Deutsche Bank

EU Transparency Register ID Number 271912611231-56

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ESMA
CS 60747
103 rue de Grenelle
75345 Paris Cedex 07, France

2015-02-19

Re: *Technical Advice under the CSD Regulation*

Dear Sir or Madam,

Deutsche Bank welcomes the opportunity to comment on the above mentioned consultation. We support ESMA's objective of improving settlement performance. We have some suggestions which we believe could further improve the settlement process and improve the implementation of the new regulations.

When assessing penalties against a failing counterparty, the penalty should be reduced in the event that the counterparty has elected to participate in partial settlement. In that case, the penalty should only reflect the volume of securities that has yet to be delivered. Where a counterparty refuses to participate in partial settlement however, the penalty should be based on the entire volume of securities that failed to deliver, regardless of any partial amount of the security held in the failing party's inventory.

Penalty rates for equities should be a function of the liquidity of the instrument. While the penalty rate should be structured to encourage the borrowing of equities to facilitate delivery, a uniform penalty rate for both liquid and illiquid equities could serve to discourage trading in small and medium sized entities (SMEs). To compensate for this, ESMA should adopt penalty rates that will result in a maximum penalty of 4 basis points (bps) for both liquid and illiquid equities. Liquid equities would use a penalty rate of 1bp per day, whereas illiquid equities would use a penalty rate of roughly a quarter of this rate. The result in both cases would be a penalty of 4 bps at the end of the maximum extension period for both classes of equities.

We welcome ESMA's decision to exempt transactions that fail to settle for reasons unrelated to the participants or the CSD. Assessing penalties on such transactions serves no regulatory purpose and does nothing to improve settlement efficiency as such failures are outside the control of participants and CSDs.

Please let us know if you would like to discuss the above points with us or any aspect of our response.

Yours sincerely,

Daniel Trinder
Global Head of Regulatory Policy

Q1: What are your views on the proposed basis for the cash penalty calculation?

We agree with the general principles with respect to the proposed basis for calculating the cash penalty. In particular, we agree that in cases where a participant has sufficient inventory to make a partial delivery, but is prevented from doing so due to its counterpart opting out of partialing, then any fine should only be calculated based on the unavailable balance. We also agree in cases where a failing participant has sufficient inventory to make a partial delivery but has opted out of partialing, the penalties should be based on the total amount of the failing settlement instruction.

It should be clarified that fail fees will only be charged on matched transactions.

Q2: What are your views on the proposed approach regarding the categories of financial instruments and the penalty rates? In particular, do you consider that these penalty rates could dis-incentivise trading in small caps? Please provide evidence to support your views.

With respect to the penalty rates for equity shares, the following points should be considered. We note that ESMA's logic was to align the penalty to the perceived borrowing rates irrespective of size, i.e. whether large cap or small and medium entities (SME). This could have the effect of reducing liquidity in SME-shares as market participants may refrain from trading to avoid incurring high penalty costs when delivery is not possible. To address this concern, penalties should be assessed based on the liquidity of the underlying instrument. Level 1 of CSDR (L1) states the buy-in process will commence once the failing participant does not deliver the financial instruments to the receiving party within four business days after the intended settlement date. This four day period represents the extension period. L1 goes on to state in the case of equities traded on an SME growth market, the extension period shall be 15 days, unless the SME growth market applies a shorter period. The Regulatory Technical Advice (RTA) proposes a 1bp per day penalty for failure to deliver on all equities, regardless of liquidity levels. Using the four day extension period would result in a 4bp penalty for liquid equities. In the case of SME shares however, ESMA's proposed 1bp per day penalty would result in a 15bp penalty. This disproportionately punishes failures in SME shares in relative terms. Instead, we recommend ESMA adopts a uniform 4bp maximum penalty for all equities, both liquid and illiquid. Under such a system the penalty rate for liquid equities would be 1bp per day, with SME shares subject to a penalty rate of .27bp per day. The end result is a maximum penalty of 4bps when buy-in does not occur until the end of the extension period for both categories of equities.

ESMA should consider whether further categories of instruments would be needed. ETFs, Depository Receipts etc often have limited liquidity and a penalty fine on par with cash equities might be detrimental to settlement efficiency if liquidity dries up.

With respect to bonds, we expect future price offers to include a premium to incorporate the risk of settlement failure. As a result, no distinction is needed between government and corporate bonds. In addition, the penalty should be greater than the normal margin on a transaction. Otherwise there is no incentive to cure the fail if the cost for borrowing the bonds and paying the penalty are equal. Likewise, for fails due to missing cash the penalty rate should be higher than the actual borrowing rate. ESMA should provide clarification on how the penalty will be assessed in the event the discount rate is negative.

Finally, it would be beneficial if ESMA could clarify that the penalty regime should not be treated as taxable elements. Otherwise this could create significant issues with regards to WHT and certificates of residency, especially in case of redistribution.

Q3: What are your views on the proposed approach regarding the increase and reduction of the basic penalty amount?

We agree with the general approach as it will provide participants with a reliable system of penalties. We also agree that increases and decreases in penalties for various situations could lead to imbalances within the settlement system and would be difficult to be reconciled. Should a CSD have to balance those "imbalances" it might be taking up risk that is not justified.

Insufficient settlement efficiency is clearly an item for discussion between trading participants as the subsequent costs will be addressed and should lead to improved settlement efficiency.

Further, Deutsche Bank welcomes the opportunity to exempt certain transactions from a settlement penalty when failure occurs for reasons unrelated to the participants or the CSD. In order to ease the process we believe that exemptions for not charging should be defined by a general approach rather than case-by-case issues.

This general approach should include the reason codes and address situations where the CSD participant is not in control of the settlement of the transaction. i.e. if an account is blocked, security suspended, or corporate action processing. The International Organisation of Standards (ISO) offers a number of reason-codes for why a transaction has not settled. Only those codes relating to a lack of Cash or Securities as well as an instruction set on hold by the Participant should be considered for a penalty. A list of the relevant ISO codes, including codes for fails due to circumstances outside the control of participants and CSDs, may be found in the following link.

http://www.iso15022.org/uhb/uhb/mt548-12-field-24b.htm.

Q4: What are your views on the proposed approach regarding the cash penalties in the context of chains of interdependent transactions?

We agree with the general proposed approach, however there needs to be more work to ensure that the failed transaction within a chain of interdependent transactions is properly identified.