Introduction

These notes are intended to provide a brief summary of the ESMA CSD Regulation Level 2 Consultation Papers and draft Regulatory Technical Standards (RTS) as they relate to Settlement Discipline\(^1\). While CSDR is primarily ‘settlement level regulation’, the provisions for settlement discipline, in particular for mandatory buy-ins and cash penalties for fails, have direct and significant trading level impacts. These provisions have the potential to impair considerably market efficiency and liquidity across all asset classes, including both outright markets and repo/securities lending markets, and to increase the risks and costs of transacting in European securities markets for both market-makers and investors.

Since the publication of the Level 1 draft text, ICMA has been highly engaged in cross-industry advocacy related to settlement discipline, in particular mandatory buy-ins, which is broadly recognized as having a potentially catastrophic impact on European bond and repo market liquidity and efficiency. Given the potential market risks of these provisions, ICMA intends to submit a comprehensive and detailed response to the consultation, and requests that its members be engaged in the response process and to share their thoughts, concerns, and suggestions. The deadline for the response is February 19\(^{th}\) 2015. Note that ICMA will continue to work very closely with AFME, ISLA, and other relevant associations in formulating its response.

These notes are intended to be an introductory overview to the draft provisions and related questions for CSDR settlement discipline, and members are encouraged to refer to the relevant text which is also referenced.

Members wishing to engage in the response process should contact Andy Hill at ICMA.

Preventing Settlement Fails

Section 2.1 of the CP (pages 9-17); Articles 2 and 3 of the draft RTS (Annex 1, Chapter II, pages 113-118)

Context:

This section has significant overlap with existing ICMA operational work-streams, including Trade Matching and Affirmation standardization and interoperability; messaging; and SFT reporting. There is scope here to provide for mandatory matching fields and timelines under the regulation.

Summary of provisions:

- The RTS provide for the fields for trade confirmations and allocations for investment firms

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\(^1\) These notes relate to the ESMA Consultation Papers: Technical Standards under the CSD Regulation and Technical Advice under the CSD Regulation, published on December 18\(^{th}\) 2014.
• The RTS suggest that trade confirmations and allocations should occur on the same day as the transaction (or by 11am the next day in case of time zone differences greater than 2 hours, or where the trade is executed after 4pm).

• The RTS outline mandatory matching fields for settlement instructions to CSDs (potential requirements of SFTR are taken into consideration)

• CSDs should process settlement instruction on an automated basis (to facilitate STP), and report any types of manual intervention.

• CSDs should match settlement instructions prior to settlement, except where these are already matched by other entities such as CCPs or trading venues, or for FoP transfers between accounts held by the same participant.

• CSDs should offer a hold and release mechanism with a bilateral cancelation facility.

• CSDs should offer the possibility to opt in or out for partial settlement.

• CSDs should offer real-time gross settlement throughout the day, or at least three settlement batches per day.

• The requirements for hold and release, bilateral cancelation, and partial settlement will not apply to CSDs where the value of settlement fails is less than €2.5bn per year and the settlement fails rate is below 0.5%.

• There is no proposal that CSDs be obliged to provide securities lending facilities.

Related questions:

Q1: Do you think the proposed timeframes for allocations and confirmations under Article 2 of the RTS on Settlement Discipline are adequate? If not, what would be feasible timeframes in your opinion? Please provide details and arguments in case you envisage any technical difficulties in complying with the proposed timeframes.

Q2: Do you agree with the cases when matching would not be necessary, as specified under Article 3(2) of the draft RTS? Should other cases be included? Please provide details and evidence for any proposed case.

Q3: What are your views on the proposed approach under Article 3(11) of the draft RTS included in Chapter II of Annex I? Do you think that the 0.5% settlement fails threshold (i.e. 99.5% settlement efficiency rate) is adequate? If not, what would be an adequate threshold? Please provide details and arguments.

Do you think that the 2.5 billion EUR/year in terms of the value of settlement fails for a securities settlement system operated by a CSD is adequate? If not, what would be an adequate threshold? Please provide details and arguments.

Q4: What are your views on the proposed draft RTS included in Chapter II of Annex I?

**Monitoring Settlement Fails**

*Section 2.2 of the CP (pages 17-20); Articles 4, 5, and 6 of the draft RTS (Annex 1, Chapter III, Section 1, pages 119-122)*
Context:

Settlement efficiency rates across European CSDs and asset classes have hitherto been opaque. It would even seem that the settlement discipline provisions were passed into law without any reference to, or analysis of, settlement efficiency rates.

Summary of provisions:

- CSDs are required to monitor settlement fails, including information on buy-ins and penalties.
- CSDs are required to set up a ‘working flow’ with the top ten participants with the highest fails rates to identify causes.
- CSDs are required to report data on settlement fails to the competent authority on a monthly basis (but may be required to provide more detailed information on a more frequent basis).
- CSDs are required to report to the competent authority measures taken to improve settlement efficiency on an annual basis.
- CSDs are required to make publicly available information on fails rates, including the identity and details relating to the top ten participants with the highest fails rates.

Related questions:

Q5: What are your views on the proposed draft RTS on the monitoring of settlement fails as included in Section 1 of Chapter III of Annex I?

Cash Penalties

Section 2.3 of the CP (pages 21-24); Articles 7-10 of draft RTS (Annex I, Chapter III, Section 2, pages 122-124)
Section 2 of ‘Technical Advice under the CSD Regulation’ (pages 9-17)

Context:

ICMA is broadly supportive of a cash penalty system in principle, particularly in a low interest rate environment. In coordination with AFME, ICMA has advocated for a penalty mechanism that is simple, consistent, allows for redistribution, and is implemented on a gross (trade-by-trade) basis. The ESMA draft RTS are very much consistent with this perspective, although the reasoning behind the proposed penalty rates and asset differentiation seems muddled.

Summary of provisions:

- CSDs are to calculate and impose cash penalties against failing counterparties for each day of a settlement fail.
- Where CSDs use a common settlement infrastructure (such as T2S), they should jointly manage the penalty system.
- CSDs are to redistribute the cash penalty to the counterparty suffering the fail (in full).
• Penalties and redistribution should take place at least on a monthly basis (with cash flows being netted)
• CCPs will be in scope for penalties and redistribution (and will pass on the relevant clearing members).
• Any costs to the CSDs related to implementing the penalty mechanism should be charged to participants separately, with full disclosure.
• The penalty mechanisms and calculations should be harmonized across all CSDs.
• Where a receiving participant does not accept partial deliveries, the penalty will only apply to the missing portion of cash or securities.
• Penalty rates should be the same regardless of the transaction type (so the same for repo/securities lending as for outright transactions).
• Penalty rates should be based on the expected liquidity of the asset type, and relate to the expected cost of borrowing the asset type:
  o Equities are perceived to be least problematic to source and the most likely to cause fail-chains, so warrant a higher penalty
  o Government bonds are likely to be traded in bigger size, are more price sensitive, and are important to the financial system, so should have a smaller penalty coefficient
  o Corporate bonds are less liquid than government bonds, and have smaller transaction sizes, so the penalty should be low, but higher than government bonds.
  o Others financial instruments are likely to be OTC bilateral transactions, are less liquid than bonds, so should have a higher penalty rate than bonds, but no more than for equities.
• The suggested daily flat penalty rates are:
  o Equities and others: 1.0bp (3.60% annualized)
  o Government bonds: 0.25bp (0.90% annualized)
  o Corporate bonds: 0.5bp (1.80% annualized)
  o Cash: discount rate per currency
• ESMA should review the penalty rates on an ad hoc basis in response to changing market conditions.
• To ensure simplicity and consistency, the penalty rates should not vary depending on circumstances (such as repeated fails), at least at the initial stage of implementation.
• The amount of the penalty collected and the amount of the redistribution should be the same in order to immunize failing counterparties that are being failed to (i.e. where the counterparty is part of a chain), and to dis-incentivize the original, root cause of the fail.

Related questions:

Q6: What are your views on the proposed draft RTS related to the penalty mechanism? Do you agree that when CSDs use a common settlement infrastructure, the procedures for cash penalties should be jointly managed?

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

TA: Q2: What are your views on the proposed approach regarding the categories of financial instruments and the penalty rates? In particular, do you consider that these penalty rates could dis-incentivise trading in small caps? Please provide evidence to support your views.
TA: Q3: What are your views on the proposed approach regarding the increase and reduction of the basic penalty amount?

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

The Buy-in Process

*Section 2.4 of the CP (pages 24-35); Articles 11-17 of draft RTS (Annex I, Chapter III, Section 3, pages 125-131)*

**Context:**

ICMA has advocated strongly against the implementation of mandatory buy-ins, which is widely seen as likely to be counterproductive and damaging to market efficiency and liquidity. However, after the Level 1 text was passed into law, both ESMA and the industry have been forced into recommending RTS that will be implementable (a challenge in itself), while causing the least disruption to the effective functioning and liquidity of capital markets. To this end, ICMA, along with AFME and other industry representatives, has advocated that for fixed income buy-ins be initiated and executed at the trading level (and not by CSDs or trading venues), that multiple buy-ins be avoided in the case of fail-chains, and that the first-leg of securities financing transactions (SFTs) be exempt, regardless of the term of the transaction. These recommendations seem to be largely overlooked in the draft RTS.

**Summary of provisions:**

- The buy-in process shall be part of the contractual documentation applicable to each participant of a CSD, CCP, and trading venue.
- Buy-ins should avoid unnecessary costs for the failing counterparty and avoid any risk taking by the CSD, CCP, and trading venue.
- The CSD, CCP, or trading venue should notify both the failing and receiving counterparties: (a) at the end of the last business day of the extension period; (b) on the last day of the buy-in period with the results.
- Buy-ins can only be executed against the missing amount of securities, and partials must be accepted by the receiving counterparty at the end of the extension period, regardless of counterparties opting out of partial settlement.
- Where buy-ins are only partially successful, the receiving counterparty must accept the amount of securities successfully bought-in. For the residual amount, the receiving counterparty can choose to defer the buy-in or receive cash compensation.
- Where the buy-in fails, the receiving counterparty can choose to defer the buy-in or receive cash compensation.
- In the case of non-cleared transactions, where a counterparty is failing due to an receiving fail, the failing participant or trading venue shall, the day before the extension period lapses, inform the CSD of the details of the receiving fail. This will allow the CSD to identify the chain in order to limit the number of buy-ins to be executed.
• The buy-in period (the timeframe to deliver the securities after the extension period has lapsed) will be 4 business days for liquid securities and 7 days for illiquid securities (as defined by MiFID II/R).
• The extension period (the number of consecutive days a transaction fails before the buy-in is initiated) will be 4 business days for liquid securities and 7 days for illiquid securities (as defined by MiFID II/R).
• For operations composed of several transaction (i.e. repos and securities lending transactions):
  o The second-leg will be treated the same as an outright sale (so in scope)
  o The first-leg will be bought-in where the timeframe to settle the buy-in (extension period plus buy-in period) is shorter than the term of the transaction (i.e. the buy-in can be settled before the second-leg of the transaction).
  o For these transactions, a buy-in against the first-leg will be considered ineffective where the second-leg falls before the buy-in can be settled
  o This suggests that the first-leg of securities financing transactions (SFTs) will be in scope where the term of the SFT is 9 days or longer for liquid assets, and 15 days or longer for illiquid assets
• Where a buy-in fails or is not possible, cash compensation shall be determined by:
  o A pre-agreed price to settle cash between counterparties
  o A price determined by the buy-in agent with reference to the closing price of the relevant trading venue the previous day; or where not possible, with reference to market prices available across different trading venues or brokers.
• Where the reference price for cash compensation is less than the original transaction price, the compensation will be set at zero.
• A participant will be deemed to consistently and systematically fail where its settlement efficiency rate is 10% lower than the rate for the relevant settlement system (although no recourse is prescribed).
• CSDs shall provide to affected CCPs and trading venues information relating to failed transactions, including the list of instructions the CCP or trading venue sent for settlement to the CSD, along with information relating to intended settlement date, end of extension period, end of buy-in period, end of deferral period, and payment of cash compensation or settlement or cancelation.

Related questions:

Q7: What are your views on the proposed draft RTS related to the buy-in process? In particular, what are your views on applying partial settlement at the end of the extension period? Do you consider that the partialling of the settlement instruction would impact the rights and obligations of the participants? What do you think about the proposed approach for limiting multiple buy-in and the timing for the participant to provide the information to the CSD?

Q8: What are your views on the proposed draft RTS related to the buy-in timeframe and extension period?

Q9: What are your views on the proposed draft RTS related to the type of operations and their timeframe that render buy-in ineffective?
Q10: What are your views on the proposed draft RTS related to the calculation of the cash compensation?

Q11: What are your views on the proposed draft RTS related to the conditions for a participant to consistently and systematically fail?

Q12: What are your views on the proposed draft RTS related to the settlement information for CCPs and trading venues?

**Anti-avoidance rules for cash penalties and buy-in**

*Section 2.5 of the CP (pages 35-36); Article 19 of draft RTS (Annex I; Chapter 5, page 131)*

**Context:**

One suggestion to avoid buy-ins or penalties is for counterparties to cancel instructions and re-instruct until the trade has settled (thus it will never appear to be failing).

**Summary of provisions:**

- Given that various CSDs and CCPs have different operational structures or models (e.g. continuous net settlement) ESMA proposes an anti-circumvention provision to ensure that cash penalties and the buy-in process are applied from the first day of the settlement fail.

**Related questions:**

Q13: What are your views on the proposed draft RTS related to anti-avoidance rules for cash penalties and buy-in?

**Phase-in for settlement discipline**

*Section 2.6 of the CP (pages 36-37); Recital 38 of draft RTS (Annex I; page 111-12)*

**Context:**

ICMA (and others) has long maintained that implementation of settlement discipline should be delayed until after the successful implementation of T2S. ICMA has further recommended that settlement discipline should be phased, with cash penalties preceding mandatory buy-ins.

**Provisions:**

- The publication of the RTS on settlement discipline in the OJ is expected for late 2015 (normally this would suggest that implementation would be in early 2016).
• In light of T2S migration, and the related time and costs of adaptation for market participants and infrastructures, many stakeholders have requested more time for implementation of settlement discipline.
• CSDs will require time to consult with CCPs, trading venues, and participants in order to set-up settlement discipline systems and to implement necessary IT changes.
• For the appropriate, effective, and efficient application of the settlement discipline regime, the settlement discipline and procedures that a CSD needs to put in place should be carefully assessed before being applied.
• For these reasons, a delay of 18 months after publication of the RTS before implementation is suggested.
• There is no suggestion of a phase-in, and concrete data and evidence from respondents would be required to justify this.

Related questions:

Q14: Do you agree that 18 months would be an appropriate timeframe for the implementation of the settlement discipline regime under CSDR? If not, what would be an appropriate timeframe in your opinion? Please provide concrete data and evidence justifying a phase-in for the settlement discipline measures and supporting your proposals.