Reply Form

**to the Consultation Paper on Technical Advice on the Scope of CSDR Settlement Discipline**

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:

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

ESMA will consider all comments received by **9 September 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\_SETD\_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\_ SETD\_nameofrespondent.

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

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**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 Bank of New York Mellon SA/NV |
| Activity | Credit institution |
| Are you representing an association? |  |
| Country / Region | Belgium |

# Questions

1. Do you agree with ESMA’s proposal regarding the underlying causes of settlement fails that are considered as not attributable to the participants in the transactions? Please specify which cases you agree with and which cases you don’t agree with (if applicable). Please justify your answer and provide examples and data where available.

<ESMA\_QUESTION\_SETD\_1>

We agree with the proposal that the six cases/scenarios identified by ESMA should not be subject to cash penalties.

We do, however, believe that for two of the cases/scenarios, namely, suspension of trading, and sanctions, greater precision and clarification would be helpful.

We also note that in paragraph 8 (on pages 8 and 9) ESMA identifies that the start of insolvency proceedings should in some cases suspend the application of cash penalties. However, the scope of application of this suspension appears to be too limited; we suggest that this be broadened.

We also believe that the case of suspension of trading highlights a problem in ESMA’s approach to the definition of the scope of settlement discipline.

Additional details on these four topics are set out below.

1/ Suspension of trading

One of the cases for which ESMA is proposing that cash penalties do not apply is the case set out in paragraph 17, item b), specifically, “ISIN suspension from trading, such as for example under Article 32(1), Article 52(1), Article 69(2) of MiFID II or Article 40(1) of MiFIR”.

In this case, we are not certain that we understand ESMA’s proposal, and we are concerned that this case is not fully appropriate as a case for the non-application of cash penalties.

The extract in paragraph 8 on page 8 from the ESMA CSDR Q&A document states that “cash penalties should not be applied in the following situations where settlement cannot be performed for reasons that are independent from the involved participants” (underlining added) and includes in the list of situations the situation of a suspension or removal from trading.

We believe that it is possible for a suspension of trading, or removal from trading, to occur on one or other trading venue without necessarily the issuer CSD suspending settlement in that ISIN.

In the ESMA consultation document, the description in paragraph 17 (on page 11) of this case does not explicitly include the condition that settlement should not be possible. Accordingly, it is possible to interpret the ESMA proposal as being that a suspension or removal from trading is sufficient to suspend the application of cash penalties.

We would see such an interpretation as being problematic for several reasons. Firstly, it is not clear why a suspension of trading should, in itself, and with settlement continuing, result in the suspension of the application of cash penalties. Secondly, a CSD may not be aware of a suspension of trading on a trading venue, and may continue to apply penalties, thus creating the requirement for appeals. Thirdly, it would not be clear what should be done when one trading venue suspends trading, while trading continues on another trading venue.

We believe that a key driver for the suspension of cash penalties should be the suspension by the CSD of settlement.

Accordingly, we suggest that this case be redrafted in order to eliminate the connection with a suspension of, or removal from, trading. On this topic, please also see point 4/ below, and our answer to Question 3.

2/ Sanctions

As a general principle, we believe that rules relating to sanctions and to anti-money laundering derive from public order considerations that are broader than the considerations that underlie the rules on settlement discipline.

In line with this general principle, we fully support the approach that if settlement is halted or postponed for reasons relating to sanctions and to anti-money laundering then the application of cash penalties for late settlement should also be suspended.

In paragraph 18 (on page 11), ESMA makes the general point that “additional scenarios may be considered where settlement cannot be performed or has to be postponed for reasons that are independent from the involved participants”, and then provides two specific examples:

i. settlement instructions involving securities under sanctions or anti-money laundering proceedings

ii. settlement instructions put on hold due to the order issued by a court, the police or similar authority with relevant mandate.

We agree with this general point, and with the two examples.

However, as the text is not completely explicit, we would like to stress three important points with relation to these two examples.

The first is that sanctions, and anti-money laundering proceedings, may apply to issuers, and to securities issued by those issuers, but they may also apply to CSD participants, intermediaries and trading parties.

The second is that intermediaries and trading parties may be direct CSD participants, but they may also be clients, or indirect clients, of the direct CSD participants.

The third is that EU CSDs and EU intermediaries are obliged to comply with sanctions and anti-money laundering proceedings not just from EU authorities, but also from some non-EU authorities.

To the greatest extent possible, the suspension of cash penalties should apply when settlement is halted in any of these specific cases and should apply when settlement is halted both through the action of a CSD, and through the action of a CSD participant.

3/ Scope of application of suspension as a result of insolvency

As with the application of rules relating to sanctions, we believe, as a general principle, that rules relating to insolvency derive from public order considerations that are broader than the considerations that underlie the rules on settlement discipline.

In line with this general principle, we fully support the approach that if settlement is halted or postponed for reasons relating to insolvency then the application of cash penalties for late settlement should also be suspended.

In paragraph 8 (on page 8), ESMA identifies that penalties for late settlement should no longer apply with relation to the activity of a CSD participant that is insolvent.

We agree with this view but wish to highlight that this approach should apply both when an insolvent trading party is a direct CSD participant, and when an insolvent trading party is a client, or indirect client, or a CSD participant.

4/ Definition of scope of settlement discipline measures

There is a fundamental problem in the discussion in paragraph 17 (on page 11) of the scope of settlement discipline.

This discussion appears to suggest that the same scope should apply to the cash penalty regime, to the mandatory buy-in regime and to settlement fails reporting.

Such an approach is highly problematic. These three measures are very different in nature, and apply to very different activities, so that the scope of these measures should be different. Using the same scope will create anomalies.

One example of an anomaly caused by applying the same scope is the case of a suspension or, or removal from, trading. As set out above, if a security is suspended or removed from trading, then it probably is not necessary or appropriate to suspend the cash penalty regime. But in such a case there is a strong rationale for any buy-in obligations to be suspended, as – if trading is suspended – it would not be possible to effect a buy-in.

<ESMA\_QUESTION\_SETD\_1>

1. ESMA would like to ask for the stakeholders’ views on the costs and benefits of the implementation of the respective exemptions from settlement discipline (based on the underlying causes of settlement fails that are considered as not attributable to the participants in the transactions). 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’s proposal - underlying causes of settlement fails that are considered as not attributable to the participants in the transactions** |  | |
|  | **Qualitative description** | **Quantitative description/ Data** |
| **Benefits** |  |  |
| **Compliance costs:**  **- One-off**  **- On-going** |  |  |
| **Costs to other stakeholders** |  |  |
| **Indirect costs** |  |  |

<ESMA\_QUESTION\_SETD\_2>

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<ESMA\_QUESTION\_SETD\_2>

1. Do you have other suggestions regarding the underlying causes of settlement fails that are considered as not attributable to the participants in the transactions? Please justify your answer and provide examples and data where available.

<ESMA\_QUESTION\_SETD\_3>

We do note that in paragraph 18 (page 11) ESMA suggests that the six cases/scenarios set out in paragraphs 17 and 18 may not be exhaustive. We agree with this suggestion.

As mentioned in our answer to Question 1, the most basic case of a settlement fail that is not attributable to a participant arises when a CSD suspends settlement.

We do agree that the six cases/scenarios will cover many cases in which a CSD suspends settlement. However, we are not fully certain that these six cases/scenarios will cover all situations in which a CSD suspends settlement.

Accordingly, we would suggest adding an extra case/scenario covering simply the case of a CSD suspending settlement.

As also mentioned in our answer to Question 1, we are concerned that the six cases/scenarios do not cover all the possible cases/scenarios associated with sanctions and insolvency. Accordingly, there may be a rationale for adding additional cases/scenarios.

<ESMA\_QUESTION\_SETD\_3>

1. If you have answered yes to the previous question, 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** |  |  |

<ESMA\_QUESTION\_SETD\_4>

The main benefits of a rule that penalties are suspended when the CSD suspends settlement are (i) simplicity in definition, (ii) compliance with the principle that a penalty should not be imposed if the cause of the fail is not attributable to the participant, and (iii) operational ease and simplicity in that a CSD that suspends settlement is necessarily aware of the suspension and can at the same time suspend the application of the cash penalty regime.

<ESMA\_QUESTION\_SETD\_4>

1. Do any of the exemption proposed above breaks the immunization principle? Please provide arguments.

<ESMA\_QUESTION\_SETD\_5>

At a high level, any exemption does create a risk that the immunisation principle will be breached.

The actual risk that an exemption creates a breach in the immunisation principle will vary considerably by the type of exemption, but even for very low risk exemptions there is still the possibility of a breach of the immunisation principle.

As an example of this last point, if settlement in a particular ISIN is suspended, and if all penalties for all transactions in that ISIN are suspended, so that the immunisation principle is preserved for transactions in that ISIN, there is still the risk that a party with a delivery against payment transaction in that security suffers a penalty for a receipt against payment transaction in another security, if this second transaction is failing because of insufficient cash.

The immunisation principle is an important principle, and it is important to preserve it to the greatest extent possible, but it is not the only relevant consideration.

Fairness is also a relevant consideration. If a party fails to deliver through no fault of its own, then there is a valid reason why a penalty should not be applied.

Similarly, the core justification for the existence of the penalty mechanism is to improve settlement efficiency, but if settlement is not possible then this justification disappears.

The immunisation principle is not an absolute principle. If it is breached, the effects can be mitigated by a bilateral claim between parties. The core rationale for the immunisation principle is that it creates operational efficiencies by minimising the need for burdensome, manual bilateral claims.

The exemptions that are proposed by ESMA, and by BNY in our answer to Question 3, may in some cases breach the immunisation principle, but in general the practical impacts will be relatively limited, and the exemptions will have the benefit of avoiding the need for bilateral claims to rectify inappropriately applied penalties.

As mentioned above, the suspension of all penalties in a particular ISIN will result in very few breaches of the immunisation principle, even though it may not totally avoid the risk of a breach.

There is a greater risk of the breach of the immunisation principle when there is a suspension of penalties for transactions involving a specific trading party, as a result, for example, of insolvency, sanctions, or a court judgement. This is because counterparties of that trading party may be directly impacted, as, for example, they may not receive penalties on failing receipts in a particular ISIN, but they may have to pay penalties on failing deliveries in that ISIN.

Despite such possible breaches of the immunisation principle, we do not believe that this would eliminate the justification for exemptions from cash penalties in the cases of insolvency, sanctions, or a court judgement. On this point, please also see our answer to Question 1/.

Nonetheless, it is important to take steps to mitigate the impact of breaches of the immunisation principle. One important mitigating step would be to reduce the recycling period for failing matched transactions.

We believe that the current recycling periods for failing matched transactions are too long, and this creates multiple problems. For more information on this point, as well as a specific proposal to limit such recycling periods to twenty business days after intended settlement date, please see our response to the ESMA Consultation Paper on Technical Advice on CSDR Penalty Mechanism dated 15 December 2023, and, specifically, our answers to Questions 6, 11 and 37 of this consultation paper.

<ESMA\_QUESTION\_SETD\_5>

1. Which of the exemptions proposed above do you think can be filtered out before penalties are applied in an automated way? And which ones can only be exempted ex-post, as part of the already existing appeal mechanism at CSDs?

**Please provide details regarding the cost for ex-ante filtering compared to ex-post exemption via the appeal mechanism.**

<ESMA\_QUESTION\_SETD\_6>

We believe that the operational process for the management of exemptions should follow four distinct steps.

1/ To the greatest extent possible all exemptions should be built into the penalty identification, calculation, and allocation engine of the CSD, so that all penalties are calculated and allocated correctly at the source.

2/ If this is not possible, then CSDs should filter out the output of the calculation and allocation engine, so that any errors resulting from unapplied exemptions are identified and corrected before being passed on the CSD participants.

3/ In the event that this filtering process does not work, and incorrect penalties are passed on to CSD participants, then CSD participants should have the ability to request that the CSD corrects the incorrectly applied penalties.

4/ In the event that this correction process does not work, then trading parties will still have the possibility for a bilateral claim.

We would like to highlight that the correction process at the CSD (step 3/) should be made up of two distinct processes.

If the results from the steps 1/ and 2/ are incorrect (meaning, specifically, that the CSD has applied penalties that do not match the information (on exemptions etc) of which the CSD is aware at the time of application of the penalties, then the CSD should correct these penalties as soon as possible, and should not require that the corrections follow the formal CSD appeals process.

The CSD appeals process should be followed in cases in which the CSD has applied the penalties correctly in line with the information that was available to the CSD at the time of calculation, and in which the appeal is based on new information that is submitted to the CSD.

We believe that all suspensions of penalties that are based on the suspension of settlement in a particular ISIN can, and should, be handled in step 1/.

For the suspension of penalties relating to an individual trading party, we acknowledge that it may not be possible always to manage these penalties in step 1/, but we would see it as important that to the greatest extent possible these penalties be identified and managed in step 2/.

<ESMA\_QUESTION\_SETD\_6>

1. For exemptions that can be filtered out in advance, do you think that a CSD would prefer to implement this filter or not? Also considering the very large number of appeals they might have to deal with and also the costs it will entail.

<ESMA\_QUESTION\_SETD\_7>

We believe that CSDs have a basic obligation to apply the penalties mechanism correctly, and this should include taking account of any applicable exemptions.

From an overall cost perspective, it is cheaper to solve problems at the source, namely, steps 1/ and 2/, rather than to implement complex and burdensome manual processes (steps 3/ and 4/).

<ESMA\_QUESTION\_SETD\_7>

1. Do you agree with ESMA’s proposal regarding the circumstances in which operations are not considered as trading? Please specify which cases you agree with and which cases you don’t agree with (if applicable). Please justify your answer and provide examples and data where available.

<ESMA\_QUESTION\_SETD\_8>

It is important to distinguish between two categories of operations at the level of the CSD.

*Definition of two categories*

A first category of operations consists of technical operations carried out by a CSD, either following an external event (such as a corporate action announced by an issuer), or following an instruction by a single CSD participant (such as the exercise of rights associated with a securities position, making securities available for auto-collateralisation, instructing the registration of a securities position, etc). One key characteristic of such operations is that they are initiated by one party.

A second category of operations consists of bilateral transfers between two separate accounts at a CSD, and that are, in most cases, instructed by two separate parties, or by a party acting on a power of attorney put in place by the two parties.

Of the circumstances set out in paragraph 19 (on pages 13 and 14), we see items b, c, d, and e, as falling into the first category of operations.

We see item a, as covering operations that fall into both categories. We would see auto-collateralisation movements at the CSD as falling into the first category, while other free of payment transfers of securities collateral between two accounts at a CSD would fall into the second category.

With relation to item b, we note that this item covers corporate actions on stock, as well as one type of corporate actions on flows, namely, market claims, but excludes transformations. We agree with this definition of item b. In line with market standards, we believe that all the corporate actions listed under item b should be processed by CSDs, so that they can be treated as falling in the first category. But we do note that in some limited cases some CSDs do not process the full range of corporate actions listed in item b, so that market participants are forced to process these corporate actions on a bilateral basis. These cases will cause problems and complexity. (Please see our answers to questions 10 and 15 for more information on this point).

With relation to item c, we think that the description of this item should be modified so that it covers not just a transfer to the “issuer’s CSD account” but also to a distribution account. (For more information on this point, please see the description of a generic issuance process on pages 32 and 33 of [Annex 3 of the Final Report of the European Commission’s European Post Trade Forum](https://finance.ec.europa.eu/document/download/0481b029-e716-4474-9ac1-9b5819d7e26e_en?filename=170515-eptf-report-annex-3_en.pdf) (EPTF)). In this context, we would also like to highlight that issuance processes may be complex and may diverge from the generic process described in the EPTF Report. Specifically, an issuance process may involve additional, administrative transfers (that fall in category 2).

*Whether operations in category 1 should not be considered as trading*

With relation to the first category of operations, we believe that all operations that fall into this first category should not be considered as trading.

Specifically, this means that we agree with ESMA’s proposal that item a (for those operations that fall into first category of operations) and items b, c, d, and e, should not be considered as trading.

However, we believe that this list of types of operations that should not be considered as trading is incomplete, as there are additional types of operations that fall into the first category of operations. (Please see our answer to Question 10 for some more information on this point).

We also disagree with ESMA’s proposal to exclude the creation and redemption of ETFs from item d. We see no reason for distinguishing between ETFs and other fund units and thus disagree with this exclusion of ETFs from item d.

*Whether operations in category 2 should not be considered as trading*

We believe that some operations in the second category should be not considered as trading, as they are administrative in nature, while other operations in this category should be considered as trading.

We would agree that some of the category 2 operations that fall under item a should not be considered as trading. But, overall, we see the description of item a as being unclear, and as inadequate in providing guidelines to distinguish between operations that should not be considered as trading, and those that should.

Please see our answer to Question 10 for a full discussion on which category 2 operations should not be considered as trading, and for a fuller explanation as to why the definition of item a is unclear and inadequate.

<ESMA\_QUESTION\_SETD\_8>

1. ESMA would like to ask for the stakeholders’ views on the costs and benefits of the implementation of the respective exemptions from settlement discipline (based on the circumstances in which operations are not considered as trading). 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’s proposal - circumstances in which operations are not considered as trading** |  | |
|  | **Qualitative description** | **Quantitative description/ Data** |
| **Benefits** |  |  |
| **Compliance costs:**  **- One-off**  **- On-going** |  |  |
| **Costs to other stakeholders** |  |  |
| **Indirect costs** |  |  |

<ESMA\_QUESTION\_SETD\_9>

Please see out answer to Question 11.

<ESMA\_QUESTION\_SETD\_9>

1. Do you have other suggestions regarding circumstances in which operations are not considered as trading? Please justify your answer and provide examples and data where available.

<ESMA\_QUESTION\_SETD\_10>

As set out in our answer to question 8, here are our suggestions as to (i) additional examples of operations that fall into category 1, and, thus, that should not be considered as trading, (ii) how to distinguish between category 2 operations that should not be considered as trading, and those that should, and (iii) why the definition of item a is inadequate.

(i) additional examples of operations that fall into category 1 (and that should not be considered as trading)

1. Securities movements at a CSD reflecting the registration of securities positions

(ii) how to distinguish between category 2 operations that should not be considered as trading, and those that should

In most cases, category 2 operations, as they are bilateral, reflect some form of trading.

However, there are bilateral transfers that are administrative in nature, and that do not reflect trading activity.

Some examples of an administrative activity are:

1. A portfolio transfer whereby an end investor transfers securities from one custodian to another and/or from one CSD to another.
2. Transfers of securities between a depositary receipt (DR) issuer and an investor as part of the process of converting underlying securities into DRs or DRs into the underlying securities.
3. Transfers of securities by an investor to an account held by the investor at a triparty collateral management agent, so that that investor can use the services of the triparty agent in the provision of collateral to a third party.
4. Transfers of securities by an investor from an account held at a triparty collateral management agent to an account of the investor at a custodian or CSD, as part of the process whereby the investor is withdrawing its securities from the triparty agent.
5. Technical account transfers between two separate accounts of the same CSD participant.
6. As part of an issuance process, transfers of securities to one or more additional distribution accounts.

A very common characteristic of an administrative transfer is that the end investor/beneficiary does not change as part of the transfer. It is, of course, the case that an administrative transfer may be followed by separate transfer that does reflect trading activity.

One case of an administrative transfer that is complex, and that will need more analysis and consideration, is the case, mentioned in our answer to question 8, of a corporate action that cannot be processed by a CSD, and that market participants have to process bilaterally. (On this point, please also see our answer to question 15, and the discussion on the use of transaction type codes).

(iii) why the definition of item a is inadequate

The definition of item a (in paragraph 19 on page 13) is the following:

*free-of-payment (FoP) securities transfers to securities accounts at CSDs in the context of the (de)mobilisation of collateral;*

This definition is very broad and covers a wide diversity of activities.

As mentioned in the answer to Question 8, this definition covers some technical operations carried out by a CSD that should not be considered as trading. It also covers some administrative transfers that, as set out in point (ii) above, should not be considered as trading. But it also appears to cover transfers of collateral between two trading parties, and that take place in support of trading activity between the two parties.

<ESMA\_QUESTION\_SETD\_10>

1. If you have answered yes to the previous question, 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** |  |  |

<ESMA\_QUESTION\_SETD\_11>

As set out in our answers to Questions 8 and 10, we propose that the only types of operations that should not be considered as trading are (i) technical operations carried out by a CSD, and (ii) administrative transfers.

For these two types of operations, the application of cash penalties for late settlement is both inappropriate (given the nature of the operation) and burdensome (as there is a need for an operational process to manage the inappropriate penalties).

Accordingly, there are clear benefits if penalties are no longer applied to these types of operations.

No longer applying penalties for these types of operations will require CSDs to effect changes in their penalty identification, calculation and allocation engine, and may also require intermediaries in the custody chain to effect changes in their systems.

For technical operations carried out by a CSD, we would believe that these changes are relatively small, and relatively inexpensive, as CSDs can easily identify these operations. The impact for intermediaries is that they will no longer receive penalties, and will no longer incur time and cost in correcting inappropriate penalties.

But we do recognise that the changes will be potentially more costly for administrative operations. These operations are category 2 operations, and a CSD will in most cases receive instructions from two separate CSD participants. For the CSD to be able to identify a matched transaction as being an administrative operation, there will be a requirement that the CSD and the intermediaries in the custody chain have the ability to receive, process, and (where necessary) pass on relevant information.

The cost of these changes for CSDs and for intermediaries will depend in good part on the design of the information transmission mechanism.

Please see out answer to question 15 for a fuller discussion of this point.

<ESMA\_QUESTION\_SETD\_11>

1. Do any of the exemption proposed above breaks the immunization principle? Please provide arguments.

<ESMA\_QUESTION\_SETD\_12>

Some of our answer to question 5 is relevant for this question.

However, it is important to emphasise that there is a major difference between an exemption based on a cause of failure (question 5) and an exemption based on a type of activity (this question).

An exemption based on a cause of failure may apply to many different types of operations between many different parties (including between different trading parties), and thus may create many different possibilities for the breach of the immunisation principle.

An exemption based on a type of activity will apply just to specific range of operations.

We believe that applying an exemption just to CSD technical operations and to administrative operations will result in very few, if any, breaches of the immunisation principle. This is because such operations do not reflect trading activities, and there are not two trading parties. Penalties on such operations typically accrue to the same party, and thus are in any event netted.

In this context, one other relevant consideration is that the application of the exemption for administrative operations will be conditional on explicit and matching instructions from both instructing parties. If one of the instructing parties would be disadvantaged by the application of the exemption, then presumably that instructing party would not send its settlement instruction in a form that would trigger the exemption.

<ESMA\_QUESTION\_SETD\_12>

1. Which of the exemptions proposed above do you think can be filtered out before penalties are applied in an automated way? And which one can only be exempted ex-post, as part of the already existing appeal mechanism at CSDs?

**Please provide details regarding the cost for ex-ante filtering compared to ex-post exemption via the appeal mechanism.**

<ESMA\_QUESTION\_SETD\_13>

Please see our answer to question 6 for some relevant background.

We believe exemptions for CSD technical operations and for administrative operations (as set out in our answers to questions 8 and 10) can, and should, be built into the penalty identification, calculation, and allocation engine of the CSD, so that all penalties are calculated and allocated correctly at the source.

<ESMA\_QUESTION\_SETD\_13>

1. For exemptions that can be filtered out in advance, do you think that a CSD would prefer to implement this filter or not? Also considering the very large number of appeals they might have to deal with and also the costs it will entail.

<ESMA\_QUESTION\_SETD\_14>

Please see our answer to question 7.

In this context, we would like to highlight a scenario in which there is a risk of duplicate penalties.

Such a risk occurs in the case of manual partial settlement. Manual partial settlement can occur if a delivering party has insufficient securities to settle a delivery completely but has some securities that can be used to settle the delivery partially, and if the CSD does not have, or it is not possible to use, CSD functionalities for partial settlement. In such a case, it is common for each counterparty to cancel its original settlement instruction, and to replace it by two or more new settlement instructions, so that a settlement instruction can settle using the available securities. As a result, it is possible for penalties to be applied twice for the same time-period and for the same securities.

One major step to reduce this risk would be to improve the provision and use of automated partial settlement functionalities at the level of the CSD.

However, we also believe that more work is needed both at the level of market practice and at the level of the CSD to develop operational processes to reduce this risk.

<ESMA\_QUESTION\_SETD\_14>

1. Which transaction types based on the codes allowed by T2S (or potentially other codes such as ISO transaction codes) should be exempted from settlement discipline measures? Please provide the codes, their definition and arguments to justify the exemption.

<ESMA\_QUESTION\_SETD\_15>

As set out in our answer to question 8, there is an important distinction between category 1 and category 2 operations at a CSD.

*Exemption process for category 1 operations (CSD technical operations)*

For category 1 operations (CSD technical operations), CSDs have full information as to the nature of the operation, have full control as to the processing, including the choice as to which ISO transaction codes to use, and have the full technical ability to exclude these operations from the scope of the penalty mechanism.

Accordingly, for category 1 operations the ISO transaction type codes that should be exempted are those transaction type codes that are used by CSDs for these types of operation. These will undoubtedly include CORP and CLAI for corporate actions processing, but they should also include other transaction type codes that are used for other technical activities, such as registration movements and auto-collateralisation. (Please see our answers to questions 8 and 10 for more information on these points).

*Exemption process for category 2 operations (bilateral transfers)*

For category 2 operations (bilateral transfers), CSDs need to receive from information as to the nature of the transfer, in order for the CSD to be able to determine whether a transfer is exempt from the penalty regime.

This raises two important questions, namely, (i) what the mechanism is whereby trading parties/end investors send this information to the CSD, and (ii) what the matching mechanism is for this information.

It is important to note that it will be necessary for both parties to the transaction to provide this information, and for the CSD to have a mechanism that matches the information provided by both parties. This is because, whether a transaction is exempt from the penalty regime may have financial consequences for both parties, so that both parties have explicitly to give their agreement for any exemption.

*Discussion - Mechanism for sending information to the CSD*

The core information that CSDs need to receive from both parties is the information (Yes/No) of whether an instruction, when matched, is exempt, or not, from the penalty regime.

As suggested by question 15, a specific field in a securities settlement instruction could be used to provide this information.

There are several different possibilities as to which field should be used, and how it is used.

Conceptually, the simplest solution would be to use one single field, and to have just two possible values for that field (Yes/No), as well as blank.

The text of question 15 suggests that the transaction type code field should be used. But it is important to note that there are other possibilities, such as a field providing information on whether (Yes/No) there is a change of beneficial ownership.

The transaction type code field has many different possible values, so this raises the question whether just one value (i.e. one specific transaction type code) is used to claim an exemption, or whether several different values (transaction type codes) can be used to claim an exemption. The text of question 15 suggests that multiple different transaction type codes could be used to claim an exemption.

*Discussion - Issues associated with the use of transaction type codes as carrier of information*

It is the case that the transaction type code field is designed to provide information as to the nature of a transaction, and thus it appears well-placed to provide information as to the whether a transaction should be exempt from the penalty mechanism.

However, there are several important challenges and issues associated with such a use of the transaction type code field.

These include:

1. Specification of the exact equivalence between a transaction type code and one or more types of activity that are out of scope of the CSDR penalty mechanism
2. Consistency and/or compatibility in the use of transaction type codes for different purposes

Transaction type codes are currently used for a variety of different purposes. It will be necessary for the use of such codes for the purposes of CSDR late settlement penalties to be consistent and compatible with other usages, both current and future.

In this context it is important to take account of the global dimension, as ISO standards are global standards, and as market participants will be located across the globe and will have activities in securities from many different countries, including from countries outside of Europe.

In Europe, some CSDs and settlement platforms currently use some transaction type codes for some specific operational purposes and impose restrictions on the use of some specific transaction type codes. For example, it may be the case that some CSDs and settlement platform limit the use of corporate action-related transaction type codes CSD technical operations, and refuse to accept such codes for bilateral transfers.

There is also the possibility that there will be future regulatory requirements, in the context, for example, of the FASTER withholding tax proposal, for the use of specific transaction type codes.

1. Development of a common understanding, and common market practice

There will be a need for market participants and all intermediaries, including CSDs, to develop a common understanding and common practice, as to what transaction type codes should be used for which purposes.

1. Adaptation costs (for all parties in the custody chain)

As mentioned in our answer to question 11, there will be adaptation costs for all parties in the custody chain from the trading parties to the CSDs, given that the usage of transaction type codes by all these parties will change. It is, for example, our understanding that not all CSDs use all transaction types. The size of these adaptation costs will depend on the magnitude and complexity of the new requirements.

*Discussion - Matching mechanism*

As set out above, there is a need for a bilateral matching mechanism, as whether a transaction is within scope of the penalty mechanism may have financial consequences for the instructing parties.

There are three main options as to how the matching process could be designed:

1. Mandatory matching field for settlement: the field in the securities settlement instruction containing information on the exemption status becomes a mandatory matching field for all settlement instructions.
2. Additional matching field for settlement: if a securities settlement instruction has the relevant field populated with a value that claims an exemption from the penalty mechanism, then this field becomes a mandatory matching field for any matching instruction. This is a variant on the T2S concept of an “additional” matching field.
3. Matching for exemption: the value in the relevant field for claiming an exemption has no impact on the matching for settlement, but the exemption from the penalty mechanism is granted only if the same value claiming exemption is present in the relevant field in the two matched settlement instructions.

Of these options, option 3) will most probably be the simplest to implement, as it has no impact on the matching mechanism for settlement, and has the benefit, compared to options 1) and 2), that it does not lead to an increase in settlement fails. Option 3) has the feature that an instructing/trading party not claiming an exemption on an instruction can be certain that no exemption will be applied. However, an instruction/trading party that is claiming an exemption on an instruction cannot be certain that the exemption will be applied (as the application depends on the counterparty’s instruction).

By contrast, option 2) will avoid this problem, as any claim for an exemption will make the relevant field a mandatory matching field, so that either the counterparty agrees with the exemption, or the instruction does not match.

For this reason, option 2) has the disadvantage that it may lead to an increase in mismatches, and, in consequence, to failed settlements. Option 2) is also a relatively complex option and in many CSDs it may be difficult and expensive to implement. However, it may also be the case that T2S already has some functionalities, such as the ability to create specific CSD restrictions, that may be helpful.

Option 1 would be a far-reaching option, especially if it applied to the transaction type code field, as this field has many different possible values, and as there are issues with respect to the use of this field (see above). If this option applied to the transaction type code field, then it is to be anticipated that there will be a significant increase in settlement fails. Option 3) may also require significant changes to the core matching engine of a CSD.

*Conclusions / Suggestions for category 2 operations (bilateral transfers)*

We believe that eliminating penalties on CSD technical operations and on administrative operations has the potential to reduce overall costs and improve efficiency in the settlement process.

At the same time, we concerned that the design of the future exemption mechanism will be overly complex and will require a costly implementation by all parties in the custody chain, from trading parties to the CSD.

Specifically, we believe that for category 2 operations (bilateral transfers) the use of the transaction type code field, and the use of multiple values for this field, may require significant adaptation efforts by all parties.

Accordingly, we would suggest that ESMA review alternative options, including the use of a single field, with the use of just three possible values (Yes/No/Blank).

If ESMA decides on the transaction type code field is used, together with the option of using multiple different values to claim an exemption, then we suggest that at a minimum the list includes the following codes:

* PORT
* REAL
* RELE

as well as specific codes to cover free of payment securities transfers to/from triparty collateral management providers, as well as administrative transfers in the process of issuance of a security.

<ESMA\_QUESTION\_SETD\_15>