

Mr Rodrigo Buenaventura  
European Securities and Markets Authority  
103 rue de Grenelle  
Paris, 75007  
France

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Dear Mr Buenaventura,

Further to the round-table discussions in September, AFME and ICMA members have collaborated to provide some further insight that ESMA may find useful when considering the Regulatory Technical Standards and the Technical Advice for the European Commission on Settlement Fines. We are supportive of the objective contained in CSDR to introduce a harmonised settlement fines regime across Europe to reduce the number of failing transactions. We favour a simple and efficient mechanism that would provide certainty to all market participants and we have outlined below some of the elements that will be important to clarify when considering such a regime for Europe.

AFME and ICMA believe that a fundamental objective of ESMA should be to help create the regulatory framework for a future settlement discipline regime that meets the key objectives of any settlement discipline regime.

The two main objectives of any settlement discipline regime are:

- (i) Ensuring that market participants are faced with an appropriate incentive structure so that good behavior is encouraged and bad behavior is deterred.
- (ii) Providing a redistribution mechanism so that parties, who impose costs on other parties through their bad behavior, are forced to pay a financial contribution to those that have suffered costs.

A settlement discipline regime may also have as a subsidiary objective the creation of a centralised mechanism that reduces and automates bilateral claim processing between counterparties. (It should be noted that any central mechanism cannot fully replace the need for the possibility for bilateral claim processing).

To achieve the goals set out in CSDR any settlement discipline regime should fulfill the below requirements:

- Compatibility with CSDR
- Compatibility with the functioning of T2S
- Compatibility with a variety of account holding structures (omnibus accounts, direct holding models, etc.), and with a variety of business activities (cash trading, repo, securities lending, portfolio transfers, etc.)
- Efficiency (for all parties in the custody chain)

**Association for Financial Markets in Europe**

London Office: St. Michael's House, 1 George Yard, London EC3V 9DH T: +44 (0)20 7743 9300 F: +44 (0)20 7743 9301

Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971

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- Ability for intermediaries to allocate fines to parties in the custody chain that were responsible for individual failing transactions
- Ability for intermediaries to allocate proceeds of fines to parties in the custody chain that suffered cost as a result of bad behavior.
- No creation of anomalies (for example, incentives for inappropriate behavior)

In the industry discussions so far two archetypal models for a settlement discipline regime have been identified. One is a so-called “penalty with direct redistribution” model, and the other is a so-called “penalty with indirect distribution” model. Industry participants also have considered the option of a model without any distribution to CSD participants, but do not consider such a model to be in line with the requirements of CSDR.

## **Distribution of fines**

### **Characteristics of a “Penalty with direct redistribution” Model**

- Bilateral model (late settlement fine passes between the individual counterparties or their agents at the level of the CSD)
- Looks at individual transactions
- Logic is for no, or very limited, minimum thresholds

### **Characteristics of a central “Penalty with indirect distribution” Model**

- Multilateral model (indirect redistribution from good performers to bad performers)
- Looks at patterns of behavior (even though individual fines may be generated by individual transactions):
- Can handle minimum settlement efficiency thresholds

## **Approaches to fines regimes**

We recognise that different mechanisms can be applied in relation to the collection and distribution of settlement fines. We understand that the principal objective is to penalise late settlement of a transaction. However, there is also the possibility to transfer the collected penalties to the prejudiced counterparty or his agent. This will also address concerns that market makers or intermediaries in the transaction chain are unduly penalised. This can be achieved via a direct or indirect mechanism.

- An indirect mechanism may decide on a specific market settlement rate that should be adhered to. In simple terms, over a specific period, those parties that fall below that threshold would be charged and the respective penalties rebated to CSD participants (less CSD costs) that achieved a higher settlement rate than prescribed.
- The direct mechanism would seek to pass on the penalties from the failing counterparty (seller of buyer) or his agent to the aggrieved counterparty or his agent.

In order to assist ESMA’s thinking industry participants have tried to summarise their perceptions of some of the advantages and disadvantages of each model.

Basic Principles	Penalty with direct redistribution	Penalty with indirect redistribution
<b>Model</b>	Bilateral	Multilateral
<b>Compatible with CSDR</b>	Yes	Yes
<b>Penalises bad behaviour</b>	Yes	Yes
<b>How defined</b>	Individual transactions	Pattern of behavior
<b>Rewards good behaviour</b>	Yes (compensations are credited)	Depends on design of both fining mechanism and or redistribution mechanism
<b>Threshold</b>	No minimum settlement efficiency thresholds	Allows for thresholds
<b>Impact on participants with offsetting deliveries and receipts (e.g. market makers)</b>	Mostly neutral as penalties levied are largely offset by compensations (depending on the portion left to the CSD for its administration costs)	Negative (no direct offset/compensation)
<b>Allows participant to calculate and allocate amount of fine to be passed to its participant</b>	Yes	Depends on design
<b>Overall impact on market settlement costs</b>	Neutral (except for CSD admin fee)	Neutral (except for CSD admin fee)

The view held by the majority of AFME/ICMA participants is that a penalty system with direct redistribution is preferable. There is also a unanimous view that any system would need to distribute fines (whether direct or indirect), and that a system which would only collect fines but not pass them back to settlement participants would be overly punitive, increase overall costs, and fail to adequately encourage good behaviour.

Administration charges levied by CSDs should be based on objective and transparent criteria, able to cover costs but be kept as low as possible (hence the preference for a simple and harmonised penalty regime).

### Context for any settlement discipline regime

While ad valorem might appear most suitable for debt securities transactions, the same is deemed applicable for equities transactions despite the regularly lower cash equivalents in those transactions. The cost-of-carry varies depending on current market interest rates. Any

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settlement discipline regime should take into account this existing natural market deterrent. This suggests in particular that penalty rates should vary with interest rates.

## Collection of fines

Another element of Article 7(15b) requires ESMA to define how late settlement fines should be collected. Here a distinction should be made between collection of fail fines based on a net or on a gross basis.

Net collection:

- Consideration of failing instructions in a security in one account as a whole against available position in the account (under conditions – see matrix below)

Gross collection:

- Consideration of each individual failing transaction

Currently both systems exist in Europe. Maintaining choice for CSDs to retain existing infrastructure does not harmonise the process across Europe. A lack of harmonisation in settlement fine regimes will be inefficient for all participants active in multiple markets and especially those participating in T2S.

The below offers a few thoughts on the different models:

Basic Principles	Net Model	Gross Model
<b>Number of Fines to be applied</b>	Medium – application only on failing net missing amount, per account (see below)	High – every failing settlement
<b>Calculation of basis for late settlement fine</b>	<ul style="list-style-type: none"> <li>- Consideration of all of the failing deliveries and receipts:</li> <li>- offset by available position in participants and clients accounts (if any and if the available stock has not been put under any protection measure as the use of the Hold option)</li> <li>- define the correct” net missing quantity” to be considered for fails; a reference price will be used to calculate the</li> </ul>	<ul style="list-style-type: none"> <li>Consideration of all the failing deliveries and application of fines to each failing transaction</li> <li>- no offset by available position</li> <li>- no calculation of net missing quantity of security (fine is based only on transaction quantity; a reference price will</li> </ul>

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Basic Principles	Net Model	Gross Model
	amount	be used to calculate the amount)
<b>CSD participant development required</b>	<p>Participants receive fines linked to the real missing quantity for each account they have in the CSD</p> <p>Participants to replicate the regime applied by the CSD (to calculate a net position per client on their books)</p> <p>The total of penalties /compensations levied by the CSD to Participants may be different from what is levied on underlying clients</p>	<p>Participants to pass on fines/compensations received from CSD to their own clients.</p> <p>Participants to build pass-on functionality, but no need to replicate the regime applied by the CSD (no need to calculate a net position per client)</p> <p>The total of penalties/compensations levied by the CSD to Participants is passed on to underlying clients</p>
<b>Potential complexity of the mechanism</b>	CSDs should also consider, for each participant's account, failing receipts in addition to failing deliveries and potentially the available position	<p>CSD should consider all failing deliveries;</p> <ul style="list-style-type: none"> <li>- to apply a fine to the participant at fault for each transaction</li> <li>- to pass on each fine as a compensation to the non defaulter participant (the counterparty in the transaction)</li> </ul>
<b>Transparency of client of CSD Participant</b>	Positions of multiple fails for different clients included to calculate "net missing quantity".	Penalties are linked to individual settlement transactions.
<b>Compatible with distribution model</b>	Indirect redistribution	Direct redistribution

The view held by the majority of AFME/ICMA participants is that the gross model is preferable.

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AFME recognises that both net and gross systems are used in markets today. Whichever system is decided on by ESMA, it is vital that the settlement fines can be easily identified and passed on to the ultimate offender. The complexity of build for each system should be discussed carefully with CSDs, especially in the run up to joining T2S, and it is essential that systems are harmonised across markets to avoid duplication of build/different treatment. Whichever route is chosen, participants should never face uncertainty as to which transaction has incurred a penalty and which has not.

## **Other considerations**

On a related note we would like to highlight that ESMA in preparation of its Draft Standards should ensure that late settlement fines can only be charged to failing transactions which have been “matched” at the CSD applying the fine (matched being agreement between two participants of economic terms of trade and availability of resources to allow settlement). Only then will a CSD know if a transaction is a valid instruction from a participant or whether some elements are still under discussion between the counterparties. In this context AFME, in its response to the May 2014 consultation paper, recommended that [“...transactions with a T+2 or longer settlement cycle should match by ISD-1 end of business day, while for transactions with ISD with T+1 or T+0 settlement cycle, the trade should match on ISD. This would include the sending of instructions as early in the lifecycle as possible to enable the matching process at the CSD / T2S...”]. It should be noted that in the scenario where a transaction matches trades match post ISD, the settlement discipline regime should apply a principle whereby the party instructing and matching last should be penalised.

## **Timing aspects of the implementation**

We are in broad agreement with the objective of CSDR to introduce a harmonised settlement fines regime across Europe. Ideally this would also be structured simply and efficiently providing certainty to market participants about the type of regime they can expect when accessing the securities market in Europe.

As a general consideration ESMA will be aware that the industry, as well as a number of CSDs, is currently preparing for migration to T2S as of June 2015. Imposing further requirements on them at this stage may put the migration of several infrastructures to T2S at risk. In addition, T2S is designed to provide sufficient Fail Reason Codes for transactions which could be used as basis for any settlement fine calculation in order to avoid the wrong party being penalised.

Any European solution should be built and implemented once only (there are 24 different CSDs are migrating to T2S, potentially creating 24 different settlement regimes). The alternative is significant additional infrastructure build and related costs to CSDs and market participants. We would like to reiterate, that any system implemented by CSDs or T2S would have to be replicated by CSD participants to reconcile and verify the penalties calculated by the CSD in order to forward those costs to underlying clients.

### **Clarifications on variable fines charged to participants**

We have noted ESMA's consideration for an increase or decrease of settlement fines depending on the performance of the participant. We believe that such measures would not target the right participant in the securities chain and render the system overly complex. It should be highlighted that this is not an accepted market practice today and members are not aware of a settlement system that allows for increases or decreases applied to individual participants based on their past settlement performance. Variable fines will generate complexities and inconsistencies in chains of transactions, and are also difficult to manage in the case that a trading party uses an intermediary to access a settlement system.

### **Conclusion**

Industry participants welcome the initiative for a settlement fines regime. This paper should be seen as a contribution to the debate as to the best design for such a regime.

In order for such system to achieve the ultimate goal of increased settlement efficiency, the majority of AFME and ICMA members believe that such a system should be designed to fulfil the following criteria:

- Fines should be calculated to cater for the actual cost of the fail
- Fines should be calculated ad valorem, not with a flat fee
- Fines should only be levied on "matched" transactions
- When calculating fines the authorities and CSDs should consider a system that is not overly complex to build and run
- The system should allow for a direct redistribution mechanism to the aggrieved participant, preferably through the adoption of a gross model of application of penalties
- Ability for participants to pass penalties fairly and transparently to their underlying clients that are responsible for causing the fails
- A harmonised fines regime throughout Europe
- Penalty rates should vary with interest rates in order to take into account the natural deterrent to failure.
- Participants need reliable and predictable mechanisms without increases or decreases

We hope that ESMA finds our comments useful and stand ready to discuss further any element of the above.

Yours sincerely,



Stephen Burton  
Post Trade  
Director  
AFME



Asif Godall  
Secondary Market Practices Committee  
Chair  
ICMA



Godfried de Vidts  
European Repo Council  
Chair  
ICMA



## Annex: Practical example of incentives a compensation mechanism would provide

Counterparty A sells €100,000,000 value of German Government Bunds to counterparty B. Counterparty A fails to deliver the Bunds. Current overnight rates are 3%<sup>1</sup>.

Counterparty A no longer has the economic benefit of owning the Bunds, but since it has failed and has not received cash<sup>2</sup>, it must still fund this position for every day of the fail which would be a strong deterrent for A to continue failing. The daily cost is:

$$\frac{3\%}{360} * €100,000,000 = (€8,333)$$

Counterparty B benefits from the fail, since it has the economic benefit of owning the Bunds, and since it still holds the cash needed to purchase the Bunds, this can be reinvested at the overnight rate. Thus B can earn €8,333 per day of the fail.

If B has sold these Bunds on to counterparty C, this will create a fails-chain. B is flat, with no cash coming in from the sale to C, nor going out to the purchase from A. However, there is a natural market incentive for B to borrow the Bunds in the repo market, and to make good its settlement to C.

Assume that B can borrow the Bunds in the repo market for a cost of 50bp (a repo rate of 2.50%). B can now settle its onward sale to C while earning the repo rate on the cash it will receive from C. By borrowing the Bunds and making settlement, B can earn:

$$\frac{2.5\%}{360} * €100,000,000 = €6,944$$

In other words, so long as the repo rate is above 0% (or, the cost of borrowing the securities as a spread to money-market rates is no more than cost of failing), there is a financial incentive for counterparties to settle, even if they are in a fails-chain. Furthermore, the higher the prevailing money-market rates, the greater the deterrent/incentive; the lower the rate, the less effective the deterrent/incentive.

<sup>1</sup> Note that the cost may be greater, depending on the level where the failing bank can obtain funding

<sup>2</sup> Assumes delivery-versus-payment (DVP) settlement