Reply Form

**to the Consultation Paper on Technical Advice on CSDR Penalty Mechanism**

Responding to this Consultation Paper

ESMA invites comments on all matters in this Consultation Paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

* respond to the question stated;
* indicate the specific question to which the comment relates;
* contain a clear rationale; and
* describe any alternatives ESMA should consider.

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

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input - Consultations’.

Instructions

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

• Insert your responses to the questions in the Consultation Paper in this reply form.

• Please do not remove tags of the type < ESMA\_QUESTION\_CSDR\_0>. Your response to each question has to be framed by the two tags corresponding to the question.

• If you do not wish to respond to a given question, please do not delete it but simply leave the text “TYPE YOUR TEXT HERE” between the tags.

• When you have drafted your responses, save the reply form according to the following convention: ESMA\_CP1\_CSDR \_nameofrespondent.

For example, for a respondent named ABCD, the reply form would be saved with the following name: ESMA\_CP1\_CSDR \_ABCD.

• Upload the Word reply form containing your responses to ESMA’s website (**pdf documents will not be considered except for annexes**). All contributions should be submitted online at *www.esma.europa.eu* under the heading *‘Your input - Consultations’.*

**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](http://www.esma.europa.eu) under the heading ‘[Data protection](https://www.esma.europa.eu/about-esma/data-protection)’.

**Who should read this paper?**

All interested stakeholders are invited to respond to this consultation paper. In particular, ESMA invites market infrastructures (CSDs, CCPs, trading venues), their members and participants, other investment firms, credit institutions, issuers, fund managers, retail and wholesale investors, and their representatives to provide their views to the questions asked in this paper.

# General information about respondent

|  |  |
| --- | --- |
| Name of the company / organisation | The Investment Association |
| Activity | Associations, professional bodies, industry representatives |
| Are you representing an association? |  |
| Country / Region | UK |

# Questions

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

<ESMA\_QUESTION\_CSDR\_1>

**About the Investment Association**

The Investment Association (IA) champions the interests of the UK-based investment management industry. We represent over 250 firms, a third of which are headquartered in the EU and operate from 642 offices across Europe.

Our members put €9.9 trillion to work across the economy, representing 35% of the total €28.4 trillion of assets managed in Europe. In 2022, IA members managed €2.7 trillion on behalf of European clients and invested €820 billion into EU businesses and projects needing capital, all while providing European clients access to global investment opportunities.

**Executive Summary**

The Investment Association welcomes the opportunity to respond to the ESMA Consultation Paper on Technical Standards on the CSDR penalty mechanism. The IA worked closely with members up to and after the go-live date of CSDR cash penalties, as their introduction represented a significant operational impact for investment management firms.

The buy-side are largely net receivers of cash penalties, with 70-80 percent of penalties received being credits and due to the broker being short of stock. Despite mostly being in credit, the operational challenges of applying cash penalties down the settlement chain can impose additional costs to the manager.

Our headlines positions are that:

* **ESMA should review the “accuracy” rate of cash penalties.**

One of the challenges with the current penalty regime is that it’s difficult to automate for a buy-side firm and their client(s). The penalty that a CSD pays out cannot be taken at face value to be correct. As the AFME bilateral claims guidelines explain (https://www.afme.eu/Portals/0/DispatchFeaturedImages/CSDR%20Settlement%20Discipline%20-%20Bilateral%20Penalty%20Claims%20FINAL.pdf), cash penalties can be posted in the wrong direction under a few scenarios. This includes where a counterpart gives incorrect SSIs (standard settlement instructions) to the failing counterpart or if a counterpart asks for a manual partial on an already failing trade, with the recipient counterparty inputting in the new trades last and wrongly suffering a debit.

ESMA should prioritise a better understanding of these scenarios and look at ways in which cash penalty “accuracy” rate can go up, such that firms can automate the process. We have a proposed solution for manual partials in our answer to question 18.

* **Any change to the cash penalty regime should aim to make cash penalties as operationally simple as possible (the proportionality element).**

Given the above, it has been a challenge for many firms to automate the investigation and posting of cash penalties, despite the values often being very small. Whilst a CSD and custodian can pass penalties on, an investment manager and their client(s) may face local jurisdiction rules to ensure a fund or client cannot be unduly debited (e.g. ESMA’s opinion on undue costs - https://www.esma.europa.eu/sites/default/files/2023-05/ESMA34-45-1747\_Opinion\_on\_undue\_costs\_of\_UCITS\_and\_AIFs.pdf). This may mean that all debits have to be individually reviewed, even if the buy-side is not at fault and the value is immaterially small.

Some of the proposals in this consultation, such as progressive penalties, a minimum value de-minimis, or an increased rate for counterparts with the highest fail rates, will increase operational complexity, to the detriment of both those suffering debits or receiving credits. Time spent on processing cash penalties may detract from the amount of time that firms can dedicate to settlement efficiency and process improvement.

* **ESMA’s proposals for the cash penalty regime should be based on data.**

We note ESMA’s call for data in a number of questions alongside their proposals.

We believe it would be helpful for the market if ESMA were able to share the pre-existing data that they’re using for reference alongside the consultation (e.g. paragraph 46 notes that ETF settlement fails are particularly high). Under CSDR, CSDs are obligated to pass data on to NCAs who should then be sharing data with ESMA to inform a wider market view.

This data could then be used to guide discussion on an appropriate cash penalty rate level.

* **Any change to CSDR cash penalties should be discussed alongside improvements to other settlement efficiency tooling and should not make settlement efficiency worse.**

Cash penalties are a tool to improve settlement rates but can occasionally have an opposite effect.

For example, a receiving party of a failing trade may be reluctant to manually partial a transaction given they may input the new shapes second and receive a late matching debit, reducing overall settlement efficiency on an asset but making sure that the receiver doesn’t get impacted by an incorrect debit. If CSDR cash penalties weren’t in effect the receiver would not fear an incorrect debit and would more readily partial.

Tooling like auto-partialing would reduce scenarios such as this but must be offered by all jurisdictions and preferably by all custodians.

* **Any change to the cash penalty regime should not have a detrimental impact on market attractiveness or on the end investor.**

As discussed in later question responses, there’s a concern that if a penalty rate is particularly high, it will pass on costs to all market participants which may ultimately impact the end investor. An example of this is for ETFs, where additional cash penalties imposed on authorised participants (APs) may force them to price this into the spreads offered to the end investor and make EU products less attractive when compared against jurisdictions without cash penalties.

With some of the proposed increases (e.g. 600% increase for equities on day one), there’s a concern that market liquidity providers will reduce liquidity provision given the cash penalty rates are too punitive. Instead, we have proposed benchmarking against an overnight funding regime, with any increases limited to a maximum of 50% against what they’re at today.

Cash penalty rates should be proportionate to the outcome desired.

* **ESMA must consider the whole settlement chain when considering changes to cash penalties**

Whilst much of the focus of CSDR settlement discipline legislation and this consultation is on the CSD and the immediate CSD participant, there is a much longer chain of participants that should be considered when making any changes.

ESMA should consider how changes to CSD or direct CSD participants will impact down the settlement chain and the end investor.

* **Mandatory buy-ins are not fit for purpose.**

As discussed by many participants on prior consultations, mandatory buy-ins remain a very difficult and expensive process for both the failing and receiving counterpart. The introduction of MBIs will introduce additional costs on European stocks which are not felt within other jurisdictions, reducing market attractiveness.

* **The IA and members are committed to optimising the cash penalty process.**

As generally net receivers of a cash penalty credit, IA member firms and their clients are in regular engagement with their sell-side counterparts to improve settlement efficiency.

Cash penalties are part of this conversation but must remain operationally efficient to process so that firms can prioritise time and resourcing to solving the root cause issues instead.

Answer to Q1 - Our buy-side member firms are not significantly impacted by this – No IA response

<ESMA\_QUESTION\_CSDR\_1>

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

<ESMA\_QUESTION\_CSDR\_2>

No IA response

<ESMA\_QUESTION\_CSDR\_2>

1. 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.

<ESMA\_QUESTION\_CSDR\_3>

No IA response

<ESMA\_QUESTION\_CSDR\_3>

1. 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.

<ESMA\_QUESTION\_CSDR\_4>

|  |  |  |
| --- | --- | --- |
| **Option** |  | |
|  | **Qualitative description** | **Quantitative description/ Data** |
| **Benefits** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Compliance costs:**  **- One-off**  **- On-going** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Costs to other stakeholders** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Indirect costs** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |

No IA response

<ESMA\_QUESTION\_CSDR\_4>

1. 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).

<ESMA\_QUESTION\_CSDR\_5>

We would expect that T2S and CSDs would help in presenting this data to ESMA already.

Whilst we expect that the proposal to limit reference data to either 40 pr 92 business days will have minimal impact and understand the need for a limit, we would be concerned if CSDs and T2S claim that storing this relatively small amount of data has an adverse impact on the functioning of their settlement system.

<ESMA\_QUESTION\_CSDR\_5>

1. 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?

<ESMA\_QUESTION\_CSDR\_6>

We think that the market would benefit from ESMA sharing statistics on late matching fail penalties (LMFP) and to understand whether ESMA consider them particularly high compared to settlement fail penalties (SEFPs) as the question suggests.

In terms of late matching, they can occur in a few ways. LMFP encompasses both true late matched trades, where one or both counterparties are late to input, but also trade re-bookings, which doesn’t actually reflect a late match. Unfortunately, it’s very difficult to separate these two categories out for further analysis.

Examples where trades might have to be re-booked and are not true LMFPs:

**A manual partial on a failing trade** – If a trade is already failing and the delivering party asks the receiving party to split the trade into two shapes, the re-matched shapes will be considered as “late matching”, even though it was originally a conventional settlement fail penalty.

The introduction of auto-partialing across all CSDs and custodians would help reduce this number, and improve the “accuracy” of cash penalties applied.

**Incorrect Settlement Standing Instructions (SSIs) submitted –** One of the counterparts has not submitted the correct SSIs. This is particularly prevalent with newly onboarded accounts/clients.

Use of an SSI repository helps with this, though an investment manager (IM) often cannot mandate that a custodian adopts the use of one. The custodian may be chosen by the investment manager’s client, such that there is little leverage to encourage settlement discipline by the IM of the custodian.

**Instructed in the incorrect settlement location –** A commonly occurring error can be for either counterpart to be instructing settlement at different CSDs (e.g. instruction to deliver out of Euroclear as ICSD and instruction to receive into a domestic CSD such as Iberclear). The re-instructing party would then have to amend settlement location, creating an LMFP, despite both counterparts having their instructions in the market.

In would be helpful if ESMA mandated that custodians provided the place of safekeeping (field 94a) within MT535 (statement of holding) messages such that counterparts could trade and instruct in the location where they hold stock.

<ESMA\_QUESTION\_CSDR\_6>

1. 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.

<ESMA\_QUESTION\_CSDR\_7>

This would have limited impact on buy-side firms, though it would be good to understand from the CSDs at what point the performance of their systems is impacted by the storage and use of reference data. It does not sound like a big imposition to store and use this data.

Could the period be increased to 365 calendar days to reduce the amount of trades impacted?

<ESMA\_QUESTION\_CSDR\_7>

1. 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).**

<ESMA\_QUESTION\_CSDR\_8>

No IA response

<ESMA\_QUESTION\_CSDR\_8>

1. 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.

<ESMA\_QUESTION\_CSDR\_9>

We agree

It may make sense for ESMA to help determine where responsibility lies instrument reference data for cross-CSD alignment transactions (e.g. Iberclear into Euroclear in Spain). One of the issues of the current regime has been where CSDs use different rates on cross-border trades.

<ESMA\_QUESTION\_CSDR\_9>

1. 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.

<ESMA\_QUESTION\_CSDR\_10>

No IA response.

<ESMA\_QUESTION\_CSDR\_10>

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

<ESMA\_QUESTION\_CSDR\_11>

No IA response.

<ESMA\_QUESTION\_CSDR\_11>

1. 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.

<ESMA\_QUESTION\_CSDR\_12>

No IA response.

<ESMA\_QUESTION\_CSDR\_12>

1. 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.

<ESMA\_QUESTION\_CSDR\_13>

|  |  |  |
| --- | --- | --- |
| **Approach proposed by ESMA** |  | |
|  | **Qualitative description** | **Quantitative description/ Data** |
| **Benefits** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Compliance costs:**  **- One-off**  **- On-going** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Costs to other stakeholders** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Indirect costs** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |

No IA response.

<ESMA\_QUESTION\_CSDR\_13>

1. 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.

<ESMA\_QUESTION\_CSDR\_14>

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

No IA response.

<ESMA\_QUESTION\_CSDR\_14>

1. 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.

<ESMA\_QUESTION\_CSDR\_15>

Our members’ experience is that CSDR cash penalties have triggered marginal gains in settlement efficiency.

Settlement rates in some instruments have become better, and the risk profile and value of failing trades have reduced (e.g. counterparts have prioritised the higher value transactions). This has been an improvement in settlement rates over time, as shown in the ESMA TRV report (chart 37).

We believe that this question should be driven by CSD provided data that is split per jurisdiction and instrument type, and with subsequent ESMA analysis of this data. The ESMA TRV reports over the last couple of years alongside the T2S report suggest that settlement efficiency is improving across all asset classes.

That being said, the primary reason for fails that the asset management community see (CLAC (counterparty lack of securities)– broker short) remains by far the biggest cause of failing trades.

<ESMA\_QUESTION\_CSDR\_15>

1. 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.

<ESMA\_QUESTION\_CSDR\_16>

Whilst the cash penalty mechanism is still fairly new, we believe that the current CSDR penalty mechanism is deterrent given the improvement to settlement rates seen by our members and by ESMA’s reports.

Despite the buy-side largely being net receivers of cash penalty credits, we consider that there are cases where the current CSDR cash penalty mechanism is disproportionate and do not think that the legislation had full regard to the entire settlement chain, instead focusing on the CSDs and the direct CSD participants only. This has led to fragmentation in the way that custodians pass down penalties to counterparts, the way that investment managers process penalties and the asks or responses of underlying clients.

In terms of proportionality, we see the following challenges to automating the cash penalty process:

**Operationally Complex - The existing cash penalty framework has already been difficult to implement.**

Consider a scenario:

Pension fund has 500 shares in the depot at the CSD and is pending return of a 500 share stock loan to settle an onward sell transaction of 1000 shares. Borrow return settles on ISD+1 (intended settlement date) within the FOP (free of payment window) but after the DVP (delivery vs payment) settlement window has closed. The onward sell therefore only settles on ISD+2.

Fund receives penalty based on 500 shares for 1 day for the borrow return fail. Fund pays penalty for 1,000 shares for 2 days for the ongoing sell.

In this scenario it becomes very difficult to manage who is at fault between the fund manager, the investment manager, the custodian, the agency lender and the broker. Underpinning this there are competing interests in that a broker may consider the value too low to reimburse, but the fund manager may be obliged by regulation not to allow undue debits to hit the fund (e.g. ESMA opinion on undue costs for funds - https://www.esma.europa.eu/sites/default/files/2023-05/ESMA34-45-1747\_Opinion\_on\_undue\_costs\_of\_UCITS\_and\_AIFs.pdf).

This scenario becomes even more difficult to manage with progressive penalties and with the scale of quantity seen.

**Application to the underlying client/fund**

Some funds and clients may be impacted by local jurisdiction rules or standard practices on whether they can receive debits or credits.

* As an example, a Japanese Trust client may receive 100 credits of EUR 10 and suffer 20 debits of EUR 10. Some of these debits are because the client has accepted a manual partial but input the new shapes into the market second and got an undue LMFP debit.
* The account is in credit for EUR 800.
* The Japanese Trust does not allow for undue debits so all 20 debits must be investigated and claimed back.
* Even if they are at fault, the broker(s) are not likely to agree to reimburse a debit of EUR 10, so the investment manager may have to cover the loss.
* The amount of resource dedicated to investigating all debits (and potentially credits), will likely far exceed the value of the penalties themselves.
* Potential regulatory issues if debits hit the account.

**Some cases where cash penalties negatively impact settlement efficiency** – Given the way cash penalties are calculated, there are some scenarios in which they can dis-incentivise settlement efficiency.

**Manual partialing** – If a failing trade is re-booked into smaller shapes, if the receiving counterpart submit the newly shaped transactions 2nd they incorrectly receive a late matching cash penalty debit. This disincentivises partials that would have happened prior to cash penalty implementation. We have proposed a solution to this in question 18.

**Inventory management and auto-partial** – Firms have to be very careful around inventory management, which is a process many firms would like to automate. As an example:

* On intended settlement date, firm has 100,000 shares in receipt to offset 100,000 shares to deliver, with 0 shares held in depot at the CSD.
* Firm is signed up for auto-partial where available.
* Firm receives 90,000 shares through receipt auto-partial, but delivering counterpart does not accept auto-partial.
* Firm now has 10,000 failing receipt, 90,000 held at the CSD and is failing for 100,000 shares. They receive a cash penalty receipt based on 10,000 shares and a debit based on 100,000 shares, an overall debit.
* Given negative impact, firm decides to forego auto-partialling in the future, negatively impacting overall settlement efficiency of the market.

**Inconsistent custodian and prime broker application**

Investment managers and their clients may use an array of custodians and prime brokers (PBs).

Given CSDR legislates only for the CSD and their direct participant, custodians and PBs were inconsistent in how and whether they pass cash penalties onwards, making it hard for downstream firms to operationalise cash penalties and apply the same process for all custodian relationships.

**Cash penalties are still preferable to mandatory buy-ins.**

Cash penalties are still preferable to a mandatory buy-in regime however, which would impose significant costs on many parts of the industry.

<ESMA\_QUESTION\_CSDR\_16>

1. 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.

<ESMA\_QUESTION\_CSDR\_17>

The IA surveyed investment manager members on fail rates in early 2023. The below percentages are an average taken from the 18 firms that answered. Whilst the data is somewhat aged, we don’t believe that this has changed materially.

**81% caused by the counterpart (broker)**

This was largely due to CLAC (counterparty lack of securities) or broker short.

The broker community should be able to explain in more detail why they’re commonly short of securities, but we understand that this is due to their inventory management model and where they agree a transaction despite not yet holding the securities. For any given security on any given day, a broker may have tens or hundreds of internal and client buy and sell transactions on a stock. The broker manages the overall net receipt or deliver through securities borrowing or borrow returns. It is generally in a broker’s interest to keep a clearing (CSD) position of a stock near zero for funding reasons. If the underpinning borrow fails or is delayed, many offsetting delivers will fail.

There’s a concern that if a broker needs to “overborrow” to double cover delivery transactions due to high cash penalty rates, these additional costs will be passed on to the industry via higher trading costs.

**14% caused by the custodian/client**

Our members have discussed that this portion of fails is commonly caused by securities lending. It’s often a client decision to undertake securities lending with a lending agent, such that the portfolio manager has limited or no visibility of which stocks are on loan when a stock is sold.

When an on-loan stock is sold, there’s an extended chain of events that needs to happen compared to a conventional trade, which makes the trade more likely to fail. For example:

* Portfolio manager sells security that’s on loan.
* Sale notification goes to custodian
* Custodian instructs agency lender to recall.
* Agency lender instructs recall to borrower.
* Borrower may have to source alternate stock before being able to return the securities.
* If the recall fails by intended settlement date, the onward sale leg fails.
* Even if the recall settles (as FOP), it may be only after the DvP settlement window has closed, which causes the fail of the onward sale.

Given the numerous entities involved, it can be difficult to know where to apportion debit penalties as one or more parties may be at fault for the fail of the borrow return and subsequent settlement fail of the sell.

**6% caused by the investment manager.**

Investment management firms are looking to continue to make marginal gains on settlement efficiency, including:

* Depository realignments - Being aware of whether stock is at the local CSD or ICSD and instructing to the right place.
* Incorrect static data such as SSIs – Employing the use of SSI repositories or encouraging custodians to do so.
* Late instruction
* Late sale notification where inventory is out on loan.
* Looking to further improve pre-matching rates and encourage counterparts to do the same.

<ESMA\_QUESTION\_CSDR\_17>

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

<ESMA\_QUESTION\_CSDR\_18>

**Auto-partialing** – We believe that ESMA should encourage and explore mandating the use of auto-partialing. As outlined in our response to Q16 and below, manual partialing of already failing trades can cause issues.

As part of this, ESMA would need to ensure that auto-partialing is available across all EU jurisdictions, and then follow-up to ensure that intermediaries such as custodians are then offering the service to clients.

**Resolving cash penalty “inaccuracies”** - ESMA should encourage CSDs to resolve the issue in manually partialing already failing trades where, when the recipient counterparty being failed into submits the new shapes second, they suffer the debit. CSDs should develop a methodology to link the cancelled original trade to the new split shapes, such that the penalty direction remains the same. This will encourage more manual partialing of stock.

We believe that this could be resolved through the following logic for a newly booked trade:

* Is the intended settlement date in the past? (This should be a small minority of trades.)
* If yes, does the trade date, intended settlement date and counterparty details of the trade match with other unsettled or newly cancelled trades (same-day) between the same counterparties.
* If yes, does the aggregate total of the newly input trades match the quantity and price of the existing trade?
* If yes, apply the LMFP in the same direction as it was applied to the initial cancelled trade (rather than applying the late matching fail penalty to the counterpart that input the new trades into the CSD second).

Whilst we understand that this would be a build for CSDs, it would fix for incorrect cash penalty postings and encourage greater manual partialing and liquidity. We are happy to engage with ESMA to explore other options to resolve this issue.

**Custodian mandatory reporting of field 94a (place of safekeeping) on MT535 (statement of holding messages)** – Most custodians inform where stock is held through this field, but not all of them do. We believe this reporting is crucial such that selling counterparts can instruct sales from the correct location (e.g. an ICSD or the domestic market).

**Encouraging the use of place of settlement as required by pre-matching tools** – This can be turned on in industry tools such as CTM. This will flag mismatches prior to settlement date.

<ESMA\_QUESTION\_CSDR\_18>

1. 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.

<ESMA\_QUESTION\_CSDR\_19>

We would like to hear of ESMA and the Commissions’ view on current settlement efficiency rates in Europe compared to other jurisdictions and what they would like to see.

As the buy-side, whilst settlement rates are not perfect, there is a balance to be struck. Whilst we would like to see better settlement efficiency, we do not wish for discipline to impact market liquidity and pricing. There’s a concern that if the penalty rates go high or the mechanism becomes too complex, any costs that the sell-side incur will be passed on to the end investor through additional trading costs or in the case of ETFs, the imposition of wider spreads on investors. This will have a detrimental impact on the end investor and EU market competitiveness. Currently, the mechanism seems to be treading an appropriate line between settlement discipline without negatively impacting liquidity and pricing.

Even if the fund or investor receives an overall CSDR net credit, this may be offset by higher trading costs.

<ESMA\_QUESTION\_CSDR\_19>

1. 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.

<ESMA\_QUESTION\_CSDR\_20>

We think the proportionality element needs to considered from two angles:

**Proportionality of value** – Are cash penalties enough of a disincentive to net failing counterparts to improve processes?

This is difficult to answer as the buy-side tend to be net receivers. Our members are continuing to see some broker improvement to improve processes and would expect this to continue as some transformation projects and fixes can take a longer time.

**Proportionality of operational footprint** – Is the value and operational complexity of the cash penalty process, compensated by the value of the penalties (especially for those in credit)?

The difficulty underpinning this aspect is that not all cash penalties are posted “accurately” (the CSD will debit the counterpart they see at fault but this is not always the party truly at fault per our comment in the executive summary and Q18). This makes the process very hard to automate.

This answer will also differ depending on each firm and the operational processes they have with their clients. Some clients will allow all cash penalties (credits and debits) to be applied to their account as long as they’re in net credit over a calendar month and therefore don’t consider the account to be negatively impacted. This results in quite a small operational footprint. Some clients or jurisdictions may require the investigation and reimbursement of any debits and credits, even those of immaterial value. This can cause costs of greater value than penalties received.

<ESMA\_QUESTION\_CSDR\_20>

1. 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.

<ESMA\_QUESTION\_CSDR\_21>

The IA and its members agree that the CSDs should share this data with ESMA. We consider this data, and subsequent analysis, is crucial prior to making any decisions on a recalibration of cash penalty rates.

We ask also that this data is made public with a breakdown per asset type and per jurisdiction, such that the market can see the direction of travel and focus on the jurisdiction, instrument and trade types with the highest rate of fails..

We note that T2S have done a report outlining some stats on cash penalties in their securities annual report, and should have this data readily available for most major European markets.

<ESMA\_QUESTION\_CSDR\_21>

1. 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.

<ESMA\_QUESTION\_CSDR\_22>

We do not think progressive penalty rates would be justified and strongly discourage ESMA against their use.

**Older fails make-up a minority of fails** – Anecdotal discussion among buy-side firms and their clients suggest that many failing trades are resolved on day 1, with only a small percentage of trades failing past 3 days. This is supported by the T2S 2022 report (https://www.ecb.europa.eu/paym/intro/publications/html/ecb.t2sar2022.en.html#toc11), chart 15 which shows a steep drop in failing trades after day 1 and 2.

We consider that progressive cash penalties would carry a significant operational footprint, but will only impact a relatively small proportion of outstanding cash penalties.

**Operationally Complexity** - The existing cash penalty framework has already been difficult to implement but becomes harder still with the potential introduction of progressive penalties. It can already be difficult to allocate or reclaim a cash penalty.

We do not think introducing progressive penalty rates is operationally proportionate to the value of the penalty and will divert resource from the improvement of settlement efficiency into the operational process of cash penalties. The operational cost of processing cash penalties is already higher than the value of the penalty credits in some cases, but would become much higher still with progressive penalties.

When setting the mechanics of the CSDR cash penalty mechanism, ESMA should consider the impact on how cash penalties (credits/or debits) are passed down the settlement chain to the end investor/buyer/seller and also how a manual claim function may operate given cash penalties are not always punitive to the party truly at fault.

<ESMA\_QUESTION\_CSDR\_22>

1. 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.

<ESMA\_QUESTION\_CSDR\_23>

We do not think convexity should be introduced for the same reason as outlined in our response to question 22.

<ESMA\_QUESTION\_CSDR\_23>

1. 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.

<ESMA\_QUESTION\_CSDR\_24>

We do not think convexity should be introduced for the same reason as outlined in our response to question 22

<ESMA\_QUESTION\_CSDR\_24>

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

**a) as proposed under Option 1?**

**b) as proposed under Option 2?**

<ESMA\_QUESTION\_CSDR\_25>

We do not think progressive cash penalty rates should be introduced per our answer to question 22.

We think recalibrations to the existing rate should be considered instead.

<ESMA\_QUESTION\_CSDR\_25>

1. 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.

<ESMA\_QUESTION\_CSDR\_26>

The industry is already seeing a reduction in settlement fails and we consider the cash penalty regime to still be in its infancy. We do see scope for improvements in settlement efficiency and therefore a potential recalibration and increase in cash penalty rates but believe that this should be very carefully measured against the potential impact to EU market liquidity and pricing. ESMA should move carefully to ensure that any changes to cash penalties do not negatively impact the end investor.

We believe that the 600% increase proposed in the ESMA consultation (scaling up to a 2500% increase on day 6 in some cases) is a disproportionately high rate and will have a significant negative impact on market liquidity and competitiveness in the EU.

A cash penalty regime with excessive rates will likely work counter-intuitively, as liquidity providers will likely price any additional costs into product pricing, which would then be passed back to the client being failed into. This may entirely offset cash penalty credits, and potentially also result in overall thinner liquidity for the market.

This is a concern for ETF products in particular, which we cover in the subsequent question response.

We do not have sufficient information to ascertain at what level of cash penalties brokers will impose additional costs on the market and urge ESMA to perform a deep dive analysis on this aspect. As a very rough guide, any increases in the first instance should be limited to 50% of current values at the very most.

**A potential option to incorporate funding costs into flat cash penalty rates could include a benchmarking against overnight funding rates.**

For example, cash penalties could be reviewed and calibrated against the ESTR rate on a periodic (e.g. yearly) basis with a reference date:

* As of 27th February the ESTR rate is 3.904% which represents a ~1.07 basis point charge per day.
* This could include a multiplier (between 0 and 1) against different product types. For example, against current rates this could include no multiplier against liquid equities (making the charge 1.07 bps per day vs 1.0 as of today) but a 0.5 multiplier against non-liquid equities (0.504 bps per day vs 0.50 as of today)
* We believe this multiplier should be determined after careful consideration with the industry. As noted previously, any changes should result in penalties no more than 50% higher than today.
* We appreciate this may need a “floor” basis point per day charge depending on the current funding rate (e.g. when it’s near or below zero),. This could be the same charge as it is today (1 basis point per day for liquid equities with different multipliers for different products).
* This should remain a flat rate that is changed no more regularly than yearly.

<ESMA\_QUESTION\_CSDR\_26>

1. 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.**

<ESMA\_QUESTION\_CSDR\_27>

**Categorization of asset types**

We agree with the categorisation of asset types under option 1 (penalty rates split per existing asset class rather than liquid/illiquid). This leaves ESMA and the Commission with the best flexibility to apply penalty rates depending on instruments that are most impacted by low settlement rates. If all asset classes were instead categorised by liquid or illiquid, it would remove agency from ESMA to determine fail rates for a particular asset class (e.g. if liquid equities had high fail rates but liquid fixed income had low fail rates).

In addition the market has already undertaken a significant CSDR cash penalty implementation build according to the categories of option 1, maintaining these categories reduces implementation costs.

**ETFs**

We agree with the split out of ETFs under a separate category. This will enable more focussed analysis and action on ETF settlement efficiency.

**Overview of factors limiting timely settlement of European ETFs**

European ETFs are typically issued under the EU’s UCITS framework and simultaneously listed, traded, and settled in multiple currencies across different jurisdictions in the EU, the UK, Switzerland and the Nordics, without a primary venue. As such, flow and liquidity for European ETFs remains fragmented across multiple market centres. Structural limitations of European capital markets – notably a lack of real-time transparency on ETF trading data, insufficient depth of securities financing market for ETF shares, localised settlement requirements, operational inefficiencies associated with lack of interconnectedness amongst national CSDs – coupled with a wide range of product offerings, often pose significant challenges with the efficient recycling of ETF shares inventory. In our consultations with different market participants – ETF issuers, market makers and investors – this matrix of factors is often attributed to high instances of settlement fails for European ETFs.

**Our view of the impact of ESMA’s proposed penalties on ETF trading**

Owing to the aforementioned limitations arising from European capital market structure, our view is that the proposed increase in penalties for failed settlement may not be as effective in solely addressing the underlying challenges with European ETF settlement. We also caution ESMA that in the absence of structural improvements, higher settlement failure charges would be detrimental to the existing efficiency of European ETF ecosystem as low-cost financial instruments. Market participants – especially brokers intermediating the flow of ETF shares across different market centres – may factor in the penalties in the transaction costs they charge to end-investors and/or may withdraw their activity in certain ETFs. This will be detrimental to the domestic and international competitiveness of UCITS ETFs.

**Our recommendations on improving the ETF settlement efficiency in Europe –**

**1. We welcome ESMA’s proposal in the current CSDR consultation for creating a standalone category for ETF settlement penalties** - Going forward, this categorisation will naturally drive more focussed action on improving settlement rules and practices underlying ETFs.

**2. We recognise ESMA’s proposal to increase the current settlement penalty charges, as an effective disincentive against “actionably avoidable” fails** - However, we believe the potential costs associated with the current proposed charges is disproportionately higher than the perceived benefits.

**3. We recommend cash penalties, including ETFs, be periodically benchmarked against a short-term financing benchmark such as the ESTR** - We discourage the use of any other benchmark such as ETF stock borrow charges.

**4. We do not support the proposal for progressive penalties** – Our ETF issuing member firms suggest a high volume of ETF orders are settled within 3-4 days of trade execution and progressive increase in penalties are unlikely to have any meaningful impact on expediting settlement. Instead, we recommend ESMA to have a flat rate of penalty.

5. A more detailed analysis of ETF settlement fails must be carried out to understand and delineate various issues underlying ETF settlement fails - To this effect, we recommend ESMA must make public the current mandatory reporting of ETF settlement data by EU CSDs.

6. We also recommend a periodic review – every 12-24 months – of the settlement efficiency and the impact (and any changes) to current penalty regime - Such a review will also help ESMA calibrate an appropriate roadmap to accelerating the settlement cycle for EU capital markets. be considered when considering the application of cash penalties against these products.

<ESMA\_QUESTION\_CSDR\_27>

1. 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.

<ESMA\_QUESTION\_CSDR\_28>

|  |  |  |
| --- | --- | --- |
| **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** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Compliance costs:**  **- One-off**  **- On-going** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Costs to other stakeholders** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Indirect costs** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **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** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Compliance costs:**  **- One-off**  **- On-going** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Costs to other stakeholders** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Indirect costs** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |

No IA response

<ESMA\_QUESTION\_CSDR\_28>

1. 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.**

<ESMA\_QUESTION\_CSDR\_29>

We do not think progressive cash penalty rates should be introduced per our answer to question 22

|  |  |  |
| --- | --- | --- |
| **Progressive penalty rates – respondent's proposal** *(if applicable)* |  | |
|  | **Qualitative description** | **Quantitative description/ Data** |
| **Benefits** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Compliance costs:**  **- One-off**  **- On-going** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Costs to other stakeholders** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Indirect costs** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |

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<ESMA\_QUESTION\_CSDR\_29>

1. 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.

<ESMA\_QUESTION\_CSDR\_30>

We do not think that progressive cash penalty rates should be introduced per our answer to question 22.

For the same reason, we do not think that cash penalty rates should be adjusted based on the value of the settlement fail. It will impose significant additional costs on the CSD, CSD participant and down the settlement chain in calculating the differing rates with little expected impact on prioritisation.

It’s unclear from the consultation whether ESMA believe low or high value cash penalties should be prioritised.

The only proportionate variation of this that we can see is a de-minimis value, at which no cash penalties get posted by the CSD (see our response to question 46).

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| **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** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Compliance costs:**  **- One-off**  **- On-going** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Costs to other stakeholders** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Indirect costs** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |

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<ESMA\_QUESTION\_CSDR\_30>

1. 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.

<ESMA\_QUESTION\_CSDR\_31>

The operational complexity of any proposed cash penalty rates should be considered.

Additionally – The potential impact of cash penalty rates on the competitiveness and potential pricing of different instruments within the EU should be considered. Significantly high cash penalty rates will likely mean additional costs to the sell-side which may be factored into pricing and spreads, ultimately harming the end investor

<ESMA\_QUESTION\_CSDR\_31>

1. 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.

<ESMA\_QUESTION\_CSDR\_32>

We believe that the current process of reference data is sufficient in calculating the cash penalty.

Using a daily reference price will mean the value of the cash penalty is pegged to the value of settling the stock, which wouldn’t be the case with a flat reference price.

|  |  |  |
| --- | --- | --- |
| **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** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Compliance costs:**  **- One-off**  **- On-going** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Costs to other stakeholders** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Indirect costs** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |

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<ESMA\_QUESTION\_CSDR\_32>

1. 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.

<ESMA\_QUESTION\_CSDR\_33>

We believe that they should be subject to the same penalty rates as DvP transactions for the symmetry element.

If a failing deliver is contingent on a failing borrow, the counterparty in the middle should see the same values each way and be neutral. Removing this symmetry will negatively impact any counterparts who have delivers contingent on receipts and will likely cause a drop in market liquidity as firms consider waiting until stock is received before instructing an onward transaction.

<ESMA\_QUESTION\_CSDR\_33>

1. 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.

<ESMA\_QUESTION\_CSDR\_34>

If the penalty rates remain the same across DvP and FOP transactions and the rates do not increase significantly, we do not think that this will become an issue.

For standard buy/sell transactions, counterparts will want to continue using DvP/RvP transactions to minimise settlement risk. FOP transactions are used for internal movements or for collateralised movements such as securities lending.

<ESMA\_QUESTION\_CSDR\_34>

1. 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.

<ESMA\_QUESTION\_CSDR\_35>

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

We do not believe this category is necessary. The current asset class splits of CSDR cash penalties work well with the exception of ETFs, which should be a new asset class.

<ESMA\_QUESTION\_CSDR\_35>

1. 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.

<ESMA\_QUESTION\_CSDR\_36>

No IA response

<ESMA\_QUESTION\_CSDR\_36>

1. 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.

<ESMA\_QUESTION\_CSDR\_37>

There is a natural incentive pre-dating CSDR cash penalties to settle transactions as a means of managing ongoing relationships and encouraging an ongoing trading relationship.

If a counterpart was found to be actively taking measures to earn cash from failing transactions, they would develop a poor reputation and firms would consider reducing or stopping trade volume with that counterpart.

That being said, the cash penalty rates applied should not be excessively high such that they incentivise this behaviour (e.g. 6 bps per day).

It should also be pointed out that a counterpart that is being failed into may want to avoid agreeing to a manual partial or auto-partial settlement anyway to avoid an “inaccurate” penalty, as outlined in our response to question 16. In this case a counterpart is avoiding an incorrect penalty rather than purposely trying to block settlement, despite not agreeing to a partial.

<ESMA\_QUESTION\_CSDR\_37>

1. 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.

<ESMA\_QUESTION\_CSDR\_38>

ESMA should semi-regularly (every 1-2 years) take stock of cash penalties and re-calibrate them according to settlement and interest rates.

<ESMA\_QUESTION\_CSDR\_38>

1. 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).**

<ESMA\_QUESTION\_CSDR\_39>

We do not think that cash penalties should only be applied to CSDs with higher settlement fail rates. CSDs and markets should be incentivised to keep improving as long as other CSDs receive them.

<ESMA\_QUESTION\_CSDR\_39>

1. 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.

<ESMA\_QUESTION\_CSDR\_40>

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

No IA response

<ESMA\_QUESTION\_CSDR\_40>

1. 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.

<ESMA\_QUESTION\_CSDR\_41>

TYPE YOUR TEXT HERE

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

We believe that all transaction types should bear the same penalty rates as per our response to question 33

<ESMA\_QUESTION\_CSDR\_41>

1. 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).

<ESMA\_QUESTION\_CSDR\_42>

We do not think that cash penalty rates should depend on stock borrowing fees, which can fluctuate regularly, but should instead remain consistent at a flat rate to be set and periodically assessed against a funding benchmark.

We do not think that firms make a decision to either borrow the stock or suffer the cash penalty depending on the value of the penalty. Instead, counterparts (notably brokers) will typically borrow based on a holistic view of the net quantity of expected receipts and delivers on a given day. This was the case prior to CSDR cash penalties and occurs in jurisdictions where cash penalties do not apply, such as the US.

<ESMA\_QUESTION\_CSDR\_42>

1. 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.

<ESMA\_QUESTION\_CSDR\_43>

ESMA should mandate CSDs to resolve the issue in manually partialing failing trades where, when the recipient counterparty being failed into submits the new shapes second, they suffer the debit.

CSDs should develop a methodology to link the cancelled original trade to the new split shapes, such that the penalty direction remains the same. This will encourage more manual partialing of stock. We have proposed steps for this in our response to question 18.

Wide-spread use and adoption of auto-partialing should also resolve for this. All CSDs and a high proportion of custodians need to offer this for investment managers to adopt a homogenous approach.

|  |  |  |
| --- | --- | --- |
| **Respondent’s proposal** (if applicable) |  | |
|  | **Qualitative description** | **Quantitative description/ Data** |
| **Benefits** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Compliance costs:**  **- One-off**  **- On-going** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Costs to other stakeholders** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |
| **Indirect costs** | TYPE YOUR TEXT HERE | TYPE YOUR TEXT HERE |

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_43>

1. 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.

<ESMA\_QUESTION\_CSDR\_44>

Anecdotal feedback from members suggest that fail rates across the markets are broadly similar.

CSDs should have better access to this data for ESMA to undertake a more thorough analysis.

<ESMA\_QUESTION\_CSDR\_44>

1. 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.

<ESMA\_QUESTION\_CSDR\_45>

Our members and their clients have come across scenarios where custodians or prime brokers do not pass penalties onwards by default, or where it is a service offered by the custodian or prime broker.

Given some of the operational and potential regulatory challenges discussed in the rest of the response, some asset managers and their clients are happy to forego a net credit of CSDR cash penalties if it means foregoing the operational cost of investigating and processing of the penalties and potential regulatory impact of undue debits hitting a client account.

If cash penalties become more complex still given the proposals in this consultation, it may be that unsophisticated investors impacted by the above considerations further explore asking whether custodians or prime brokers can withhold all penalties.

<ESMA\_QUESTION\_CSDR\_45>

1. 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.

<ESMA\_QUESTION\_CSDR\_46>

A de-minimis can be discussed through two models:

**The minimum value de-minimis proposed in the consultation where a minimum value is applied (e.g. all penalties below EUR100 are boosted to be EUR 100).**

We think that this methodology would have a damaging effect on the cash penalty regime.

Having penalties at a minimum value would increase the operational complexity of penalties and make them difficult to manage.

It may also impact the shaping of transactions and liquidity in the market. Brokers and market-makers may shy away from smaller transaction sizes and shapes given the relatively higher punitive costs, reducing the liquidity of trading in smaller to medium value sizes. Reduced liquidity in these sizes of transactions will have a negative impact on retail investors.

**A de-minimis at which the CSD withholds cash penalties where the value of a cash penalty does not reach a certain value (e.g. nothing below a given value is posted)**

ESMA should explore a model whereby for immaterial cash penalties, the CSDs withhold the credit and debit to CSD participants given the operational cost of processing such small values would likely exceed the value of the penalty itself.

We appreciate the challenges in this, but think blocking low value penalties would satisfy the proportionality element of the CSDR consultation.

We will attach a PDF document as a case for a de-minimis alongside this response.

<ESMA\_QUESTION\_CSDR\_46>

1. 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.

<ESMA\_QUESTION\_CSDR\_47>

The time would depend on the changes proposed.

If a simple recalibration of a new flat rate is decided as we understand many respondents will ask for, 6-9 months could be sufficient. If ESMA introduce some of the proposed elements such as progressive penalties, convexity in rates and differing penalty rates per value, the time needed will be much longer and more like 18-24 months from the amendments being published as it will pose an additional tech build for processing cash penalties

<ESMA\_QUESTION\_CSDR\_47>

1. 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?

<ESMA\_QUESTION\_CSDR\_48>

As a trade association we do not discuss individual participants so do not have sight on this data. As the buy-side our members are unlikely to be detected in these lists.

It may be difficult for CSDs to provide this data given holdings through omnibus accounts.

<ESMA\_QUESTION\_CSDR\_48>

1. 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.

<ESMA\_QUESTION\_CSDR\_49>

Special penalties would not work if added on to the existing CSDR structure. Counterparts who fail more often already receive a higher proportion of cash penalties.

<ESMA\_QUESTION\_CSDR\_49>

1. 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?

<ESMA\_QUESTION\_CSDR\_50>

As a reminder of the requirement – “CSDs shall establish working arrangements with the participants referred to in fields 17 and 18 (top 10 participants failing in terms of value and quantity) of Table 1 in Annex I which have 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.”

We are not aware of any formal working arrangements with the top 10 failing participants but as the buy-side our members are unlikely to be captured within these participant lists.

<ESMA\_QUESTION\_CSDR\_50>

1. 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.

<ESMA\_QUESTION\_CSDR\_51>

We agree that this should be discussed at CSD User Committees.

We ask that CSDs be reminded of international investors and to seek representation from those communities where possible in these discussions.

<ESMA\_QUESTION\_CSDR\_51>