment for bonds available for trading on EU trading venues, with further updates within each quarter published in ESMA’s [Financial Instruments Transparency System \(FITRS\)](#)¹⁶. These publications would be used as a reference to identify illiquid bonds for the purpose of CSDR penalty

¹⁵ MiFIR Review may need to be considered. Changes to the liquidity assessment methodology for equity and equity-like instruments will be introduced in the future, as a result of the MiFIR review. These changes may affect the annual publication of liquidity calculations for equity and equity-like instruments.

¹⁶ MiFIR review may need to be considered. Changes to the liquidity assessment for non-equity instruments will be introduced in the future, as a result of the MiFIR review. These changes may affect the quarterly publication of liquidity calculations for non-equity instruments.

rates. The latest bonds quarterly liquidity assessment published on 31 October 2023¹⁷ identifies 1,148 liquid bonds (sovereign and corporate ones) out of 124,197 bonds subject to MiFID II transparency requirements for Q3 2023, meaning that most of the bonds would be considered illiquid.

70. However, ESMA is also aware that this may add to the operational burden for CSDs that would need to check the liquidity of bonds before applying cash penalties. As such, ESMA would like to ask for the stakeholders' views on the costs and benefits of such a measure.

71. ESMA would also welcome input from stakeholders in response to this CP regarding other ways to achieve further flexibility with regards to penalties for settlement fails imposed on illiquid financial instruments.

5.2.5 Automation of calculation of cash penalties

72. ESMA considers that the proposed alternative rates should be easy to source and compute, which should support the automation of cash penalties.

73. The potential increase of the penalty rates and their progressive nature may render less relevant the daily marking to market of financial instruments in order to determine the basis for the calculation of cash penalties. As such, ESMA would like to ask for the stakeholders' views regarding the use of the market value of the financial instruments on the first day of the settlement fail as a basis for the calculation of penalties for the entire duration of the fail, as this would simplify the process. ESMA would like to ask for the stakeholders' views on the costs and benefits of such a measure.

74. ESMA would also welcome input from stakeholders in response to this CP regarding additional ways to support the automation of calculation of cash penalties.

5.2.6 Ad hoc measures for CSD participants with high settlement fail rates

75. In anticipation of ESMA's future work on the RTS on additional tools to improve settlement efficiency, as foreseen by the political agreement on CSDR Refit, ESMA intends to explore the possibility to have special penalties in place for CSD participants with high settlement fails. The introduction of such penalties would not be part of the Technical Advice to the EC.

76. Currently, Article 7(9) of CSDR provides that CSDs, CCPs and trading venues shall establish procedures that enable them to suspend any participant that fails consistently

¹⁷ <https://www.esma.europa.eu/press-news/esma-news/esma-publishes-data-quarterly-bond-liquidity-assessment-systematic>

and systematically to deliver the financial instruments. CSDR Refit will not introduce any change in CSDR on this aspect.

77. Article 39 of the RTS on Settlement Discipline states that a participant shall be considered as consistently and systematically failing to deliver where its rate of settlement efficiency, determined by reference to the number or to the value of settlement instructions, is at least 15 % lower than the rate of settlement efficiency of that securities settlement system, during at least a relevant number of days over the 12 previous months. The relevant number of days is equal to 10 % of the number of days of activity of that participant in the security settlement system over the 12 previous months.
78. One possibility would be to identify CSD participants with high settlement fail rates using the same threshold as participants failing consistently and systematically in order to leverage from systems and procedures already in use, but within a shorter period, for instance 2 months instead of the 12 months provided for in Article 39 of the RTS on Settlement Discipline. When calculating a participant's rate of settlement efficiency, exclusive reference should be made to settlement fails caused by that participant, as currently envisaged by Article 39(2) of the RTS on Settlement Discipline.
79. These special penalties would be in addition to the general cash penalty mechanism provided for in CSDR. In principle, they would not be credited to the participant's counterparties and should not represent an additional source of income for the CSD.
80. In addition, Article 13(2) of the RTS on Settlement Discipline provides that CSDs shall establish working arrangements with the participants having the most significant impact on their securities settlement systems and, where applicable, with relevant CCPs and trading venues to analyse the main reasons for the settlement fails.
81. As a starting point to further reflections, ESMA proposes to collect data about (i) participants that have been detected as failing consistently and systematically with the meaning of Article 7(9) and how many of them, if any, have been suspended pursuant to Article 7(9) and (ii) working arrangements established by CSDs and their participants.

5.3 Proposal

82. ESMA would like to ask for the stakeholders' views on two options to potentially amend the penalty mechanism. Responses to this CP will be crucial in further calibrating the penalty rates and the overall approach.

Option 1 - progressive penalty rates based on the current types of fails/ asset types + ETFs

83. With Option 1, ESMA is proposing a revision of the penalty rates based on the **current types of fails/ asset types**, while a new type is introduced for fails due to a lack of ETFs. **Progressive rates** are introduced by multiplying the current rates.

Option 2 - progressive penalty rates with streamlined asset types and convexity

84. With Option 2, ESMA is putting forward an approach regarding the penalty mechanism based on a number of innovative concepts compared to the current penalty mechanism, for which ESMA seeks feedback:

85. **Simplification of the fail types/ asset types:** The assumption underpinning the penalty regime is that penalties will drive settlement efficiency, provided that the failing party is able to prevent or to solve the settlement fail. In the cases where this assumption holds true, one can assume that penalties will create strong incentives to carry out viable remedial action. One of the determinants of the ability of failing parties to address fails is the availability/liquidity of the underlying instruments. ESMA is proposing to simplify the type of fails based on the liquidity parameter only as a proxy of the agency of the failing party to act. Therefore, ESMA proposes to apply different penalty rates based on the following 3 asset types: a) liquid financial instruments; b) illiquid financial instruments; and c) cash, which is deemed super-liquid as universally fungible.

86. **Introduction of convexity in penalty rates:** If one can act to avoid fails then increasing the economic cost as the problem persists will also increase the urgency to address it. Progressive penalty rates make waiting without acting an unsustainable strategy, while being understanding of minor problems that are resolved quickly.

87. **Proportionality:** According to information gathered by ESMA so far, one of the main high-level reasons for settlement fails is the “lack of securities”. Securities may be missing in different scenarios, such as short selling, pending delivery of securities subject to back-to-back transactions (especially for bonds), issues in the settlement chain (e.g. for ETFs), other inventory issues. In some scenarios, the liquidity of the financial instruments subject to transactions has no impact on the settlement of the transactions, while in other scenarios, the liquidity is relevant. Liquid financial instruments should be readily available and hence increasing the related penalty rates should be very effective. However, after a certain point, if a security deemed ex-ante liquid is still not available it may be fair to assume that other factors may be impacting the settlement fail. Therefore, long dated fails for otherwise liquid financial instruments might be treated with more leniency on the assumption that a contingent problem beyond the reach of the failing counterparty may have materialised. On the other hand, illiquid financial instruments may be more difficult to source. While some leniency might be provided in facilitating the transactions of these financial instruments, those that do

engage in illiquid markets should also be capable of delivering on their commitments. Therefore, in this latter case, lower rates are proposed for the first few days of fails, but afterwards the proposed rates increase sharply to make repeated inability to source the financial instruments an unviable economic proposition.

88. **Penalty levels:** The overarching drive in terms of setting penalty levels is that failing on a transaction should never be an economically viable option. Especially in the case of cash fails. Cash is infinitely fungible, and very high cost of fails should prompt agents to prioritise settlement efficiency above all other activities. This also becomes a very powerful indicator of problems with the failing entity. For non-cash instruments, levels are calibrated thinking of the new function assigned to penalties after the reform of the mandatory buy in framework. As buy-ins become a measure of last resort, penalties must be sufficiently effective to ensure that this eventuality never happens. The likelihood of a buy-in for liquid financial instruments is already rather low. The issue might arise for illiquid ones where very high long-term penalty rates are designed to force the failing counterparty to put in place remedial action well before the buy-in becomes a necessity, such as securities lending.

89. Having regard to the above, ESMA would like to ask for the stakeholders' views on two options based on progressive penalty rates:

a) Option 1 with revised penalty rates (without convexity, i.e. penalty rates increase progressively up to a number of business days, after which they remain constant) based on the existing types of fails, and introducing a new type of settlement fail for lack of ETFs;

b) Option 2 with revised penalty rates (with convexity for liquid financial instruments, i.e. penalty rates increase progressively up to a number of business days, after which they decrease) and streamlined types of fails, based on the asset types and their liquidity.

Option 1: progressive penalty rates based on the current types of fails/asset types + ETFs

The existing 7 types of fails due to a lack of securities and the existing type of fail due to a lack of cash are maintained, while a new type is introduced for fails due to a lack of ETFs. Progressive rates are introduced by multiplying the current rates with the following calculation method:

Day of fail	Day 1	Day 2	Day 3	Day 4	Day 5	Day 6 and beyond
Proposed new rate	current rate X 6	current rate X 8	current rate X 10	current rate X 15	current rate X 20	current rate X 25

Type of fail	Current rate ¹⁸	Proposed rates ¹⁹	Example
1. Settlement fail due to a lack of shares that have a liquid market within the meaning of point (b) of Article 2(1)(17) of Regulation (EU) No 600/2014, excluding shares referred to in point 3	1,0 basis point	6 basis points – 1 st BD ²⁰ of fail 8 basis points - 2 nd BD of fail 10 basis points – 3 rd BD of fail 15 basis points – 4 th BD of fail 20 basis points – 5 th BD of fail 25 basis points – starting with 6 th BD of fail	Delivery of 1,000 liquid shares, failing due to “lack of securities” for 2 BD after the ISD ²¹ , penalty reference price per share for BD 1 = 100.00 EUR/ for BD 2 = 102.00 EUR. Formula: Security Penalty Rate*Reference Price*Quantity Fail penalty for BD 1: 6 basis points * 100 *1,000 = 0.06% * 100,000 EUR = 60 EUR Fail penalty for BD 2: 8 basis points * 102 *1,000 = 0.08% * 102,000 EUR = 81.6 EUR Total penalties for 2 BD of fail: 60 EUR + 81.6 EUR = 141.6 EUR

¹⁸ Based on the Annex to Commission Delegated Regulation (EU) 2017/389.

¹⁹ Subject to further calibration following the stakeholders’ input during the public consultation

²⁰ Business day as defined in point 14 of Article 2(1) of CSDR.

²¹ Intended settlement date as defined in point 12 of Article 2(1) of CSDR.

Type of fail	Current rate ¹⁸	Proposed rates ¹⁹	Example
2. Settlement fail due to a lack of shares that do not have a liquid market within the meaning of point (b) of Article 2(1)(17) of Regulation (EU) No 600/2014, excluding shares referred to in point 3	0,5 basis point	3 basis point – 1 st BD of fail 4 basis points – 2 nd BD of fail 5 basis points – 3 rd BD of fail 7.5 basis points – 4 th BD of fail 10 basis points - 5 th BD of fail 12.5 basis points – starting with 6 th BD of fail	Delivery of 1,000 illiquid shares, failing due to “lack of securities” for 2 BD after the ISD ²² , penalty reference price per share for BD 1 = 100.00 EUR/ for BD 2 = 102.00 EUR. Formula: Security Penalty Rate*Reference Price*Quantity Fail penalty for BD 1: 3 basis points * 100 *1,000 = 0.03% * 100,000 EUR = 30 EUR Fail penalty for BD 2: 4 basis points * 102 *1,000 = 0.04% * 102,000 EUR = 40.8 EUR Total penalties for 2 BD of fail: 30 EUR + 40.8 EUR = 70.8 EUR

²² Intended settlement date as defined in point 12 of Article 2(1) of CSDR.

Type of fail	Current rate ¹⁸	Proposed rates ¹⁹	Example
3. Settlement fail due to a lack of financial instruments traded on SME growth markets, excluding debt instruments referred to in point 6	0,25 basis point	1.5 basis point – 1 st BD of fail 2 basis points – 2 nd BD of fail 2.5 basis points – 3 rd BD of fail 3.75 basis points – 4 th BD of fail 5 basis points - 5 th BD of fail 6.25 basis points – starting with 6 th BD of fail	Delivery of 1,000 illiquid shares traded on a SME growth market, failing due to “lack of securities” for 2 BD after the ISD , penalty reference price per share for BD 1 = 100.00 EUR/ for BD 2 = 102.00 EUR. Formula: Security Penalty Rate*Reference Price*Quantity Fail penalty for BD 1: 1.5 basis points * 100 *1,000 = 0.015% * 100,000 EUR = 15 EUR Fail penalty for BD 2: 2 basis points * 102 *1,000 = 0.02% * 102,000 EUR = 20.4 EUR Total penalties for 2 BD of fail: 15 EUR + 20.4 EUR = 35.4 EUR
3a. Settlement fail due to a lack of Exchanged-Traded Funds (ETFs) as defined in Article 4 (1) (46)	n/a	2.5 basis point – 1 st BD of fail 3.5 basis points – 2 nd BD of fail	Delivery of 1,000 ETFs, failing due to “lack of securities” for 2 BD after the ISD, penalty reference price per ETF for BD 1 = 100.00 EUR/ for BD 2 = 102.00 EUR.

Type of fail	Current rate ¹⁸	Proposed rates ¹⁹	Example
		5 basis points – 3 rd BD of fail 7.5 basis points – 4 th BD of fail 10 basis points - 5 th BD of fail 12.5 basis points – starting with 6 th BD of fail	Formula: Security Penalty Rate*Reference Price*Quantity Fail penalty for BD 1: 2.5 basis points * 100 *1,000 = 0.025% * 100,000 EUR = 25 EUR Fail penalty for BD 2: 3.5 basis points * 102 *1,000 = 0.035% * 102,000 EUR = 35.7 EUR Total penalties for 2 BD of fail: 25 EUR + 35.7 EUR = 60.7 EUR
4. Settlement fail due to a lack of debt instruments issued or guaranteed by: (a) a sovereign issuer as defined in Article 4(1)(60) of Directive 2014/65/EU; (b) a third country sovereign issuer; (c) a local government authority; (d) a central bank; (e) any multilateral development bank referred to in the second subparagraph of	0.10 basis point	0.6 basis point – 1 st BD of fail 0.8 basis points – 2 nd BD of fail 1 basis points – 3 rd BD of fail 1.5 basis points – 4 th BD of fail	Delivery of 1,000 sovereign bonds, failing due to “lack of securities” for 2 BD after the ISD , penalty reference price per bond for BD 1 = 100.00 EUR/ for BD 2 = 102.00 EUR. Formula: Security Penalty Rate*Reference Price*Quantity Fail penalty for BD 1: 0.6 basis points * 100 *1,000 = 0.006% * 100,000 EUR = 6 EUR

Type of fail	Current rate ¹⁸	Proposed rates ¹⁹	Example
Article 117(1) and in Article 117(2) of Regulation (EU) No 575/2013 of the European Parliament and of the Council; (f) the European Financial Stability Facility or the European Stability Mechanism.		2 basis points - 5 th BD of fail 2.5 basis points – starting with 6 th BD of fail	Fail penalty for BD 2: $0.8 \text{ basis points} * 102 * 1,000 = 0.008\% * 102,000 \text{ EUR} = 8.16 \text{ EUR}$ Total penalties for 2 BD of fail: $6 \text{ EUR} + 8.16 \text{ EUR} = 14.16 \text{ EUR}$
5. Settlement fail due to a lack of debt instruments other than those referred to in points 4 and 6	0,20 basis point	1.2 basis point – 1 st BD of fail 1.6 basis points – 2 nd BD of fail 2 basis points – 3 rd BD of fail 3 basis points – 4 th BD of fail 4 basis points - 5 th BD of fail	Delivery of 1,000 bonds, failing due to “lack of securities” for 2 BD after the ISD , penalty reference price per bond for BD 1 = 100.00 EUR/ for BD 2 = 102.00 EUR. Formula: Security Penalty Rate*Reference Price*Quantity Fail penalty for BD 1: $1.2 \text{ basis points} * 100 * 1,000 = 0.012\% * 100,000 \text{ EUR} = 12 \text{ EUR}$ Fail penalty for BD 2: $1.6 \text{ basis points} * 102 * 1,000 = 0.016\% * 102,000 \text{ EUR} = 16.32 \text{ EUR}$

Type of fail	Current rate ¹⁸	Proposed rates ¹⁹	Example
		5 basis points – starting with 6 th BD of fail	Total penalties for 2 BD of fail: 12 EUR + 16.32 EUR = 28.32 EUR
6. Settlement fail due to a lack of debt instruments traded on SME growth markets	0,15 basis point	0.9 basis point – 1 st BD of fail 1.2 basis points – 2 nd BD of fail 1.5 basis points – 3 rd BD of fail 2.25 basis points – 4 th BD of fail 3 basis points - 5 th BD of fail 3.75 basis points – starting with 6 th BD of fail	Delivery of 1,000 bonds traded on a SME growth market, failing due to “lack of securities” for 2 BD after the ISD , penalty reference price per bond for BD 1 = 100.00 EUR/ for BD 2 = 102.00 EUR. Formula: Security Penalty Rate*Reference Price*Quantity Fail penalty for BD 1: 0.9 basis points * 100 *1,000 = 0.009% * 100,000 EUR = 9 EUR Fail penalty for BD 2: 1.2 basis points * 102 *1,000 = 0.012% * 102,000 EUR = 12.24 EUR Total penalties for 2 BD of fail: 9 EUR + 12.24 EUR = 21.24 EUR

Type of fail	Current rate ¹⁸	Proposed rates ¹⁹	Example
7. Settlement fail due to a lack of all other financial instruments not covered in points 1 to 6	0,5 basis point	3 basis point – 1 st BD of fail 4 basis points – 2 nd BD of fail 5 basis points – 3 rd BD of fail 7.5 basis points – 4 th BD of fail 10 basis points - 5 th BD of fail 12.5 basis points – starting with 6 th BD of fail	Delivery of 1,000 other financial instruments, failing due to “lack of securities” for 2 BD after the ISD , penalty reference price per other financial instrument for BD 1 = 100.00 EUR/ for BD 2 = 102.00 EUR. Formula: Security Penalty Rate*Reference Price*Quantity Fail penalty for BD 1: 3 basis points * 100 *1,000 = 0.03% * 100,000 EUR = 30 EUR Fail penalty for BD 2: 4 basis points * 102 *1,000 = 0.04% * 102,000 EUR = 40.8 EUR Total penalties for 2 BD of fail: 30 EUR + 40.8 EUR = 70.8 EUR
8. Settlement fail due to a lack of cash	Official interest rate for overnight credit	10 basis points - 1 st BD of fail 15 basis points – 2 nd BD of fail	Delivery of 1,000 (liquid or illiquid) shares, failing due to “lack of cash” for 2 BD after the ISD, penalty reference price per share for BD 1 = 100.00 EUR/ for BD 2 = 102.00 EUR.

Type of fail	Current rate ¹⁸	Proposed rates ¹⁹	Example
	charged by the central bank issuing the settlement currency with a floor of 0	20 basis points – 3 rd BD of fail 25 basis points – 4 th BD of fail 30 basis points – starting with 5 th BD of fail (These penalty rates are applied irrespective of the currency)	Fail penalty for BD 1: 10 basis points * 100 *1,000 = 0.1% * 100,000 EUR = 100 EUR Fail penalty for BD 2: 15 basis points * 102 *1,000 = 0.15% * 102,000 EUR = 153 EUR Total penalties for 2 BD of fail: 100 EUR + 153 EUR = 253 EUR

Example 1

Type of fail	Day of fail	Proposed rates (Bps)	Daily penalty amounts for a €1,000,000 transaction	Equivalent yearly funding rate (day) ²³	Cumulated penalty amounts per protracted fail	Equivalent yearly funding rate (average daily rates) ²⁴
1. Settlement fail due to a lack of liquid shares	Day 1	6	600	21.9%	600	21.9%
	Day 2	8	800	29.2%	1400	25.6%
	Day 3	10	1000	36.5%	2400	29.2%
	Day 4	15	1500	54.8%	3900	35.6%
	Day 5	20	2000	73%	5900	43.1%
	Day 6 and beyond	25	2500	91.3%	8400	51.1%
	Day 1	3	300	11.0%	300	11.0%

²³ Proposed daily rate (percent) x 365 days

²⁴ Cumulative proposed daily rate (percent) x 365 days / number of days of fail

2.Settlement fail due to a lack of illiquid shares	Day 2	4	400	14.6%	700	12.8%
	Day 3	5	500	18.3%	1200	14.6%
	Day 4	7.5	750	27.4%	1950	18%
	Day 5	10	1000	36.5%	2950	21.5%
	Day 6 and beyond	12.5	1250	45.6%	4200	25.6%
3.Settlement fail due to shares traded on a SME growth market	Day 1	1.5	150	5.5%	150	5.5%
	Day 2	2	200	7.3%	350	6.4%
	Day 3	2.5	250	9.1%	600	7.3%
	Day 4	3.75	375	13.7%	975	8.9%
	Day 5	5	500	18.3%	1475	10.8%
	Day 6 and beyond	6.25	625	22.8%	2100	12.8%
	Day 1	2.5	250	9.1%	250	9.1%

3a.Settlement fail due to a lack of ETFs	Day 2	3.5	350	12.8%	600	11.0%
	Day 3	5	500	18.3%	1100	13.4%
	Day 4	7.5	750	27.4%	1850	16.9%
	Day 5	10	1000	36.5%	2850	20.8%
	Day 6 and beyond	12.5	1250	45.6%	4100	24.9%
4.Settlement fail due to sovereign bonds	Day 1	0.6	60	2.2%	60	2.2%
	Day 2	0.8	80	2.9%	140	2.6%
	Day 3	1	100	3.7%	240	2.9%
	Day 4	1.5	150	5.5%	390	3.6%
	Day 5	2	200	7.3%	590	4.3%
	Day 6 and beyond	2.5	250	9.1%	840	5.1%
	Day 1	1.2	120	4.4%	120	4.4%

5.Settlement fail due to a lack of bonds other than sovereign bonds and not traded on a SME growth market	Day 2	1.6	160	5.9%	280	5.1%
	Day 3	2	200	7.3%	480	5.8%
	Day 4	3	300	11.0%	780	7.1%
	Day 5	4	400	14.6%	1180	8.6%
	Day 6 and beyond	5	500	18.3%	1680	10.2%
6.Settlement fail due to bonds traded on a SME growth market	Day 1	0.9	90	3.3%	90	3.3%
	Day 2	1.2	120	4.4%	210	3.8%
	Day 3	1.5	150	5.5%	360	4.4%
	Day 4	2.25	225	8.2%	585	5.3%
	Day 5	3	300	11.0%	885	6.5%
	Day 6 and beyond	3.75	375	13.7%	1260	7.7%
	Day 1	3	300	11.0%	300	11.0%

7.Settlement fail due to a lack of other financial instruments	Day 2	4	400	14.6%	700	12.8%
	Day 3	5	500	18.3%	1200	14.6%
	Day 4	7.5	750	27.4%	1950	17.8%
	Day 5	10	1000	36.5%	2950	21.5%
	Day 6 and beyond	12.5	1250	45.6%	4200	25.6%
8.Settlement fail due to a lack of cash	Day 1	10	1,000	36.5%	1,000	36.5%
	Day 2	15	1,500	54.8%	2,500	45.7%
	Day 3	20	2,000	73%	4,500	54.8%
	Day 4	25	2,500	91.3%	7,000	63.9%
	Day 5 and beyond	30	3,000	109.5%	10,000	73%

Option 2: progressive penalty rates with streamlined asset types and convexity

The existing 7 types of fails due to a lack of securities are streamlined into two types of fails depending on the liquidity status of each type of financial instrument. New progressive rates are introduced, with convexity.

Type of fail	Current rate ²⁵	Proposed types of fail (New categories)	Proposed rates ²⁶	Example
1. Settlement fail due to a lack of shares that have a liquid market within the meaning of point (b) of Article 2(1)(17) of Regulation (EU) No 600/2014, excluding shares referred to in point 3	1,0 basis point	New category (merging former points 1, 3 and 4): 1. Settlement fail due to a lack of liquid financial instruments a) shares that have a liquid market within the meaning of point (b) of	2.5 basis points – 1 st BD ²⁷ of fail 3.5 basis points - 2 nd BD of fail 5 basis points – 3 rd BD of fail	Delivery of 1,000 liquid shares, failing due to “lack of securities” for 2 BD after the ISD ²⁸ , penalty reference price per share for BD 1 = 100.00 EUR/ for BD 2 = 102.00 EUR.

²⁵ Based on the Annex to Commission Delegated Regulation (EU) 2017/389.

²⁶ Subject to further calibration following the stakeholders’ input during the public consultation

²⁷ Business day as defined in point 14 of Article 2(1) of CSDR.

²⁸ Intended settlement date as defined in point 12 of Article 2(1) of CSDR.

	<p>Article 2(1)(17) of Regulation (EU) No 600/2014;</p> <p>b) bonds for which there is a liquid market in accordance with the methodology specified in Article 13(1), point (b) of Commission Delegated Regulation (EU) 2017/583 (RTS 2);</p> <p>c) debt instruments issued or guaranteed by:</p> <p>i) a sovereign issuer as defined in Article 4(1)(60) of Directive 2014/65/EU;</p> <p>ii) a third country sovereign issuer;</p> <p>iii) a local government authority;</p> <p>iv) a central bank;</p> <p>v) any multilateral development bank referred to in the second subparagraph of Article 117(1) and in Article 117(2) of Regulation (EU)</p>	<p>7.5 basis points – 4th BD of fail</p> <p>10 basis points – 5th BD of fail</p> <p>5 basis points – starting with 6th BD of fail</p>	<p>Formula: Security Penalty Rate*Reference Price*Quantity</p> <p>Fail penalty for BD 1:</p> <p>2.5 basis points * 100 *1,000 = 0.025% * 100,000 EUR</p> <p>= 25 EUR</p> <p>Fail penalty for BD 2:</p> <p>3.5 basis points * 102 *1,000 = 0.035% * 102,000 EUR</p> <p>= 35,7 EUR</p> <p>Total penalties for 2 BD of fail: 25 EUR + 35.7 EUR = 60.7 EUR</p>
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		No 575/2013 of the European Parliament and of the Council; vi) the European Financial Stability Facility or the European Stability Mechanism.		
2. Settlement fail due to a lack of shares that do not have a liquid market within the meaning of point (b) of Article 2(1)(17) of Regulation (EU) No 600/2014, excluding shares referred to in point 3	0,5 basis point	<i>New category (merging former points 2, 5, 6 and 7):</i> 2. Settlement fail due to a lack of illiquid financial instruments, i.e. those financial instruments not referred to in point 1 above	1 basis point – 1 st BD of fail 3 basis points – 2 nd BD of fail 5 basis points – 3 rd BD of fail 7 basis points – 4 th BD of fail 10 basis points - 5 th BD of fail	Delivery of 1,000 illiquid shares, failing due to “lack of securities” for 2 BD after the ISD ²⁹ penalty reference price per share for BD 1 = 100.00 EUR/ for BD 2 = 102.00 EUR. Formula: Security Penalty Rate*Reference Price*Quantity Fail penalty for BD 1: 2 basis points * 100 *1,000

²⁹ Intended settlement date as defined in point 12 of Article 2(1) of CSDR.

			<p>20 basis points – starting with 6th BD of fail</p> <p>= 0.02% * 100,000 EUR = 20 EUR</p> <p>Fail penalty for BD 2: 10 basis points * 102 * 1,000 = 0.03% * 102,000 EUR = 30.6 EUR</p> <p>Total penalties for 2 BD of fail: 20 EUR + 30.6 EUR = 50.6 EUR</p>
<p>3. Settlement fail due to a lack of financial instruments traded on SME growth markets, excluding debt instruments referred to in point 6</p>	<p>0,25 basis point</p>	<p><i>Covered under point 1 above</i></p>	

<p>4. Settlement fail due to a lack of debt instruments issued or guaranteed by:</p> <p>(a) a sovereign issuer as defined in Article 4(1)(60) of Directive 2014/65/EU;</p> <p>(b) a third country sovereign issuer;</p> <p>(c) a local government authority;</p> <p>(d) a central bank;</p> <p>(e) any multilateral development bank referred to in the second subparagraph of Article 117(1) and in Article 117(2) of Regulation (EU) No 575/2013 of the European Parliament and of the Council;</p> <p>(f) the European Financial Stability Facility or the European Stability Mechanism.</p>	<p>0,10 basis point</p>	<p><i>Covered under point 1 above</i></p>		
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5. Settlement fail due to a lack of debt instruments other than those referred to in points 4 and 6	0,20 basis point	<i>Covered under point 2 above</i>		
6. Settlement fail due to a lack of debt instruments traded on SME growth markets	0,15 basis point	<i>Covered under point 2 above</i>		
7. Settlement fail due to a lack of all other financial instruments not covered in points 1 to 6	0,5 basis point	<i>Covered under point 2 above</i>		
8. Settlement fail due to a lack of cash	Official interest rate for overnight credit charged by the central bank issuing the	3. Settlement fail due to a lack of cash	10 basis points - 1 st BD of fail 15 basis points – 2 nd BD of fail 20 basis points – 3 rd BD of fail 25 basis points – 4 th BD of fail	Delivery of 1,000 (liquid or illiquid) shares, failing due to “lack of cash” for 2 BD after the ISD, penalty reference price per share for BD 1 = 100.00 EUR/ for BD 2 = 102.00 EUR. Fail penalty for BD 1:

	<p>settlement currency with a floor of 0</p>		<p>30 basis points – starting with 5th BD of fail (These penalty rates are applied irrespective of the currency)</p>	<p>10 basis points * 100 *1,000 = 0.1% * 100,000 EUR = 100 EUR Fail penalty for BD 2: 15 basis points * 102 *1,000 = 0.15% * 102,000 EUR = 153 EUR Total penalties for 2 BD of fail: 100 EUR + 153 EUR = 253 EUR</p>
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Example 2

Type of fail	Day of fail	Proposed daily rate (Bps)	Daily penalty amounts for a €1,000,000 transaction	Equivalent yearly funding rate (day) ³⁰	Cumulated penalty amounts per protracted fail	Equivalent yearly funding rate (average daily rates) ³¹
1.Settlement fail due to a lack of liquid financial instruments	Day 1	2.5	250	9.1%	250	9.1%
	Day 2	3.5	350	12.8%	600	11.0%
	Day 3	5	500	18.3%	1100	13.4%
	Day 4	7.5	750	27.4%	1850	16.9%
	Day 5	10	1000	36.5%	2850	20.8%
	Day 6 and beyond	5	500	18.3%	3350	20.4%
2.Settlement fail due to a lack of illiquid financial instruments,	Day 1	1	100	3.7%	100	3.7%
	Day 2	3	300	11%	400	7.3%

³⁰ Proposed daily rate (percent) x 365 days

³¹ Cumulative proposed daily rate (percent) x 365 days / number of days of fail

Type of fail	Day of fail	Proposed daily rate (Bps)	Daily penalty amounts for a €1,000,000 transaction	Equivalent yearly funding rate (day) ³⁰	Cumulated penalty amounts per protracted fail	Equivalent yearly funding rate (average daily rates) ³¹
<i>i.e. those financial instruments not referred to in point 1 above</i>	Day 3	5	300	18.3%	700	11%
	Day 4	7	700	25.6%	1,400	14.7%
	Day 5	10	1,000	36.5%	2,400	19%
	Day 6 and beyond	20	2,000	73%	4,400	28%
3.Settlement fail due to a lack of cash	Day 1	10	1,000	36.5%	1,000	36.5%
	Day 2	15	1,500	54.8%	2,500	45.7%
	Day 3	20	2,000	73%	4,500	54.8%
	Day 4	25	2,500	91.3%	7,000	63.9%
	Day 5 and beyond	30	3,000	109.5%	10,000	73%

Comparative table 1

Below are comparative tables to help assess the implications of the current penalty levels compared to the proposed Option 2. The amounts represent total penalties in the currency of the transaction for a value of 1 million of the failed transaction.

Day	Type 1	Type3	Type 4	New type 1
1	100	25	10	250
2	200	50	20	600
3	300	75	30	1100
4	400	100	40	1850
5	500	125	50	2850
6	600	150	60	3350
7	700	175	70	3850
8	800	200	80	4350
9	900	225	90	4850
10	1,000	250	100	5350
11	1,100	275	110	5850
12	1,200	300	120	6350
13	1,300	325	130	6850
14	1,400	350	140	7350
15	1,500	375	150	7850

Day	Type 2	Type 5	Type 6	Type 7	New type 2
1	50	20	15	50	100
2	100	40	30	100	400
3	150	60	45	150	700
4	200	80	60	200	1,400
5	250	100	75	250	2,400
6	300	120	90	300	4,400
7	350	140	105	350	6,400
8	400	160	120	400	8,400
9	450	180	135	450	10,400
10	500	200	150	500	12,400
11	550	220	165	550	14,400
12	600	240	180	600	16,400
13	650	260	195	650	18,400
14	700	280	210	700	20,400
15	750	300	225	750	22,400

Impact of current penalty mechanism

Q15: Based on your experience, what has been the impact of CSDR cash penalties on reducing settlement fails (by type of asset as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389 since the application of the regime in February 2022? Please provide data and arguments to justify your answer.

Q16: In your view, is the current CSDR penalty mechanism deterrent and proportionate? Does it effectively discourage settlement fails and incentivise their rapid resolution? Please provide data and arguments to justify your answer.

Q17: What are the main reasons for settlement fails, going beyond the high level categories: “fail to deliver securities”, “fail to deliver cash” or “settlement instructions on hold”? Please provide examples and data, as well as arguments to justify your answer.

Q18: What tools should be used in order to improve settlement efficiency? Please provide examples and data, as well as arguments to justify your answer.

Q19: What are your views on the appropriate level(s) of settlement efficiency at CSD/SSS level, as well as by asset type? Please provide data and arguments to justify your answer.

Q20: Do you think the penalty rates by asset type as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389 are proportionate? Please provide data and arguments to justify your answer.

Q21: Regarding the proportionality of the penalty rates by asset type as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389, ESMA does not have data on the breakdown of cash penalties (by number and value) applied by CSDs by asset type. Therefore, ESMA would like to use this CP to ask for data from all EEA CSDs on this breakdown, including on the duration of settlement fails by asset type.

Progressive penalty rates

Q22: In your view, would progressive penalty rates that increase with the length of the settlement fail be justified? Please provide examples and data, as well as arguments to justify your answer.

Q23: What are your views regarding the introduction of convexity in penalty rates as per the ESMA proposed Option 2 (settlement fails caused by a lack of liquid financial

instruments)? Please justify your answer by providing quantitative examples and data if possible.

Q24: Would it be appropriate to apply the convexity criterion to settlement fails due to a lack of illiquid financial instruments as well? Please justify your answer by providing quantitative examples and data if possible.

Q25: What are your views regarding the level of progressive penalty rates:

a) as proposed under Option 1?

b) as proposed under Option 2?

Q26: If you disagree with ESMA's proposal regarding the penalty rates, please specify which rates you believe would be more appropriate (i.e. deterrent and proportionate, with the potential to effectively discourage settlement fails, incentivise their rapid resolution and improve settlement efficiency). Please provide examples and data, as well as arguments to justify your answer. If relevant, please provide an indication of further proportionality considerations, detailed justifications and alternative proposals as needed.

Q27: What are your views regarding the categorisation of types of fails:

a) as proposed under Option 1?

b) as proposed under Option 2?

Do you believe that less/further granularity is needed in terms of the types of fails (asset classes) subject to cash penalties? Please justify your answer by providing quantitative examples and data if possible.

Q28: What costs and benefits do you envisage related to the implementation of progressive penalty rates by asset type (according to ESMA's proposed Options 1 and 2)? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Progressive penalty rates (by asset type) - ESMA's proposal Option 1	Please see ESMA's proposed Option 1 in Section 5.3 of this CP.	
	Qualitative description	Quantitative description/ Data
Benefits		

Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		
Progressive penalty rates (by asset type) - ESMA's proposal Option 2	Please see ESMA's proposed Option 2 in Section 5.3 of this CP.	
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

Q29: Alternatively, do you think that progressive cash penalties rates should take into account a different breakdown than the one included in ESMA's proposal above for any or all of the following categories:

- (a) asset type;**
- (b) liquidity of the financial instrument;**
- (c) type of transaction;**
- (d) duration of the settlement fail.**

If you have answered yes to the question above, what costs and benefits do you envisage related to the implementation of progressive penalty rates according to your proposal? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Progressive penalty rates – respondent's proposal (if applicable)		
	Qualitative description	Quantitative description/ Data

Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

Q30: Another potential approach to progressive penalty rates could be based not only on the length of the settlement fail but also on the value of the settlement fail. Settlement fails based on instructions with a lower value could be charged a higher penalty rate than those with a higher value, thus potentially creating an incentive for participants in settling smaller value instructions at their intended settlement date (ISD). Alternatively, settlement fails based on instructions with a higher value could be charged a higher penalty rate than those with a lower value. In your view, would such an approach be justified? Please provide arguments and examples in support of your answer, including data where available. What costs and benefits do you envisage related to the implementation of this approach? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Progressive penalty rates – based on the length and value of the settlement fail	Settlement fails based on lower value settlement instructions could be charged a higher penalty rate than those based on higher value settlement instructions		Settlement fails based on higher value settlement instructions could be charged a higher penalty rate than those based on lower value settlement instructions	
	Qualitative description	Quantitative description/ Data	Qualitative description	Quantitative description/ Data
Benefits				
Compliance costs: - One-off - On-going				
Costs to other				

stakeholders				
Indirect costs				

Q31: Besides the criteria already listed, i.e. type of asset, liquidity of the financial instruments, duration and value of the settlement fail, what additional criteria should be considered when setting proportionate and effective cash penalty rates? Please provide examples and justify your answer.

Additional considerations to simplify the cash penalty mechanism, while ensuring it is deterrent and proportionate

Q32: Would you be in favour of the use of the market value of the financial instruments on the first day of the settlement fail as a basis for the calculation of penalties for the entire duration of the fail? ESMA would like to ask for the stakeholders' views on the costs and benefits of such a measure. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Use the market value of the financial instruments on the first day of the settlement fail as a basis for the calculation of penalties for the entire duration of the fail		
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

Q33: How should free of payment (FoP) instructions be valued for the purpose of the application of cash penalties? Please justify your answer and provide examples and data where available.

Q34: Do you think there is a risk that higher penalty rates may lead to participants using less DvP and more FoP settlement instructions? Please justify your answer and provide examples and data where available.

Q35: ESMA is considering the feasibility of identifying another asset class subject to lower penalty rates: “bonds for which there is not a liquid market in accordance with the methodology specified in Article 13(1), point (b) of Commission Delegated Regulation (EU) 2017/583 (RTS 2)”. The information on the assessment of bonds’ liquidity is published by ESMA on a quarterly basis and further updated on FITRS. However, ESMA is also aware that this may add to the operational burden for CSDs that would need to check the liquidity of bonds before applying cash penalties. As such, ESMA would like to ask for the stakeholders’ views on the costs and benefits of such a measure. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Applying lower penalty rates for illiquid bonds		
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

Q36: Do you have other suggestions for further flexibility with regards to penalties for settlement fails imposed on illiquid financial instruments? Please justify your answer and provide examples and data where available.

Q37: How likely is it that underlying parties that end up with “net long” cash payments may not have incentives to manage their fails or bilaterally cancel failing instructions as they may “earn” cash from penalties? How could this risk be addressed? Please justify your answer and provide examples and data where available.

Q38: How could the parameters for the calculation of cash penalties take into account the effect that low or negative interest rates could have on the incentives of counterparties and on settlement fails? Please provide examples and data, as well as arguments to justify your answer.

Q39: To ensure a proportionate approach, do you think the penalty mechanism should be applied only at the level of those CSDs with higher settlement fail rates? Please provide examples and data, as well as arguments to justify your answer. If your answer is yes, please specify where the threshold should be set and if it should take into account the settlement efficiency at:

- a) CSD/SSS level (please specify the settlement efficiency target);
- b) at asset type level (please specify the settlement efficiency target); or
- c) other (please specify, including the settlement efficiency target).

Q40: Please specify what costs and benefits you envisage regarding the application of the penalty mechanism only at the level of the CSDs with higher settlement fail rates. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Application of the penalty mechanism only at the level of CSDs with lower settlement fail rates		
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

Q41: Do you think penalty rates should vary according to the transaction type? If yes, please specify the transaction types and include proposals regarding the related penalty rates. Please justify your answer and provide examples and data where available. Please specify what costs and benefits you envisage related to the implementation of your proposal. Please use the table below. Where relevant, additional

tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Applying penalty rates by transaction types		
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

Q42: Do you think that penalty rates should depend on stock borrowing fees? If yes, do you believe that the data provided by data vendors is of sufficient good quality that it can be relied upon? Please provide the average borrowing fees for the 8 categories of asset class depicted in Option 1. (i.e. liquid shares, illiquid shares, SME shares, ETFs, sovereign bonds, SME bonds, other corporate bonds, other financial instruments).

Q43: Do you have other suggestions to simplify the cash penalty mechanism, while ensuring it is deterrent and proportionate, and effectively discourages settlement fails, incentivises their rapid resolution and improves settlement efficiency? Please justify your answer and provide examples and data where available. Please specify what costs and benefits you envisage related to the implementation of your proposal. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Respondent's proposal (if applicable)		
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

Q44: Based on your experience, are settlement fails lower in other markets (i.e USA, UK)? If so, which are in your opinion the main reasons for that? Please also specify the scope and methodology used for measuring settlement efficiency in the respective third-country jurisdictions.

Q45: Do CSD participants pass on the penalties to their clients? Please provide information about the current market practices as well as data, examples and reasons, if any, which may impede the passing on of penalties to clients.

Q46: Do you consider that introducing a minimum penalty across all types of fails would improve settlement efficiency? If yes, what would be the amount of this minimum penalty and how should it apply? Please provide examples and data, as well as arguments to justify your answer.

Q47: What would be the time needed for CSDs and market participants to implement changes to the penalty mechanism (depending on the extent of the changes)? Please provide arguments to justify your answer.

Ad hoc measures for CSDs participants with high settlement fail rates

Q48: Since the application of the RTS on Settlement Discipline, how many participants have been detected as failing consistently and systematically within the meaning of Article 7(9) of CSDR? How many of them, if any, have been suspended pursuant to same Article?

Q49: In your view, would special penalties (either additional penalties or more severe penalty rates) applied to participants with high settlement fail rates be justified? Should such participants be identified using the same thresholds as in Article 39 of the RTS on Settlement Discipline, but within a shorter timeframe (e.g. 2 months instead of 12 months)? If not, what criteria/methodology should be used for defining participants with high settlement fail rates? Please provide examples and data, as well as arguments to justify your answer.

Q50: How have CSDs implemented working arrangements with participants in accordance with article 13(2) of the RTS on Settlement Discipline? How many participants have been targeted?

Q51: Should the topic of settlement efficiency be discussed at the CSDs' User Committees to better identify any market circumstances and particular context of participant(s) explaining an increase or decrease of the fail rates? Please justify your answer.

6 Annexes

6.1 Annex I – Summary of Questions

6.1.1 Alternative parameters, when the official interest rate for overnight credit charged by the central bank issuing the settlement currency is not available

Q1: Do you agree with ESMA’s proposal? Which Option is preferable in your view? Please also state the reasons for your answer.

Q2: Do you have other suggestions? If yes, please specify and provide arguments.

Q3: Do you agree with the approach followed for the Option you support to incorporate proportionality in the Technical Advice? If not, please provide an indication of further proportionality considerations, detailed justifications and alternative wording as needed.

Q4: What costs and benefits do you envisage related to the implementation of each Option? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Option		
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

6.1.2 Treatment of historical reference data for the calculation of late matching fail penalties

Q5: As a CSD, do you face the issue of accumulation of reference data related to Late Matching Fail Penalties (LMFPs), that may degrade the functioning of the securities settlement system you operate? If yes, please provide details, including data where available, in particular regarding the number and value of late matching instructions, as

well as for how many business days they go in the past from the moment they are entered into the securities settlement system, and the percentage they represent compared to the overall number and value of settlement fails on a monthly basis (please use as a reference the period June 2022 – June 2023).

Q6. What are the causes of late matching? How can you explain that there are so many late matching instructions lasting during a very long period? What measures could be envisaged in order to reduce the number of late matching instructions?

Q7: Do you agree with ESMA's proposal to establish a threshold beyond which more recent reference data shall be used for the calculation of the related cash penalties to prevent the degradation of the performance of the systems used by CSDs? Please also state the reasons for your answer.

Q8: Do you agree with the threshold of 92 business days or 40 business days in order to prevent the degradation of the performance of the systems used by CSDs? Please specify which threshold would be more relevant in your view:

a)92 business days;

b)40 business days;

c)other (please specify).

Please also state the reasons for your answer and provide data where available, in particular regarding the number and value of late matching instructions that go beyond 92 business days, 40 business days in the past or another threshold you think would be more relevant, and the percentage they represent compared to the overall number and value of settlement fails on a monthly basis (please use as a reference the period June 2022 – December 2023).

Q9: Do you agree that the issuer CSD for each financial instrument shall be responsible for confirming the relevant reference data to be used for the related penalties calculation? Please also state the reasons for your answer.

Q10: In your view, where settlement instructions have been matched after the intended settlement date, and that intended settlement date is beyond the agreed number of business days in the past, the use of more recent reference data (last available data) for the calculation of the related cash penalties should be optional or compulsory? Please also state the reasons for your answer.

Q11: Do you have other suggestions? If yes, please specify, provide drafting suggestions and provide arguments including data where available.

Q12: Do you agree with the approach followed to incorporate proportionality in the Technical Advice? If not, please provide an indication of further proportionality considerations, detailed justifications and alternative wording as needed.

Q13: What costs and benefits do you envisage related to the implementation of the approach proposed by ESMA? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Approach proposed by ESMA		
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

Q14: If applicable (if you have suggested a different approach than the one proposed by ESMA), please specify the costs and benefits you envisage related to the implementation of the respective approach. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Approach proposed by respondent (if applicable)		
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

6.1.3 Alternative methods for calculating cash penalties, including progressive penalty rates

Impact of current penalty mechanism

Q15: Based on your experience, what has been the impact of CSDR cash penalties on reducing settlement fails (by type of asset as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389 since the application of the regime in February 2022? Please provide data and arguments to justify your answer.

Q16: In your view, is the current CSDR penalty mechanism deterrent and proportionate? Does it effectively discourage settlement fails and incentivise their rapid resolution? Please provide data and arguments to justify your answer.

Q17: What are the main reasons for settlement fails, going beyond the high level categories: “fail to deliver securities”, “fail to deliver cash” or “settlement instructions on hold”? Please provide examples and data, as well as arguments to justify your answer.

Q18: What tools should be used in order to improve settlement efficiency? Please provide examples and data, as well as arguments to justify your answer.

Q19: What are your views on the appropriate level(s) of settlement efficiency at CSD/SSS level, as well as by asset type? Please provide data and arguments to justify your answer.

Q20: Do you think the penalty rates by asset type as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389 are proportionate? Please provide data and arguments to justify your answer.

Q21: Regarding the proportionality of the penalty rates by asset type as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389, ESMA does not have data on the breakdown of cash penalties (by number and value) applied by CSDs by asset type. Therefore, ESMA would like to use this CP to ask for data from all EEA CSDs on this breakdown, including on the duration of settlement fails by asset type.

Progressive penalty rates

Q22: In your view, would progressive penalty rates that increase with the length of the settlement fail be justified? Please provide examples and data, as well as arguments to justify your answer.

Q23: What are your views regarding the introduction of convexity in penalty rates as per the ESMA proposed Option 2 (settlement fails caused by a lack of liquid financial instruments)? Please justify your answer by providing quantitative examples and data if possible.

Q24: Would it be appropriate to apply the convexity criterion to settlement fails due to a lack of illiquid financial instruments as well? Please justify your answer by providing quantitative examples and data if possible.

Q25: What are your views regarding the level of progressive penalty rates:

a) as proposed under Option 1?

b) as proposed under Option 2?

Q26: If you disagree with ESMA's proposal regarding the penalty rates, please specify which rates you believe would be more appropriate (i.e. deterrent and proportionate, with the potential to effectively discourage settlement fails, incentivise their rapid resolution and improve settlement efficiency). Please provide examples and data, as well as arguments to justify your answer. If relevant, please provide an indication of further proportionality considerations, detailed justifications and alternative proposals as needed.

Q27: What are your views regarding the categorisation of types of fails:

a) as proposed under Option 1?

b) as proposed under Option 2?

Do you believe that less/further granularity is needed in terms of the types of fails (asset classes) subject to cash penalties? Please justify your answer by providing quantitative examples and data if possible.

Q28: What costs and benefits do you envisage related to the implementation of progressive penalty rates by asset type (according to ESMA's proposed Options 1 and 2)? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Progressive penalty rates (by asset type) - ESMA's proposal Option 1	Please see ESMA's proposed Option 1 in Section 5.3 of this CP.
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	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		
Progressive penalty rates (by asset type) - ESMA's proposal Option 2	Please see ESMA's proposed Option 2 in Section 5.3 of this CP.	
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

Q29: Alternatively, do you think that progressive cash penalties rates should take into account a different breakdown than the one included in ESMA's proposal above for any or all of the following categories:

- (a) asset type;**
- (b) liquidity of the financial instrument;**
- (c) type of transaction;**
- (d) duration of the settlement fail.**

If you have answered yes to the question above, what costs and benefits do you envisage related to the implementation of progressive penalty rates according to your proposal? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Progressive penalty rates – respondent's proposal <i>(if applicable)</i>		
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

Q30: Another potential approach to progressive penalty rates could be based not only on the length of the settlement fail but also on the value of the settlement fail. Settlement fails based on instructions with a lower value could be charged a higher penalty rate than those with a higher value, thus potentially creating an incentive for participants in settling smaller value instructions at their intended settlement date (ISD). Alternatively, settlement fails based on instructions with a higher value could be charged a higher penalty rate than those with a lower value. In your view, would such an approach be justified? Please provide arguments and examples in support of your answer, including data where available. What costs and benefits do you envisage related to the implementation of this approach? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Progressive penalty rates – based on the length and value of the settlement fail	Settlement fails based on lower value settlement instructions could be charged a higher penalty rate than those based on higher value settlement instructions		Settlement fails based on higher value settlement instructions could be charged a higher penalty rate than those based on lower value settlement instructions	
	Qualitative description	Quantitative description/ Data	Qualitative description	Quantitative description/ Data
Benefits				
Compliance costs:				

- One-off - On-going				
Costs to other stakeholders				
Indirect costs				

Q31: Besides the criteria already listed, i.e. type of asset, liquidity of the financial instruments, duration and value of the settlement fail, what additional criteria should be considered when setting proportionate and effective cash penalty rates? Please provide examples and justify your answer.

Additional considerations to simplify the cash penalty mechanism, while ensuring it is deterrent and proportionate

Q32: Would you be in favour of the use of the market value of the financial instruments on the first day of the settlement fail as a basis for the calculation of penalties for the entire duration of the fail? ESMA would like to ask for the stakeholders' views on the costs and benefits of such a measure. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Use the market value of the financial instruments on the first day of the settlement fail as a basis for the calculation of penalties for the entire duration of the fail		
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

Q33: How should free of payment (FoP) instructions be valued for the purpose of the application of cash penalties? Please justify your answer and provide examples and data where available.

Q34: Do you think there is a risk that higher penalty rates may lead to participants using less DvP and more FoP settlement instructions? Please justify your answer and provide examples and data where available.

Q35: ESMA is considering the feasibility of identifying another asset class subject to lower penalty rates: “bonds for which there is not a liquid market in accordance with the methodology specified in Article 13(1), point (b) of Commission Delegated Regulation (EU) 2017/583 (RTS 2)”. The information on the assessment of bonds’ liquidity is published by ESMA on a quarterly basis and further updated on FITRS. However, ESMA is also aware that this may add to the operational burden for CSDs that would need to check the liquidity of bonds before applying cash penalties. As such, ESMA would like to ask for the stakeholders’ views on the costs and benefits of such a measure. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Applying lower penalty rates for illiquid bonds	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

Q36: Do you have other suggestions for further flexibility with regards to penalties for settlement fails imposed on illiquid financial instruments? Please justify your answer and provide examples and data where available.

Q37: How likely is it that underlying parties that end up with “net long” cash payments may not have incentives to manage their fails or bilaterally cancel failing instructions

as they may “earn” cash from penalties? How could this risk be addressed? Please justify your answer and provide examples and data where available.

Q38: How could the parameters for the calculation of cash penalties take into account the effect that low or negative interest rates could have on the incentives of counterparties and on settlement fails? Please provide examples and data, as well as arguments to justify your answer.

Q39: To ensure a proportionate approach, do you think the penalty mechanism should be applied only at the level of those CSDs with higher settlement fail rates? Please provide examples and data, as well as arguments to justify your answer. If your answer is yes, please specify where the threshold should be set and if it should take into account the settlement efficiency at:

- a) CSD/SSS level (please specify the settlement efficiency target);
- b) at asset type level (please specify the settlement efficiency target); or
- c) other (please specify, including the settlement efficiency target).

Q40: Please specify what costs and benefits you envisage regarding the application of the penalty mechanism only at the level of the CSDs with higher settlement fail rates. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Application of the penalty mechanism only at the level of CSDs with lower settlement fail rates		
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

Q41: Do you think penalty rates should vary according to the transaction type? If yes, please specify the transaction types and include proposals regarding the related

penalty rates. Please justify your answer and provide examples and data where available. Please specify what costs and benefits you envisage related to the implementation of your proposal. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Applying penalty rates by transaction types		
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		
Costs to other stakeholders		
Indirect costs		

Q42: Do you think that penalty rates should depend on stock borrowing fees? If yes, do you believe that the data provided by data vendors is of sufficient good quality that it can be relied upon? Please provide the average borrowing fees for the 8 categories of financial instruments depicted in Option 1 (i.e. liquid shares, illiquid shares, SME shares, ETFs, sovereign bonds, SME bonds, other corporate bonds, other financial instruments).

Q43: Do you have other suggestions to simplify the cash penalty mechanism, while ensuring it is deterrent and proportionate, and effectively discourages settlement fails, incentivises their rapid resolution and improves settlement efficiency? Please justify your answer and provide examples and data where available. Please specify what costs and benefits you envisage related to the implementation of your proposal. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Respondent's proposal (if applicable)		
	Qualitative description	Quantitative description/ Data
Benefits		
Compliance costs: - One-off - On-going		

Costs to other stakeholders		
Indirect costs		

Q44: Based on your experience, are settlement fails lower in other markets (i.e USA, UK)? If so, which are in your opinion the main reasons for that? Please also specify the scope and methodology used for measuring settlement efficiency in the respective third-country jurisdictions.

Q45: Do CSD participants pass on the penalties to their clients? Please provide information about the current market practices as well as data, examples and reasons, if any, which may impede the passing on of penalties to clients.

Q46: Do you consider that introducing a minimum penalty across all types of fails would improve settlement efficiency? Is yes, what would be the amount of this minimum penalty and how should it apply? Please provide examples and data, as well as arguments to justify your answer.

Q47: What would be the time needed for CSDs and market participants to implement changes to the penalty mechanism (depending on the extent of the changes)? Please provide arguments to justify your answer.

Ad hoc measures for CSDs participants with high settlement fail rates

Q48: Since the application of the RTS on Settlement Discipline, how many participants have been detected as failing consistently and systematically within the meaning of Article 7(9) of CSDR? How many of them, if any, have been suspended pursuant to same Article?

Q49: In your view, would special penalties (either additional penalties or more severe penalty rates) applied to participants with high settlement fail rates be justified? Should such participants be identified using the same thresholds as in Article 39 of the RTS on Settlement Discipline, but within a shorter timeframe (e.g. 2 months instead of 12 months)? If not, what criteria/methodology should be used for defining participants with high settlement fail rates? Please provide examples and data, as well as arguments to justify your answer.

Q50: How have CSDs implemented working arrangements with participants in accordance with article 13(2) of the RTS on Settlement Discipline? How many participants have been targeted?

Q51: Should the topic of settlement efficiency be discussed at the CSDs' User Committees to better identify any market circumstances and particular context of participant(s) explaining an increase or decrease of the fail rates? Please justify your answer.

6.2 Annex II – EC Mandate regarding Technical Advice on the parameters for the calculation of cash penalties for settlement fails caused by a lack of cash

REQUEST TO THE EUROPEAN SECURITIES AND MARKETS AUTHORITY (ESMA) FOR TECHNICAL ADVICE ON A POSSIBLE AMENDMENT TO THE DELEGATED ACT SPECIFYING THE PARAMETERS FOR THE CALCULATION OF CASH PENALTIES FOR SETTLEMENT FAILS CAUSED BY A LACK OF CASH (Ref: Ares(2022)8651438 – 13/12/2022)

Commission Delegated Regulation (EU) 2017/389

With this mandate the European Commission seeks ESMA's technical advice on a possible amendment to the delegated act³² specifying the parameters for the calculation of cash penalties under the Central Securities Depositories Regulation (CSDR)³³. This amendment to the delegated act should be adopted in accordance with Article 290 of the Treaty on the Functioning of the European Union (TFEU).

The Commission reserves the right to revise and/or supplement this mandate. The technical advice received on the basis of this mandate should not prejudice the Commission's final decision.

The mandate follows the CSDR, the Communication from the Commission to the European Parliament and the Council – Implementation of Article 290 of the Treaty on the Functioning of the European Union (the "290 Communication")³⁴, and the Framework Agreement on Relations between the European Parliament and the European Commission (the "Framework Agreement")³⁵.

According to Article 7(14) CSDR, the Commission is empowered to adopt delegated acts in accordance with Article 67 CSDR to specify parameters for the calculation of a deterrent and proportionate level of cash penalties based on asset type and liquidity of the financial instrument and type of transaction that shall ensure a high degree of settlement discipline and the smooth and orderly functioning of the financial markets concerned.

The European Parliament and the Council shall be duly informed about this mandate.

³² 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.

³³ 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.

³⁴ Communication of 9.12.2009. COM (2009) 673 final.

³⁵ OJ L 304, 20.11.2010, p. 47.

In accordance with the Declaration 39 on Article 290 TFEU, annexed to the Final Act of the Intergovernmental Conference which adopted the Treaty of Lisbon, signed on 13 December 2007, and in accordance with the established practice within the European Securities Committee³⁶, the Commission will continue, as appropriate, to consult experts appointed by the Member States in the preparation of possible delegated acts in the financial services area.

In accordance with point 15 of the Framework Agreement, the Commission will provide full information and documentation on its meetings with experts appointed by the Member States within the framework of its work on the preparation and implementation of Union legislation, including soft law and delegated acts. Upon request by the Parliament, the Commission may also invite Parliament's experts to attend those meetings.

The powers of the Commission to adopt delegated acts are subject to Article 67 of CSDR. As soon as the Commission adopts a possible delegated act, the Commission will notify it simultaneously to the European Parliament and the Council.

1. Context

1.1 Scope

The Central Securities Depositories Regulation (CSDR) includes a set of measures to prevent and address failures in the settlement of securities transactions (settlement fails), commonly referred to as settlement discipline measures. They consist of reporting requirements, cash penalties for Central Securities Depositories' (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.

The objective of the cash penalties is to act as a deterrent for participants that cause settlement fails, by charging the failing party a daily penalty for each business day that a transaction fails to settle after the intended settlement date. Commission Delegated Regulation (EU) 2017/389 defines the parameters and methodology for the calculation of the level of cash penalties that CSDs will impose on and collect from the failing participants in their securities settlement systems. Specifically, Article 2 states that "...the level of cash penalties referred to in the third subparagraph of Article 7(2) of Regulation (EU) No 909/2014 for settlement fails of transactions in a given financial instrument shall be calculated by applying the relevant penalty rate set out in the Annex to this Regulation to the reference price of the transaction determined in accordance with Article 3 of this Regulation...". Accordingly, the Annex to the Delegated Regulation specifies penalty rates applicable to settlement fails. In the case of settlement fails due to a lack of cash (point 8 of the Annex) the applicable rate should be the official interest

³⁶ Commission's Decision of 6.6.2001 establishing the European Securities Committee, OJ L 191, 17.7.2001, p. 45.

rate for overnight credit charged by the central bank issuing the settlement with a floor of 0 (“zero”).

In order to discourage settlement fails due to a lack of cash, it is appropriate to use the costs of borrowing cash as a basis for the penalty rate. The most appropriate penalty rate should be the official interest rate of the central bank issuing the settlement currency that should evidence the borrowing costs for that currency. For instance, in the case of Euro-settled transactions this would be the rate on the marginal lending facility, which is the interest rate banks pay when they borrow money overnight from the European Central Bank (ECB).

CSDR or the relevant Delegated Regulation do not provide a common definition of the overnight credit rate to be applied by CSDs or an alternative proxy interest rate for calculating the cost of borrowing in case a central bank overnight lending facility does not exist for the settlement currency. This makes it difficult to apply a penalty to a settlement fail caused by a lack of cash in the concerned currency as required under point 8 of the Annex to the Delegated Regulation (EU) 2017/389. Alternative calculation methodologies or rates have been proposed, as evidenced by the CSDR Penalties Framework³⁷ of the European Central Securities Depositories Association (ECSDA). Nevertheless, no common calculation method or agreement on the variables used to calculate the alternative rate has been developed. Currently different settlement currencies use different domestic rates or a combination of a domestic benchmark rate and spread of key ECB interest rates³⁸. This leads to a situation where different calculation methodologies can lead to varying degrees of severity of the cash penalties regime applied to settlement fails caused by a lack of cash, entrenching fragmentation of the European capital market by making settlement fails relatively less costly in some markets.

In light of the above, the Commission kindly asks ESMA to suggest a possible amendment to Commission Delegated Regulation (EU) 2017/389. Such amendment could take the form of:

- A comprehensive definition of an official interest rate for overnight credit charged by the central bank issuing the settlement currency as used in the Annex of the Delegated Regulation,
- A methodology for calculating an appropriate cost of capital rate to be applied to cash penalties calculations in the absence of a short-term interest rate charged by central banks when extending short-term loans to commercial banks,

³⁷ ECSDA CSDR Penalties Framework, update October 2021, p.42-43. Please see: https://ecsda.eu/wp-content/uploads/2021/10/2021_10_05_ECSDA_CSDR_Penalties_Framework.pdf

³⁸ Even when an ECB spread is applied it is calculated differently, as evidenced by the proposals from DK (which uses the spread between the marginal lending facility and the ECB rate on deposit facility) or BG (spread between the marginal lending facility rate and interest rate on main refinancing operations).

- Indicate alternative interest rates to be applied to failing transactions in currencies where the relevant central bank does not offer an overnight credit facility.

1.2 Principles that ESMA should take into account

On the working approach, ESMA is invited to take account of the following principles:

- The principle of proportionality: the technical advice should not go beyond what is necessary to achieve the objective of the Regulation. It should be simple and avoid excessive financial, administrative or procedural burdens for counterparties and financial infrastructure providers, in particular CSDs.
- When preparing its advice, ESMA should seek coherence within the regulatory framework of the Union.
- In accordance with the Regulation of the European Parliament and the Council establishing a European Securities and Markets Authority (the "ESMA Regulation")³⁹, ESMA should not feel confined in its reflection to elements that it considers should be addressed by the amendment to the delegated act but, if it finds it appropriate, it may indicate guidelines and recommendations which, in its view, could be appropriate to accompany the delegated act to better ensure its effectiveness.
- ESMA will determine its own working methods depending on the content of the provisions being dealt with. Nevertheless, horizontal questions should be dealt with in such a way as to ensure coherence between different standards of work being carried out by the various expert groups.
- In accordance with the ESMA Regulation, ESMA should, where relevant, involve the European Banking Authority and the European System of Central Banks in order to ensure cross-sectoral consistency. It should also cooperate, where relevant, with the European Systemic Risk Board on any issues related to systemic risk.
- In accordance with the ESMA Regulation, ESMA is invited to widely consult market participants in an open and transparent manner, and take into account the resulting opinions in its advice. ESMA should provide a detailed feedback statement on the consultation, specifying when consultations took place, how many responses were received and from whom, as well as the main arguments for and against the issues raised. This feedback statement should be annexed to its technical advice. The technical advice should justify ESMA's choices vis-à-vis the main arguments raised during the consultation.

³⁹ 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), OJ L 331, 15.12.2010, p. 84.

- ESMA is invited to justify its advice by providing a quantitative and qualitative cost-benefit analysis of all the options considered and proposed. ESMA should provide the Commission with a description of the problem, the objectives of the technical advice, possible options for consideration and a comparison of the main arguments for and against the considered options. The cost-benefit analysis should justify ESMA's choices vis-à-vis the main considered options.

- ESMA's technical advice should not take the form of a legal text. However, ESMA should provide the Commission with a clear and structured ("articulated") text, accompanied by sufficient and detailed explanations. Furthermore, the technical advice should be presented in an easily understandable language respecting current terminology in the Union.

- ESMA should provide comprehensive technical analysis on the subject matters described in section 3 below, where these are covered by the delegated powers included in:

- the relevant provision of the Regulation as amended;
- the corresponding recitals; or
- the relevant Commission's request included in this mandate.

- ESMA should address to the Commission any question to clarify the text of the Regulation or the relevant Regulatory Technical Standard it considers of relevance to the preparation of its technical advice.

2. Procedure

The Commission is requesting ESMA's technical advice in view of the preparation of an amendment of Commission Delegated Regulation (EU) 2017/389 on the calculation of penalties in particular regarding the questions referred to in section 3 of this mandate.

The mandate takes into account the CSDR (Articles 7(14) and 67), the ESMA Regulation, the Communication on the implementation of Article 290 of the Treaty on the Functioning of the European Union⁴⁰ and the Framework Agreement on relations between the European Parliament and the European Commission⁴¹.

The Commission reserves the right to revise and/or supplement this mandate. The technical advice received on the basis of this mandate will not prejudice the Commission's final decision.

⁴⁰ Communication from the Commission to the European Parliament and the Council - Implementation of Article 290 of the Treaty on the Functioning of the European Union, COM(2009) 673

⁴¹ OJ L 304, 20.11.2010, p. 47.

In accordance with established practice, the Commission may continue to consult experts appointed by the Member States in the preparation of the amendment to the delegated act.

The Commission shall duly inform the European Parliament and the Council about this mandate. As soon as the Commission adopts the delegated act, it will notify it simultaneously to the European Parliament and the Council.

3. ESMA is invited to provide technical advice on the following issues

ESMA is invited to provide technical advice to assist the Commission in amending Delegated Regulation (EU) 2017/389. In particular, this advice should specify which alternative rate or methodology should be applied in the calculation of cash penalties for settlement fails caused by a lack of cash where no overnight credit rate charged by the central bank issuing the settlement currency exists.

In order to ensure a deterrent effect of cash penalties and incentivise timely settlement by failing participants, the penalty rate should reflect the borrowing costs for that currency. ESMA should ensure that the applicable interest rate is set such that the level of cash penalties provides incentives to failing participants to promptly settle failed transactions, without endangering the integrity of the EU capital market. Simultaneously when defining the alternatives their impact on the level of penalties and on the market should be considered. In particular, the proposed rate should not lead to further fragmentation of the single market for capital. Moreover, considering the automation of calculation of cash penalties the proposed alternative rate should be easy to source and compute.

The Delegated Regulation notes that the most appropriate benchmark of borrowing costs in the calculation of a penalty rate is the official interest rate of the central bank issuing the settlement currency⁴². Other potential substitute interest rates⁴³ exist on the national and EU capital markets. Although some of them are set without the involvement of a central bank, they reflect the borrowing costs on the commercial inter-bank market and are used in several securities settlement systems⁴⁴. The technical advice should reflect upon the relevance of these proxy rates for the calculation of cash penalties in case of settlement fails caused by a lack of cash in light of the requirements of the Delegated Regulation (in particular Recital 12 and point 8 of the Annex).

⁴² Commission Delegated Regulation (EU) 2017/389, Recital 12.

⁴³ An example is the EURIBOR, the Euro Interbank Offered Rate, based on the averaged interest rates at which Eurozone banks offer to lend unsecured funds to other banks in the euro wholesale money market. It is published daily by the European Money Market Institutes. Similar rates exist for inter-bank markets loans in non-Euro currencies and are frequently compiled and published by national central banks.

⁴⁴ For instance, CREST used LIBOR, now SONIA, in the calculation of cash penalties.

4. Indicative timetable

This mandate takes into consideration that ESMA requires sufficient time to prepare its technical advice and that the Commission needs to adopt the amended delegated act according to Article 290 of the TFEU. The powers of the Commission to adopt delegated acts are subject to Article 67 of CSDR that allows the European Parliament and the Council to object to a delegated act within a period of 3 months, extendible by 3 further months at the initiative of the European Parliament or of the Council. The delegated act will only enter into force if neither European Parliament nor the Council have objected on expiry of that period or if both institutions have informed the Commission of their intention not to raise objections.

The obligation by CSDs to calculate and collect cash penalties on participants to their securities settlement systems that cause settlement fails will enter into force on 01 February 2022. Although industry-led alternatives are in place, the amendment to the delegated act should be in place as soon as possible to ensure a coherent application of the measures to monitor and prevent settlement fails across the EU capital market. It is therefore of outmost importance to start the work on this issue as soon as possible.

The deadline set to ESMA to deliver the technical advice is therefore 30 September 2024⁴⁵.

⁴⁵ According to the Commission request for ESMA technical advice on amendments to Commission Delegated Regulation (EU) 2017/389 ref. Ares(2023)5817200 – 28/08/2023.

6.3 Annex III – EC Mandate regarding Technical Advice on the treatment of historical reference data for the calculation of late matching fail penalties (LMFPs)

REQUEST TO THE EUROPEAN SECURITIES AND MARKETS AUTHORITY (ESMA) FOR TECHNICAL ADVICE ON A POSSIBLE AMENDMENT TO THE DELEGATED ACT SPECIFYING THE TREATMENT OF HISTORICAL REFERENCE DATA FOR THE CALCULATION OF LATE MATCHING FAIL PENALTIES (LMFPs) (Ref:

Ares(2023)3379353-15/05/2023)

(Commission Delegated Regulation (EU) 2017/389)

With this mandate the European Commission seeks ESMA's technical advice on a possible amendment to the delegated act⁴⁶ specifying the retention process for the parameters used in the calculation of Late Matching Fail Penalties under the Central Securities Depositories Regulation (CSDR)⁴⁷. This amendment to the delegated act should be adopted in accordance with Article 290 of the Treaty on the Functioning of the European Union (TFEU).

The Commission reserves the right to revise and/or supplement this mandate. The technical advice received on the basis of this mandate should not prejudice the Commission's final decision.

For reasons of work planning this technical advice should be combined with the technical advice request on alternative interest rates to be applied to settlement fails caused by a lack of cash, sent to ESMA on 14 December 2022⁴⁸.

The mandate follows the CSDR, the Communication from the Commission to the European Parliament and the Council – Implementation of Article 290 of the Treaty on the Functioning of the European Union (the "290 Communication")⁴⁹, and the Framework Agreement on Relations between the European Parliament and the European Commission (the "Framework Agreement")⁵⁰.

According to Article 7(14) of the CSDR, the Commission is empowered to adopt delegated acts in accordance with Article 67 of the CSDR to specify parameters for the calculation of a deterrent

⁴⁶ 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.

⁴⁷ 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.

⁴⁸ Request for ESMA technical advice on amendments to Commission Delegated Regulation (EU) 2017/389 relating to setting appropriate penalty rates in case of settlement fails caused by a lack of cash under the Central Securities Depositories Regulation (CSDR), Letter from John BERRIGAN to Verena ROSS, 14 December 2022, ARES Ref: 9591987.

⁴⁹ Communication of 9.12.2009. COM (2009) 673 final.

⁵⁰ OJ L 304, 20.11.2010, p. 47.

and proportionate level of cash penalties based on asset type and liquidity of the financial instrument and type of transaction that shall ensure a high degree of settlement discipline and the smooth and orderly functioning of the financial markets concerned.

The European Parliament and the Council shall be duly informed about this mandate.

In accordance with the Declaration 39 on Article 290 TFEU, annexed to the Final Act of the Intergovernmental Conference which adopted the Treaty of Lisbon, signed on 13 December 2007, and in accordance with the established practice within the European Securities Committee⁵¹, the Commission will continue, as appropriate, to consult experts appointed by the Member States in the preparation of possible delegated acts in the financial services area.

In accordance with point 15 of the Framework Agreement, the Commission will provide full information and documentation on its meetings with experts appointed by the Member States within the framework of its work on the preparation and implementation of Union legislation, including soft law and delegated acts. Upon request by the Parliament, the Commission may also invite Parliament's experts to attend those meetings.

The powers of the Commission to adopt delegated acts are subject to Article 67 of the CSDR. As soon as the Commission adopts a possible delegated act, the Commission will notify it simultaneously to the European Parliament and the Council.

2. Context

1.3 Scope

The CSDR includes a set of measures to prevent and address failures in the settlement of securities transactions (settlement fails), commonly referred to as settlement discipline measures. They consist of reporting requirements, cash penalties for Central Securities Depositories' (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. Cash penalties are being applied to all failing transactions on the EU capital market as of 1 February 2022.

The objective of the cash penalties is to act as a deterrent for participants that cause settlement fails, by charging the failing party a daily penalty for each business day that a transaction fails to settle after the intended settlement date (ISD). Cash penalties are calculated as from the intended settlement date until the actual settlement or (bilateral) cancellation date of the instruction. Cash penalties also apply to settlement fails due to matching of settlement instructions after their ISD (late matching).

Commission Delegated Regulation (EU) 2017/389 defines further the parameters and methodology for the calculation of the level of cash penalties that CSDs are required to impose

⁵¹ Commission's Decision of 6.6.2001 establishing the European Securities Committee, OJ L 191, 17.7.2001, p. 45.

on and collect from the failing participants in their securities settlement systems. Specifically, Article 2 states that "...the level of cash penalties referred to in the third subparagraph of Article 7(2) of Regulation (EU) No 909/2014 for settlement fails of transactions in a given financial instrument shall be calculated by applying the relevant penalty rate set out in the Annex to this Regulation to the reference price of the transaction determined in accordance with Article 3 of this Regulation...".

If the trade is matched after the ISD, the trade is subject to a late matching fail penalty (LMFP) imposed on the participant that has submitted the instruction last. The penalties are levied for each day between the ISD and until the instruction is settled or (bilaterally) cancelled. The CSDR settlement discipline provisions imply that LMFPs must be calculated for settlement fails with an intended settlement date for any point in time as of 1 February 2022 onwards. This poses a challenge for any IT system, i.e. to calculate settlement fails for any given day in the past means that the related historical reference data must be kept available in the system in case a late matching settlement instruction is submitted in the system. This means that the amount of reference data is gradually increasing every business day.

This accumulation of historical reference data may have an impact on all EU CSDs as well as, most notably, on TARGET2-Securities (T2S) where the accumulation of past data over time will degrade the functioning of the system, even if the number and share of LMFPs represent a small proportion of penalties in the T2S.

In light of the above, the Commission kindly asks ESMA to suggest a possible amendment to Commission Delegated Regulation (EU) 2017/389. Such amendment should clarify the calculation method for LMFPs that prevents the accumulation of reference date over time and ensures the efficient operation of securities settlement systems.

1.4 Principles that ESMA should take into account

On the working approach, ESMA is invited to take account of the following principles:

- The principle of proportionality: the technical advice should not go beyond what is necessary to achieve the objective of the Regulation. It should be simple and avoid excessive financial, administrative or procedural burdens for counterparties and financial infrastructure providers, in particular CSDs.
- When preparing its advice, ESMA should seek coherence within the regulatory framework of the Union.

- In accordance with the Regulation of the European Parliament and the Council establishing a European Securities and Markets Authority (the "ESMA Regulation")⁵², ESMA should not feel confined in its reflection to elements that it considers should be addressed by the amendment to the delegated act but, if it finds it appropriate, it may indicate guidelines and recommendations which, in its view, could be appropriate to accompany the delegated act to better ensure its effectiveness.
- ESMA will determine its own working methods depending on the content of the provisions being dealt with. Nevertheless, horizontal questions should be dealt with in such a way as to ensure coherence between different standards of work being carried out by the various expert groups.
- In accordance with the ESMA Regulation, ESMA should, where relevant, involve the European Banking Authority and the European System of Central Banks in order to ensure cross-sectoral consistency. It should also cooperate, where relevant, with the European Systemic Risk Board on any issues related to systemic risk.
- In accordance with the ESMA Regulation, ESMA is invited to widely consult market participants in an open and transparent manner and take into account the resulting opinions in its advice. ESMA should provide a detailed feedback statement on the consultation, specifying when consultations took place, how many responses were received and from whom, as well as the main arguments for and against the issues raised. This feedback statement should be annexed to its technical advice. The technical advice should justify ESMA's choices vis-à-vis the main arguments raised during the consultation.
- ESMA is invited to justify its advice by providing a quantitative and qualitative cost-benefit analysis of all the options considered and proposed. ESMA should provide the Commission with a description of the problem, the objectives of the technical advice, possible options for consideration and a comparison of the main arguments for and against the considered options. The cost-benefit analysis should justify ESMA's choices vis-à-vis the main considered options.
- ESMA's technical advice should not take the form of a legal text. However, ESMA should provide the Commission with a clear and structured ("articulated") text, accompanied by sufficient and detailed explanations. Furthermore, the technical advice should be presented in an easily understandable language respecting current terminology in the Union.
- ESMA should provide comprehensive technical analysis on the subject matters described in section 3 below, where these are covered by the delegated powers included in:

⁵² 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), OJ L 331, 15.12.2010, p. 84.

- the relevant provision of the Regulation as amended;
- the corresponding recitals; or
- the relevant Commission's request included in this mandate.

- ESMA should address to the Commission any question to clarify the text of the Regulation or the relevant Regulatory Technical Standard it considers of relevance to the preparation of its technical advice.

3. Procedure

The Commission is requesting ESMA's technical advice in view of the preparation of an amendment of Commission Delegated Regulation (EU) 2017/389 on the calculation of penalties in particular regarding the questions referred to in section 3 of this mandate.

The mandate takes into account the CSDR (Articles 7(14) and 67), the ESMA Regulation, the Communication on the implementation of Article 290 of the Treaty on the Functioning of the European Union⁵³ and the Framework Agreement on relations between the European Parliament and the European Commission⁵⁴.

The Commission reserves the right to revise and/or supplement this mandate. The technical advice received on the basis of this mandate will not prejudice the Commission's final decision.

In accordance with established practice, the Commission may continue to consult experts appointed by the Member States in the preparation of the amendment to the delegated act.

The Commission shall duly inform the European Parliament and the Council about this mandate. As soon as the Commission adopts the delegated act, it will notify it simultaneously to the European Parliament and the Council.

4. ESMA is invited to provide technical advice on the following issues

ESMA is invited to provide technical advice to assist the Commission in amending Delegated Regulation (EU) 2017/389. This advice should specify how to deal with reference data accumulation caused by the need to calculate LMFPs, in particular by suggesting appropriate methods to calculate settlement fails penalties and handle reference data underlying transactions that are matched after the ISD.

⁵³ Communication from the Commission to the European Parliament and the Council - Implementation of Article 290 of the Treaty on the Functioning of the European Union, COM(2009) 673.

⁵⁴ OJ L 304, 20.11.2010, p. 47.

5. Indicative timetable

This mandate takes into consideration that ESMA requires sufficient time to prepare its technical advice and that the Commission needs to adopt the amended delegated act according to Article 290 of the TFEU. The powers of the Commission to adopt delegated acts are subject to Article 67 of the CSDR that allows the European Parliament and the Council to object to a delegated act within a period of 3 months, extendible by 3 further months at the initiative of the European Parliament or of the Council. The delegated act will only enter into force if neither European Parliament nor the Council have objected on expiry of that period or if both institutions have informed the Commission of their intention not to raise objections.

It is of utmost importance to start the work on this issue as soon as possible. For reasons of work planning this technical advice should be combined with the technical advice request on alternative interest rates to be applied to settlement fails caused by a lack of cash, sent to ESMA on 14 December 2022⁵⁵. The deadline set to ESMA to deliver the technical advice is therefore 30 September 2024⁵⁶.

⁵⁵ Request for ESMA technical advice on amendments to Commission Delegated Regulation (EU) 2017/389 relating to setting appropriate penalty rates in case of settlement fails caused by a lack of cash under the Central Securities Depositories Regulation (CSDR), Letter from John BERRIGAN to Verena ROSS, 14 December 2022, ARES Ref: 9591987

⁵⁶ According to the Commission request for ESMA technical advice on amendments to Commission Delegated Regulation (EU) 2017/389 ref. Ares(2023)5817200 – 28/08/2023.

6.4 Annex IV – EC Mandate regarding Technical Advice on the potential calibration of the structure and severity of cash penalties to discourage settlement fails, incentivise their rapid resolution and improve settlement efficiency

REQUEST TO THE EUROPEAN SECURITIES AND MARKETS AUTHORITY (ESMA) FOR TECHNICAL ADVICE ON POSSIBLE AMENDMENTS TO THE DELEGATED ACT SPECIFYING THE POTENTIAL CALIBRATION OF THE STRUCTURE AND SEVERITY OF CASH PENALTIES TO DISCOURAGE SETTLEMENT FAILS, INCENTIVISE THEIR RAPID RESOLUTION AND IMPROVE SETTLEMENT EFFICIENCY *Ref: Ares(2023)5817200-28/08/2023)*

(Commission Delegated Regulation (EU) 2017/389)

With this provisional mandate, the European Commission seeks ESMA's technical advice on a possible amendment to the delegated act⁵⁷ specifying the calculation method and penalty rates under the Central Securities Depositories Regulation (CSDR)⁵⁸. This amendment to the delegated act should be adopted in accordance with Article 290 of the Treaty on the Functioning of the European Union (TFEU).

The Commission reserves the right to revise and/or supplement this mandate. The technical advice received on the basis of this mandate should not prejudice the Commission's final decision.

For reasons of work planning this technical advice may be combined with the earlier technical advice requests on (i) alternative interest rates to be applied to settlement fails caused by a lack of cash and (ii) late matching fails penalties, sent to ESMA on 14 December 2022⁵⁹ and 15 May 2023⁶⁰ respectively.

The provisional mandate follows the CSDR, the Communication from the Commission to the European Parliament and the Council – Implementation of Article 290 of the Treaty on the Functioning of the European Union (the "**290 Communication**"),⁶¹ and the Framework

⁵⁷ 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.

⁵⁸ 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.

⁵⁹ Request for ESMA technical advice on amendments to Commission Delegated Regulation (EU) 2017/389 relating to setting appropriate penalty rates in case of settlement fails caused by a lack of cash under the Central Securities Depositories Regulation (CSDR), Letter from John BERRIGAN to Verena ROSS, 14 December 2022, ARES Ref: 9591987.

⁶⁰ Request for ESMA technical advice on amendments to Commission Delegated Regulation (EU) 2017/389 relating to the treatment of historical reference data for the calculation of LMFPs under the CSDR, Letter from John BERRIGAN to Verena ROSS, 15 May 2023, ARES Ref: Ares(2023)3379353

⁶¹ Communication of 9.12.2009. COM (2009) 673 final.

Agreement on Relations between the European Parliament and the European Commission (the "**Framework Agreement**").⁶²

According to Article 7(14) CSDR, the Commission is empowered to adopt delegated acts in accordance with Article 67 CSDR to specify parameters for the calculation of a deterrent and proportionate level of cash penalties based on asset type and liquidity of the financial instrument and type of transaction that shall ensure a high degree of settlement discipline and the smooth and orderly functioning of the financial markets concerned. Despite the application of cash penalties since 1 February 2022, settlement efficiency has not improved noticeably. As such, further actions must be explored to improve settlement efficiency on the EU capital market, including a reshaping of the structure and severity of cash penalties.

The European Parliament and the Council shall be duly informed about this mandate.

In accordance with the Declaration 39 on Article 290 TFEU, annexed to the Final Act of the Intergovernmental Conference which adopted the Treaty of Lisbon, signed on 13 December 2007, and in accordance with the established practice within the European Securities Committee,⁶³ the Commission will continue, as appropriate, to consult experts appointed by the Member States in the preparation of possible delegated acts in the financial services area.

In accordance with point 15 of the Framework Agreement, the Commission will provide full information and documentation on its meetings with experts appointed by the Member States within the framework of its work on the preparation and implementation of Union legislation, including soft law and delegated acts. Upon request by the Parliament, the Commission may also invite Parliament's experts to attend those meetings.

The powers of the Commission to adopt delegated acts are subject to Article 67 CSDR. As soon as the Commission adopts a possible delegated act, the Commission will notify it simultaneously to the European Parliament and the Council.

1. Context

1.1 Scope

The Central Securities Depositories Regulation (CSDR) includes a set of measures to prevent and address failures in the settlement of securities transactions (settlement fails), commonly referred to as settlement discipline measures. They consist of reporting requirements, cash penalties for central securities depositories' (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.

Although settlement fails cannot be totally eliminated, persistent settlement fails negatively affect the functioning and competitiveness of the capital market. It is understood that the European capital market is characterised by higher settlement fails than in other developed

⁶² OJ L 304, 20.11.2010, p. 47.

⁶³ Commission's Decision of 6.6.2001 establishing the European Securities Committee, OJ L 191, 17.7.2001, p. 45.

financial markets. Furthermore, EU capital markets persistently affected by high settlement fail rates contradict the objectives of the Capital Markets Union⁶⁴, which aims to improve the functioning of market infrastructures across the EU. A fully functioning and integrated market for capital will allow the EU's economy to grow in a sustainable way and be more competitive.

Cash penalties should deter participants from causing settlement fails: the failing party is charged a daily penalty for each business day that a transaction fails to settle after the intended settlement date (ISD).

Article 7(14) CSDR specifies that cash penalties must ensure a high degree of settlement discipline and the smooth and orderly functioning of the financial markets concerned. In order to achieve this aim, the same Article empowers the Commission to adopt delegated acts in accordance with Article 67 CSDR to specify parameters for the calculation of a deterrent and proportionate level of cash penalties.

Commission Delegated Regulation (EU) 2017/389 defines further the parameters and methodology for the calculation of the level of cash penalties that CSDs will impose on and collect from the failing participants in their securities settlement systems. In particular, Article 2 states that *[t]he level of cash penalties referred to in the third subparagraph of Article 7(2) of Regulation (EU) No 909/2014 for settlement fails of transactions in a given financial instrument shall be calculated by applying the relevant penalty rate set out in the Annex to this Regulation to the reference price of the transaction determined in accordance with Article 3 of this Regulation.*

Cash penalties are being applied to all failing settlement instruction in EU CSDs as of 1 February 2022. Unfortunately, the effect of cash penalties on settlement rates on the EU capital market does not seem to show a clear improvement of settlement efficiency⁶⁵. While the settlement fail rate for equities seems to improve slowly, settlement fails rates for corporate and government bonds alike appear to have been deteriorating since February 2022.

The co-legislators recently concluded negotiations on the review of the CSDR. The provisional agreement on CSDR maintains mandatory buy-ins as part of the settlement discipline toolkit. However, they will only apply as a measure of last resort where the rate of settlement fails in the EU is not improving and is presenting a threat to financial stability. Hence, to ensure that mandatory buy-ins are a necessary, appropriate and proportionate means to address the level of settlement fails on the EU capital market the full potential of other measures, in particular cash penalties, to address settlement fails must be explored. This indicates that cash penalties will play an even greater role in ensuring settlement discipline in the future and points to the need to reassess the current framework.

In light of the above, the Commission asks ESMA to suggest a possible amendment to Commission Delegated Regulation (EU) 2017/389. The Agency should assess the

⁶⁴ Communication from the Commission, A Capital Markets Union for people and businesses – New Action Plan, COM(2020) 590 final

⁶⁵ “Report on Trends, Risks and Vulnerabilities”, European Securities and Markets Authority, ESMA50-165-2438, No. 1, 2023, Graph 45

effectiveness and proportionality of the current penalty mechanism and propose, if justified, changes to the structure or severity of the mechanism and consider alternative methods for calculating cash penalties, including by introducing progressive penalty rates. In drafting its technical advice, ESMA should consider how the changing interest rate environment, including negative interest rates, affect a participant's incentive to fail and how this could be mitigated. Furthermore, ESMA should reflect on the need for further flexibility with regards to penalties for settlement fails imposed on illiquid financial instruments. The proposed amendments to the structure and severity of the mechanism should effectively discourage settlement fails, incentivise their rapid resolution and improve settlement efficiency.

1.2 Principles that ESMA should take into account

On the working approach, ESMA is invited to take account of the following principles:

- The principle of proportionality: the technical advice should not go beyond what is necessary to achieve the objective of the Regulation. It should be simple and avoid excessive financial, administrative or procedural burdens for counterparties and financial infrastructure providers, in particular CSDs.
- When preparing its advice, ESMA should seek coherence within the regulatory framework of the Union.
- In accordance with the Regulation of the European Parliament and the Council establishing a European Securities and Markets Authority (the "ESMA Regulation")⁶⁶, ESMA should not feel confined in its reflection to elements that it considers should be addressed by the amendment to the delegated act but, if it finds it appropriate, it may indicate guidelines and recommendations which, in its view, could be appropriate to accompany the delegated act to better ensure its effectiveness.
- ESMA will determine its own working methods depending on the content of the provisions being dealt with. Nevertheless, horizontal questions should be dealt with in such a way as to ensure coherence between different standards of work being carried out by the various expert groups.
- In accordance with the ESMA Regulation, ESMA should, where relevant, involve the European Banking Authority and the European System of Central Banks in order to ensure cross-sectoral consistency. It should also cooperate, where relevant, with the European Systemic Risk Board on any issues related to systemic risk.
- In accordance with the ESMA Regulation, ESMA is invited to widely consult market participants in an open and transparent manner, and take into account the resulting opinions in its advice. ESMA should provide a detailed feedback statement on the consultation, specifying when consultations took place, how many responses were received and from whom, as well as the main arguments for and against the issues raised. This feedback statement should be annexed to its technical advice. The technical advice should justify ESMA's choices *vis-à-vis* the main arguments raised during the consultation.

⁶⁶ 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), OJ L 331, 15.12.2010, p. 84.

- ESMA is invited to justify its advice by providing a quantitative and qualitative cost-benefit analysis of all the options considered and proposed. ESMA should provide the Commission with a description of the problem, the objectives of the technical advice, possible options for consideration and a comparison of the main arguments for and against the considered options. The cost-benefit analysis should justify ESMA's choices *vis-à-vis* the main considered options.
- ESMA's technical advice should not take the form of a legal text. However, ESMA should provide the Commission with a clear and structured ("articulated") text, accompanied by sufficient and detailed explanations. Furthermore, the technical advice should be presented in an easily understandable language respecting current terminology in the Union.
- ESMA should provide comprehensive technical analysis on the subject matters described in section 3 below, where these are covered by the delegated powers included in:
 - o the relevant provision of the Regulation as amended;
 - o the corresponding recitals; or
 - o the relevant Commission's request included in this mandate.
- ESMA should address to the Commission any question to clarify the text of the Regulation or the relevant Regulatory Technical Standard it considers of relevance to the preparation of its technical advice.

2 Procedure

The Commission is requesting ESMA's technical advice in view of the preparation of an amendment of Commission Delegated Regulation (EU) 2017/389 on the calculation of penalties in particular regarding the questions referred to in section 3 of this mandate.

The mandate takes into account the CSDR (Articles 7(14) and 67), the ESMA Regulation, the Communication on the implementation of Article 290 of the Treaty on the Functioning of the European Union (TFEU)⁶⁷ and the Framework Agreement on relations between the European Parliament and the European Commission⁶⁸.

The Commission reserves the right to revise and/or supplement this mandate. The technical advice received on the basis of this mandate will not prejudice the Commission's final decision.

In accordance with established practice, the Commission may continue to consult experts appointed by the Member States in the preparation of the amendment to the delegated act.

⁶⁷ Communication from the Commission to the European Parliament and the Council - Implementation of Article 290 of the Treaty on the Functioning of the European Union, COM(2009) 673.

⁶⁸ OJ L 304, 20.11.2010, p. 47.

The Commission shall duly inform the European Parliament and the Council about this mandate. As soon as the Commission adopts the delegated act, it will notify it simultaneously to the European Parliament and the Council.

3 ESMA is invited to provide technical advice on the following issues

ESMA is invited to provide technical advice to assist the Commission in amending Delegated Regulation (EU) 2017/389. In particular, in order to ensure a continuing deterrent effect of cash penalties and incentivise timely settlement by failing participants, the technical advice should specify if and how to amend the structure and severity of cash penalties to discourage settlement fails, incentivise the timely resolution of fails and discourage keeping settlement instructions unsettled for extended periods of time.

The technical advice should contribute to lowering settlement fail rates on the EU capital market and in turn contribute to the objectives of the Capital Market Union. In its advice ESMA should take account of the different types of securities, their time to maturity and liquidity, where appropriate. In addition, ESMA should reflect if the changing interest rate environment affects the participants incentives to fail and how this should be accommodated in revised penalty rates, if justified. Lastly, the proposed methodology for calculating settlement fails penalties should not lead to further fragmentation of the single market for capital. Moreover, to support the automation of calculation of cash penalties, the proposed alternative rates should be easy to source and compute.

4. Indicative timetable

This mandate takes into consideration that ESMA requires sufficient time to prepare its technical advice and that the Commission needs to adopt the amended delegated act according to Article 290 TFEU. The powers of the Commission to adopt delegated acts are subject to Article 67 CSDR that allows the European Parliament and the Council to object to a delegated act within a period of 3 months, extendible by 3 further months at the initiative of the European Parliament or of the Council. The delegated act will only enter into force if neither European Parliament nor the Council have objected on expiry of that period or if both institutions have informed the Commission of their intention not to raise objections.

It is of utmost importance to start the work on this issue as soon as possible. For reasons of work planning and overlapping scope this technical advice may be combined with the earlier technical advice requests on alternative interest rates to be applied to settlement fails caused by a lack of cash and late matching fails penalties, sent to ESMA on 14 December 2022⁶⁹ and 15 May 2023 respectively⁷⁰. The deadline set to ESMA to deliver the technical advice is therefore 30 September 2024.

⁶⁹ Request for ESMA technical advice on amendments to Commission Delegated Regulation (EU) 2017/389 relating to setting appropriate penalty rates in case of settlement fails caused by a lack of cash under the Central Securities Depositories Regulation (CSDR), Letter from John BERRIGAN to Verena ROSS, 14 December 2022, ARES Ref: 9591987.

⁷⁰ Request for ESMA technical advice on amendments to Commission Delegated Regulation (EU) 2017/389 relating to the treatment of historical reference data for the calculation of LMFPs under the CSDR, Letter from John BERRIGAN to Verena ROSS, 15 May 2023, ARES Ref: Ares(2023)3379353