

CSDR Cash Penalty Regime --- Best Practice Recommendations

1 Article 6 notification requirements

1.1 As a measure to prevent settlement failure, Article 6 of CSDR obliges an EU investment firm executing a block trade with a professional client to require that client to promptly communicate the information needed by the investment firm to instruct settlement. Such instructions are especially vulnerable to delay because the client will need to confirm acceptance of the terms of the block trade and to make and inform the investment firm of the allocation of that block trade to the client's own clients. Note that the regulatory obligation lies solely on the investment firm and, to meet that obligation, the firm will need to contractually bind its professional client into the process, whether or not they are in the EU or in a Third Country. Those contractual arrangements must be in place with existing professional clients by 1 February 2022.

1.2 However, the regulatory requirements for prompt communications under Article 6 of CSDR do not apply where:

1.2.1 the investment firm is the custodial agent for the professional client and holds both securities and cash on its behalf; or

1.2.2 the required settlement data is available in advance of the regulatory deadlines.

1.3 However, the regulatory requirements for prompt communications under Article 6 of CSDR do apply, an investment firm must require its professional clients to send, within specified deadlines:

1.3.1 written notice of the allocation of each block trade executed with the investment firm to the professional client's own clients which identify the sub-client accounts to be credited or debited with securities or cash;

1.3.2 written confirmation of the professional client's acceptance of the terms and conditions of each block trade with the investment firm.

1.4 Notices of allocations and confirmations of terms must be sent so that they are received by the investment firm by:

1.4.1 the close of business of the investment firm on the trade date (T), where the investment firm and professional client are operating in the same time zone; or

1.4.2 close of business of the investment firm on the business day following the trade date (T+1), where the time zones of the investment firm and professional client differ by more than two hours or orders have been executed after 16:00 in the time zone of the investment firm.

1.5 In response to notices of allocation and confirmations of terms, an investment firm must send acknowledgements to a professional client within two hours of receipt.

1.6 Contrary to what might be implied from the regulations, the processes of sending notices of allocations and confirmations of the terms of a block trade are independent and not sequential.

1.7 The contractual arrangements between the investment firm and the professional client make may take any form deemed effective by the parties, provided they are clear as to the responsibilities of the two parties and the consequences of a failure to send notices and confirmations on time or at all. The contractual arrangements should include a definition or a reference to a definition of the close of business of the investment firm for the purposes of

receiving and acting upon notices of allocations and confirmations. Where notices or confirmations are received on or after the specified close of business, they should be deemed as having been received on the next business day of the investment firm. The contractual arrangements should also specify the information additional to that specified in Article 2(1) of the relevant RTS that is required by the investment firm to facilitate settlement.

- 1.8 Upon receipt of a notice of allocation from a professional client, an investment firm should timestamp and then validate the notice by checking that all the required data field specified in Article 2(1) of the relevant RTS and any other information required by the investment firm to facilitate settlement have been correctly populated. Errors and omissions should be promptly communicated to the professional client.
- 1.9 Investment firms should have in place arrangements to promptly send notices acknowledging receipt from a professional client of notices of allocations and confirmations, at the latest, within two hours.
- 1.10 The receipt of notices of allocations and confirmations of terms by investment firms and the dispatch of acknowledgements of receipt to professional clients should be monitored against the deadlines set by the regulations or any earlier deadlines agreed by the parties and audited. A record of the timeliness of incoming notices and confirmations and of outgoing acknowledgements, and the validity of incoming allocations, should be maintained as proof of regulatory compliance in whatever form the investment firm deems suitable. There should be a documented process in place to monitor timeliness and validity, and to respond effectively to late or invalid messages. Breaches of the deadlines by an investment firm should be investigated and resolved as quickly as possible. Breaches of deadlines by and invalid notices of allocations from a professional client should be notified to the client with a request for them to investigate and resolve any problem, and such a request should be followed up until the problem is resolved.
- 1.11 Article 2 of CSDR requires investment firms to provide their professional clients with the option of sending notices of allocations and confirmations of terms “electronically, through the international open communication procedures and standards for messaging and reference data”.
- 1.12 Subject only to Article 2 (see 1.9 above), the particular technology used to transmit notices of allocation, confirmations of terms and receipt of these notices is not prescribed by regulation and is entirely the choice of the investment firm. However, the likely scale and urgency of the process of sending and receiving notices of allocations, confirmations of acceptance of terms and receipts means that best practice in fulfilling these regulatory requirements is only likely to be achieved through automation of the process.
- 1.13 The particular institutional arrangements used to transmit notices of allocation, confirmations of terms and receipt of these notices (eg inhouse processes versus outsourcing) is also not prescribed by regulation and is entirely the choice of the investment firm. Where third-party platforms are employed, these should provide the functionality needed for the regulatory process of notification, confirmation and receipt within the prescribed deadlines, and to record the performance of the process. Where such platforms generate receipts for incoming messages, these should stand as evidence of the time of receipt.

2 Bilateral restitution of penalty charges

- 2.1 Where a party to a repo has offered partial delivery but the counterparty has refused, with the result that the first party suffers a CSDR cash penalty charge for the whole amount of the failed settlement, the question has been raised as to whether it is best practice for the first party to be able to seek restitution of that part of the charge that could have been avoided by partial delivery?
- 2.2 On the one hand, it has been argued that such restitution could be seen as inappropriate for inclusion in best practice recommendations as it effectively mandates partialling and deprives parties, including those who cannot accept partial delivery for valid reasons, of due compensation for a failure by the seller to fulfil its obligation to deliver the whole of an agreed amount of securities or cash. On the other hand, it can be argued that the seller is just claiming back a credit to the second party to cancel a debit on the first party could have been avoided and that restitution would align with wider industry best practice, which is to encourage partialling as a means of enhancing.
- 2.3 On balance, however, claims for restitution where partial delivery is refused are not recommended as best practice, as such claims are likely to be contentious and lacking the support of an industry consensus, and that, while it is important to encourage partialling, it has to be recognized that there are good reasons why parties may not accept partial delivery and that the failing party has breached its contractual obligation to deliver the whole of an agreed amount of securities or cash. However, parties are free to agree restitution where partial delivery is refused but this should be agreed in advance of trading.
- 2.4 Where the reference price used in the calculation of a CSDR penalty charge by a Calculating CSDs is demonstrably anomalous, one party should be able to claim restitution for the excess charge due to the anomalous price.
- 2.5 **Partial settlement.** (1) In the event of a failed settlement between two CSD Participants who have agreed to auto-partialling, no action is required by those parties to reduce the size of the failed settlement and the consequent cash penalties. The reduction in the size of the failed settlement due to partial settlement should be communicated to the parties by their CSD.
- 2.6 Where partialling is a bilateral agreement between two CSD Participants, it will be the responsibility of each party to cancel their failed instructions and reinstruct for the residual quantity yet to be delivered. Reinstructions should retain the original ISD in order preserve the economics of the original trade. If cancellation and reinstruction by both parties takes place on the ISD, CSDR cash penalties will thereafter only apply to the residual quantity.
- 2.7 On the other hand, if the partial delivery is only agreed after the ISD, then CSDR cash penalties will have been levied on the original quantity from the ISD up to but excluding the date of cancellation and reinstruction. Upon cancellation and matched reinstruction by both parties, the Calculating CSD will levy a retrospective Late Matching Fail Penalty (LMFP) on the residual quantity back to the original ISD (because the reinstructions will match after the ISD) and will then start to levy a daily Settlement Fail Penalty (SEFP). However, the retrospective LMFP on the residual quantity from the ISD up to the date of cancellation and matched reinstruction is a double penalty, given that a penalty will already have been calculated (and, in the case of an SEFP, already levied) over that same period for the original quantity. Whichever party suffers this retrospective LMFP (whoever was last to cancel and reinstruct) should claim back the

LMFP for that period from the other party using the procedure covered in the Restitution FAQs.

2.8 For example, consider a scenario in which DVP settlement of 10 million nominal of a bond for an ISD of 7th January fails and the parties agree to a partial delivery of 9 million on 12th January. Assume that, on 12th January, both parties cancel their failed instructions and reinstruct for the original ISD of 7th January but for the residual amount of 1 million. The Calculating CSD will have levied CSDR cash penalties on 10 million from and including 7th January to but excluding 12th January. Because new instructions are sent on 12th January for an ISD of 7th January, the Calculating CSD would also levy an LMFP on 1 million from and including 7th January to but excluding 12th January. Assuming the reinstructions match on 12th January, the Calculating CSD will start to levy daily SEFPs on the delivering CSD Participant. However, the LMFP for the residual of 1 million from 7th to 12th January arising from the reinstructions represents a double penalty given that a penalty or penalties will also be levied for the whole 10 million over the same period. That LMFP should be reclaimed.

2.9 Where parties to a failed settlement agree bilaterally to partial settlement after the original ISD, it is best practice to agree the date on which the original settlement instructions are to be cancelled and reinstructions issued. Should one of the parties fail to cancel and reinstruct on the agreed date, that party would be liable for any LMFP for the delay from the ISD and would have no right to reclaim the LMFP for the period of the delay.

3 Invoice and billing CSDR cash penalties

3.1 Custodians should make the following reports to clients:

3.1.1 Daily reports of CSDR cash penalties on individual failed instructions. If the custodian is a CSD Participant, it should make such reports to clients as soon as possible after receiving a daily report from the Calculating CSD, provided it has been able to reconcile the report from the Calculating CSD with its own records. If the custodian is not a CSD Participant, it should make such reports as soon as possible after receiving a daily report from the CSD Participant or the agent(s) between it and the CSD Participant.

3.1.2 Monthly reports of the aggregate CSDR cash penalties to be charged per currency and, if necessary, also per CSD. If the custodian is a CSD Participant, it should make such reports as soon as possible after receiving a daily report from the Calculating CSD, provided it has been able to reconcile the report from the Calculating CSD with its own records, which should be on the 14th Penalty Business Day of the month following the relevant failed settlement. A Penalty Business Day is any day except Christmas Day, New Year Day or a weekend, or the previous business day if the CSD and/or payment system is closed on the 14th Penalty Business Day. This deadline is to give time for clients to arrange for foreign exchange conversions. If the custodian is not a CSD Participant, it should make such reports as soon as possible after receiving a daily report from the CSD Participant or the agent(s) between it and the CSD Participant.

3.1.3 Reports to clients should be in the form of MT537 PENA SWIFT messages but custodians should consider offering alternatives (e.g. web reporting) for clients who have not developed the capability to receive MT537 PENA messages via SWIFT.

- 3.2 For the purpose of collection from and distribution to clients, custodians should aggregate CSDR cash penalties at the higher level of investment fund or custody account.

TPMG penalties

- 3.3 It is possible that a CSD Participant settling transactions in US Treasuries, Agency Debentures or Agency MBS on an EU CSD is subject to penalties on the same failed settlement under both CSDR and the TPMG rules prevailing in the US. This might occur if the failed settlement of such securities on the EU CSD was at the end of a chain of failed settlements terminating in the US. In this case, a penalty would be claimed under the TPMG, which would be passed along the settlement chain until it reached an EU CSD Participant, who would pass it to the delivery EU CSD Participant, who would also be subject to a CSDR cash penalty.
- 3.4 It is recommended that TPMG and CSDR cash penalties be paid separately.

4 The regulatory status of CSDR cash penalties

- 4.1 The question has arisen as to whether CSDR cash penalties should be treated as regulatory fines for purposes such as know-your-customer (KYC) enquiries. It is up to individual firms to take advice and decide whether this is appropriate.
- 4.2 Firms should bear in mind that, despite being called penalties, CSDR cash penalties represent compensation by one CSD Participant to another for a failed settlement. CSDR cash penalties are not a fine in the sense that they are not collected by the regulator and paid into the public purse.
- 4.3 In certain circumstances, it is clear that CSDR cash penalties should not be treated as a regulatory fine on a CSD Participant. One example is when a CSD Participant is charged a CSDR cash penalty which is passed to a client. The charge cannot reasonably be attributed to the CSD participant. Another example is when a mistake has been made by the Calculating CSD which cannot be corrected by a CSD Participant.

Disclaimer

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