

# Reply Form

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

## Responding to this Consultation Paper

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

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

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

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

## Instructions

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

- Insert your responses to the questions in the Consultation Paper in this reply form.
- Please do not remove tags of the type < ESMA\_QUESTION\_CSDR\_0>. Your response to each question has to be framed by the two tags corresponding to the question.
- If you do not wish to respond to a given question, please do not delete it but simply leave the text "TYPE YOUR TEXT HERE" between the tags.
- When you have drafted your responses, save the reply form according to the following convention: ESMA\_CP1\_CSDR \_nameofrespondent.

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

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

## **Publication of responses**

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

## **Data protection**

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading '[Data protection](#)'.

## **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.

## 1 General information about respondent

Name of the company / organisation	Association of Global Custodians – European Focus Committee
Activity	Associations, professional bodies, industry representatives
Are you representing an association?	<input checked="" type="checkbox"/>
Country / Region	Europe

## 2 Questions

**Q1 Do you agree with ESMA’s proposal? Which Option is preferable in your view? Please also state the reasons for your answer.**

<ESMA\_QUESTION\_CSDR\_1>

The members of the Association of Global Custodians (the “AGC”) are grateful for the opportunity to respond to ESMA’s Consultation Paper through the AGC European Focus Committee (“AGC-EFC”). The members of the AGC are: BNP Paribas; BNY Mellon; Brown Brothers Harriman & Co; Citibank, N.A.; Deutsche Bank; HSBC Securities Services; JP Morgan; Northern Trust; RBC Investor Services; Skandinaviska Enskilda Banken; Standard Chartered Bank; and State Street Bank and Trust Company.

The AGC-EFC considers the benefits of ESMA’s proposal to be disproportionate to the cost and time required to implement such a change to the **structure** of the penalty mechanism. A structural change represented by any of the methodologies proposed by ESMA in this consultation will require CSDs, custodians and other market participants to make significant systems changes, which would require end-to-end systems testing throughout and across the industry (reaching from CSDs through the chain to the recipients). Applying lessons learned during the implementation of the cash penalty regime (which initially faltered due to lack of testing) implementation of such a change in the structure would be significant and would risk disrupting the operation of the current regime - diverting resources away from remediating the structural issues that currently hinder securities settlement in the region.

Any of the models represented by the proposal are also disproportionate because, on balance, there is little to be gained. We understand that the number and size of fails in non-Euro markets due to lack of cash are quite minimal. For Bulgaria – which is expected to join the Eurozone 1<sup>st</sup> January 2025 - there is a very low number of settlements in only a handful of government bonds and less than 100 corporate bonds, with an average fail rate in 2023 of less than 1% and penalty amounts of less than 100 euro equivalent.

In Denmark, a solution derived by the Danish CSD and the Danish Central bank (which derives the cash discount penalty rate in the absence of official interest rate for overnight credit) already provides a result that approximates ESMA’s proposed option 3 – a solution that does not influence the T2S penalty mechanism calculation (as opposed to option 1). We defer to the response to ESMA’s consultation from the Danish market, who we understand will provide data showing penalties (settlement fails) steadily decreasing markedly through 2023 in the Danish market.

We emphasise that Option 4 - a progressive rate approach that applies regardless of currency – presents a complete change of the current systems which we do not support for the reasons stated above.

<ESMA\_QUESTION\_CSDR\_1>

**Q2 Do you have other suggestions? If yes, please specify and provide arguments.**

<ESMA\_QUESTION\_CSDR\_2>

AGC members recommend that the current methodology is retained for DKK and BGN which is consistent with the penalty charges for fails due to lack of EUR.

More generally, we continue to note language used by public authorities such as ESMA that characterises “CSD participants” as the source of the problem leading to fails (e.g., “... where a CSD Participant fails to deliver the security within a fixed extension period” (see p. 10, para 2.2)): we urge public authorities to refrain from characterising intermediaries in this way as the responsibility for delivery falls on trading counterparties, not intermediaries. To the extent problems arise in connection with the facilitation of settlement, intermediaries act solely as non-discretionary agents and take steps to carry out settlement instructions as well as ensure proper resource management: intermediaries should not be framed as the “cause” of a fail as we believe this has created misperceptions regarding their role and how they may fit into proposed solutions.

<ESMA\_QUESTION\_CSDR\_2>

**Q3 Do you agree with the approach followed for the Option you support to incorporate proportionality in the Technical Advice? If not, please provide an indication of further proportionality considerations, detailed justifications and alternative wording as needed.**

<ESMA\_QUESTION\_CSDR\_3>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_3>

**Q4 What costs and benefits do you envisage related to the implementation of each Option? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.**

<ESMA\_QUESTION\_CSDR\_4>

Option		
	Qualitative description	Quantitative description/ Data
<b>Benefits</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Compliance costs:</b> - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Costs to other stakeholders</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

<b>Indirect costs</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
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TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_4>

**Q5 As a CSD, do you face the issue of accumulation of reference data related to Late Matching Fail Penalties (LMFPs), that may degrade the functioning of the securities settlement system you operate? If yes, please provide details, including data where available, in particular regarding the number and value of late matching instructions, as well as for how many business days they go in the past from the moment they are entered into the securities settlement system, and the percentage they represent compared to the overall number and value of settlement fails on a monthly basis (please use as a reference the period June 2022 – June 2023).**

<ESMA\_QUESTION\_CSDR\_5>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_5>

**Q6 What are the causes of late matching? How can you explain that there are so many late matching instructions? What measures could be envisaged in order to reduce the number of late matching instructions?**

<ESMA\_QUESTION\_CSDR\_6>

A preliminary comment is that the number of such late matching instructions is small in comparison with the total number of settlement instructions. However, the AGC-EFC acknowledges and agrees that the existence of such late instructions creates problems.

One problem – mentioned elsewhere in our submission – relates to the impact on CSDs having to maintain historical data in order to be able to calculate the penalties. Very late instructions also create problems for corporate action processing, as they may change the entitlements for a corporate actions event, with potentially knock-on tax implications. More generally, such late

instructions, and the ensuing delay in settlement of transactions, affect the issuer/investor relationship, and the appropriateness of a custodial record as the basis for this relationship.

In this context, it is useful to note that the FASTER legislative proposal of the European Commission includes in Article 9 a requirement for custodians to report positions relating to a dividend payment no later than 25 days after the record date. The logic of the FASTER proposal, and the expectation of the European Commission and of the tax authorities, is that this reporting will be definitive and complete at this point and will not be subject to later corrections. For this reporting to be definitive and complete, it will be necessary that by this point all relevant transactions, and any associated market claims, have been identified, and fully processed.

In this context, it is also useful to note that Market Standards for Corporate Actions Processing and the T2S Corporate Actions Standards impose a time limit of 20 business days after record date for the detection of market claims.

Regarding the cause of very late settlement instructions being instructed and matched very late, it is very difficult to give specific answers. We believe that this is residual activity and that the specific underlying reasons for such late instructions may be very diverse. At a high level we believe that all the steps taken to increase the efficiency, rigour and automation in post-trade processes, as a result of the introduction of CSDR late settlement penalties, but also as part of the potential adoption of T+1, and, potentially, of the FASTER tax measures, will contribute to reducing the number of late instructions.

We do also believe that other specific measures should be taken. On this point, please see our answer to Question 11.

For further background, the AGC-EFC refers ESMA to the AFME report, *Improving the Settlement Efficiency Landscape in Europe*, which was published in Q4 2023. This report is primarily focused on matching, settlement processing, CSD and vendor functionality and lists 10 recommendations to improve matching and settlement performance. A number of AGC-EFC members were involved in the paper and on progressing recommendations on behalf of the custodian community. The paper identifies that late matching can be based on the following root causes:

**Issues:**

- “Economic” mismatches such as differences such as ISIN, nominal, cash amount due to lack of timely / accurate data, workflow management issues, and different cash tolerance in vendor matching platforms;



- “Non-economic” mismatches due to different standard settlement instructions (SSIs) or place of settlement (PSET) due to data quality issues, lack of market standards and different matching conventions in vendor matching platforms; and
- Late bookings / late instructions caused by missing data required for booking a trade such as: ISIN not set up by the data provider or at the CSD, booking account not opened in time or missing the data required to generate and flow settlement instructions and lastly issues with the settlement message template / instruction.

**Solutions:**

- Establish market standards to ensure economic and non-economic data are in place on trade date;
- PSET / SSIs to be a matching field in all vendor platforms;
- Cash amounts to share the same tolerance as the CSDs (per CSDR RTS Article 6) in vendor platforms;
- Market participants who cannot utilise such platforms should follow agreed industry standards for exchanging information in an STP format;
- Place of Settlement (PSET) should be a mandatory matching field in all allocation and pre-settlement matching tools;
- Work with data vendors to ensure that all pertinent data required to book and match trades is available, i.e., ISINs set up; and
- Work with CSDs to develop and publish an industry agreed settlement holiday calendar.

<ESMA\_QUESTION\_CSDR\_6>

**Q7 Do you agree with ESMA’s proposal to establish a threshold beyond which more recent reference data shall be used for the calculation of the related cash penalties to prevent the degradation of the performance of the systems used by CSDs? Please also state the reasons for your answer.**

<ESMA\_QUESTION\_CSDR\_7>

For this question we defer to the response of the European Central Securities Depositories Association (“ECSDA”).

<ESMA\_QUESTION\_CSDR\_7>

**Q8 Do you agree with the threshold of 92 business days or 40 business days in order to prevent the degradation of the performance of the systems used by CSDs? Please specify which threshold would be more relevant in your view:**

**a)92 business days;**

**b)40 business days;**

**c)other (please specify).**

**Please also state the reasons for your answer and provide data where available, in particular regarding the number and value of late matching instructions that go beyond 92 business days, 40 business days in the past or another threshold you think would be more relevant, and the percentage they represent compared to the overall number and value of settlement fails on a monthly basis (please use as a reference the period June 2022 – December 2023).**

<ESMA\_QUESTION\_CSDR\_8>

For this question we defer to the response of ECSDA.

<ESMA\_QUESTION\_CSDR\_8>

**Q9 Do you agree that the issuer CSD for each financial instrument shall be responsible for confirming the relevant reference data to be used for the related penalties calculation? Please also state the reasons for your answer.**

<ESMA\_QUESTION\_CSDR\_9>

Yes: the issuer CSD should be responsible for confirming the relevant data used for the cash penalties calculation as they are the entity selected by the Issuer and should preside over all pertinent data sharing – including with investor CSDs - in a timely manner where requested.

<ESMA\_QUESTION\_CSDR\_9>

**Q10 In your view, where settlement instructions have been matched after the intended settlement date, and that intended settlement date is beyond the agreed number of business days in the past, the use of more recent reference data (last available data) for the calculation of the related cash penalties should be optional or compulsory? Please also state the reasons for your answer.**

<ESMA\_QUESTION\_CSDR\_10>

As a foundational rule the criteria and data used for calculating cash penalties should be predictable, transparent and standardised across CSDs - and therefore accessible as a golden source to the wider industry. This is essential for custodians sitting in-between the CSDs and their clients to calculate / predict / investigate penalties in a timely manner in what is still a highly time-sensitive regime. Optionality, in any form, removes predictability, breaks standards and can result in discrepancies and inefficiency.

<ESMA\_QUESTION\_CSDR\_10>

**Q11 Do you have other suggestions? If yes, please specify, provide drafting suggestions and provide arguments including data where available.**

<ESMA\_QUESTION\_CSDR\_11>

We believe that the problem of CSDs having to maintain historical data can be solved by adopting the approach taken in the Market Standards for Corporate Actions Processing and the T2S Corporate Actions Standards with respect to the detection period for market claims. All, or most, European CSDs already apply a time-limit of 20 business days after record date for the detection of market claims. We suggest that they complement this approach by applying the same time limit for the receipt of settlement instructions (i.e., a time limit of 20 business days after intended settlement date).

Such a step will increase rigour in post-trade processing and help reduce the problems identified in our answer to Question 6.

We believe that this step should also be complemented by a reduction in the time period before failing matched transactions are automatically cancelled.

<ESMA\_QUESTION\_CSDR\_11>

**Q12 Do you agree with the approach followed to incorporate proportionality in the Technical Advice? If not, please provide an indication of further proportionality considerations, detailed justifications and alternative wording as needed.**

<ESMA\_QUESTION\_CSDR\_12>

We believe it would not be appropriate to incorporate proportionality in connection with the rationale for maintaining historical data: we believe the focus should be on CSDs utilising generally available, current date in the simplest process possible.

<ESMA\_QUESTION\_CSDR\_12>

**Q13 What costs and benefits do you envisage related to the implementation of the approach proposed by ESMA? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.**

<ESMA\_QUESTION\_CSDR\_13>

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

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_13>

**Q14 If applicable (if you have suggested a different approach than the one proposed by ESMA), please specify the costs and benefits you envisage related to the implementation of the respective approach. Please use the table below. Where**

relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

<ESMA\_QUESTION\_CSDR\_14>

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

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_14>

**Q15** Based on your experience, what has been the impact of CSDR cash penalties on reducing settlement fails (by type of asset as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389 since the application of the regime in February 2022? Please provide data and arguments to justify your answer.

<ESMA\_QUESTION\_CSDR\_15>

Overall, we believe that the CSDR cash penalties mechanism has had a positive impact on settlement efficiency.

Our view is based on two main considerations. Firstly, both the internal data of AGC members and the data provided during the ESMA workshop on 26 September on settlement efficiency show a reduction in settlement fails since the introduction of the mechanism in February 2022.

A second consideration is that we believe that many of the basic features of the penalty mechanism are well-designed, as they create financial incentives for timely settlement.

For further information please refer to:

[https://www.ecb.europa.eu/stats/payment\\_statistics/transactions\\_processed\\_by\\_t2s/html/23\\_tableT2S.en.html](https://www.ecb.europa.eu/stats/payment_statistics/transactions_processed_by_t2s/html/23_tableT2S.en.html)

We therefore consider that the introduction of the CSDR cash penalty regime has had a positive impact as it has attracted and focused resources and investment to improve settlement efficiency. More is needed to improve 'behavioural fails' (as identified in the above-mentioned AFME Report) but also there are structural issues to overcome in the region, which we explain in our response to Question 17.

Data quality:

It is also worth noting that the methodology used to assess and count settlement fails has changed, with the CSD's reporting obligations under CSDR Level 2 Art.14, which makes it difficult to compare settlement efficiency pre- and post- introduction of the cash penalty regime. Better comparability of settlement efficiency indicators would be achieved through more granularity of data on additional criteria, such as breakdowns by age of settlement fails, instrument type, transaction type, fail reason codes, asset class, matching time, etc. (please refer to AFME's paper on "Provision of Public Data to Support Settlement Efficiency Objectives", dated Nov 2022).

Similarly, the ESMA TRV reporting methodology has recently changed with the Q4 2023 analysis - now aligning with the CSDs' reporting as determined pursuant to RTS Art.14 rather than the methodology previously used by ESMA in these reports. This level of inconsistency means that there is no foundation to assess settlement efficiency pre- and post- introduction of the cash penalty regime on 1<sup>st</sup> Feb 2022 and no basis to identify if and under what circumstances cash penalties should be increased. Furthermore, the different reporting parameters used by ESMA draw very different conclusions, which results in ambiguity of the actual level of settlement fails. The AGC-EFC recommend that a full review of data quality and the methodology used to define and report settlement fails is effected, concluded, implemented and observed prior to any change to the cash penalty regime.

Need for an adequate observation period

ESMA note in point 45 of the consultation paper that there needs to be a longer observation period and to allow sufficient time to ensure the adequate level of data quality:

*45. Given the need to have a longer observation period since the start of the application of cash penalties to have a meaningful assessment of the impact of cash penalties on settlement efficiency, as well as to allow for sufficient time to ensure an adequate level of data quality regarding the settlement fails reports submitted under Article 7(1) of CSDR, ESMA aims to publish a more detailed impact analysis at a later stage.*

The AGC-EFC believe this to be foundational. There needs to be good data, adequate granularity, a single and robust methodology and sufficient time once the data quality issues have been corrected to assess settlement efficiency. Increasing the cash penalty rate without having effective and reliable foundations will not fix issues and may cause damage to the region's securities markets.

<ESMA\_QUESTION\_CSDR\_15>

**Q16 In your view, is the current CSDR penalty mechanism deterrent and proportionate? Does it effectively discourage settlement fails and incentivise their rapid resolution? Please provide data and arguments to justify your answer.**

<ESMA\_QUESTION\_CSDR\_16>

At a high level, we believe that the current CSDR penalty mechanism operates effectively as a deterrent to misbehaviour and is proportionate: it discourages settlement fails and incentivises timely settlement and rapid resolution of problems to the extent possible.

However, we also believe that the effectiveness of the mechanism can be improved, principally through a re-calibration of the penalties.

The reductions in settlement fails that have been observed are a testament to the focus and investment that market participants have made in the preparations in the run up to the introduction of the regime and post its implementation per the graphs we include in our response to Question 15.

With regard to proportionality, there are a number of considerations. The majority of fails owing to operational inefficiency may be due to 'behavioural issues' of market participants or structural issues at the level of the CSDs in respect of cross-CSD settlement or DVP vs FoP cut-off differences, which are generally resolved in the first 1 or 2 days post-ISD (in other words, 'rapid resolution').

Whilst misbehaviour and operational inefficiency should be penalised (i.e., late: bookings / allocations / confirmations / instructions, lack of proactive realignments, etc.) it is not

proportionate for market participants to be penalised due to misaligned CSD batch times, lack of CSD functionality or due to a borrow that arrives after DVP close owing to a later FOP batch time.

Likewise, it is not proportionate for settlement instructions to be penalised twice. As AFME notes in its Settlement Efficiency paper, there are scenarios where the cash penalty regime serves as a disincentive for trading parties to resolve settlement fails, such as agreeing to partials. Where auto-partial is not possible (e.g., where the CSD does not support it or does not offer partial release) both parties will need to ‘manually partial’, which means cancelling and re-instructing with two new settlement instructions. Since partial settlement takes place on ISD+, previously matched but failing instructions that are re-instructed will incur ‘late matching fail penalties’ for whichever party is the last to input the new instructions. Whilst ESMA guidance explicitly states that CSDR “should not lead to the application of duplicative penalties for the same settlement instructions on the period between the ISD and the date of the introduction of the new settlement instruction into the securities settlement system” there currently appears to be no systematic means for CSDs to identify and exclude such instructions from the application of penalties. Such a barrier serves as a disincentive to reduce settlement risk and optimise available inventory.

The cash penalty regime can also discourage trading parties from rebooking their settlement instructions to resolve a mismatch, at least without an agreement that the penalty amount can be reclaimed from their counterparty. This leads to delays and inefficiencies in the settlement process that again are detrimental to the objective of reducing settlement risk and achieving settlement efficiency.

The cash penalty regime is calibrated around the liquidity of the financial instruments that are “in scope” of the regime. A proportionate regime should reduce risk without reducing market liquidity, which would be detrimental to investors and would impact the ability to borrow to cover shorts or fails – which in turn would negatively impact settlement efficiency. Care needs to be taken on revising the cash penalty rates for illiquid instruments for which scarcity rather than operational error will be the likely reason for fails after ISD+3: here, the AGC-EFC defers here to AFME and ICMA responses to ESMA’s consultation paper.

<ESMA\_QUESTION\_CSDR\_16>

**Q17** What are the main reasons for settlement fails, going beyond the high level categories: “fail to deliver securities”, “fail to deliver cash” or “settlement instructions on hold”? Please provide examples and data, as well as arguments to justify your answer.



<ESMA\_QUESTION\_CSDR\_17>

It is helpful to divide the reasons for settlement fails into three categories based on the lifecycle of a securities settlement instruction plus one overall structural problem:

**1/ Late instructions**, i.e., reasons that result in settlement instructions arriving late at the CSD. Clients of custodians, i.e., trading parties, may instruct late due to the following reasons:

- OTC trade booked late by trader;
- Late allocation by Investment Manager resulting in late booking by the broker (and late confirmation); similarly, late confirmation by the broker leading to late instruction by the Investment Manager;
- Missing reference data required for booking a trade such as: ISIN not set up by the data provider or ISIN not set up at the CSD results in the settlement instruction being rejected;
- Client account not opened in time or missing the data required to generate and provide onward settlement instructions such as SSIs;
- Settlement instruction template not set up in time;
- Systems issues; and
- The client may be in a different time-zone and instructs the custodian in their operating hours rather than the operating hours of the CSD, resulting in late instructions

Custodians transmit their clients' instructions through to a CSD but are constrained by cut-off times dictated by the CSD. If a client sends their instruction late in the day close to the CSD deadline, the custodian can only process these instructions on a 'best efforts basis'. It is important to note that - whilst a custodian will typically process its client's instructions in quick order - it must allow sufficient time to validate an instruction's format and eligibility and perform sanctions screening and credit checks (where appropriate) before sending on to the CSD. There may be situations in which a custodian instructs late due to their own data quality or systems issues.

**2/ Matching problems**, i.e., reasons that result in settlement instructions failing to match at the CSD. Matching issues at the CSD typically fall into two categories as follows:

- "Economic" mismatches regarding or due to ISINs, nominal, value date, cash amount due to lack of timely / accurate data, workflow management issues. Incorrect holiday

calendars can create value date mismatches. Lack of clarity whether an instrument should be settled as a unit or in nominal amount can also create issues.

The data / systems and operational teams who support ‘trade level matching’, i.e., allocation / confirmation matching and broker matching’, can be different depending on the teams / operational systems used to support ‘settlement matching’.

In addition, the cash tolerance used for matching in vendor matching platforms might not conform to the tolerances used by CSDs per CSDR RTS Article 6.

- “Non-economic” mismatches due to different standard settlement instructions (SSIs) or place of settlement (PSET) due to data quality issues, lack of market standards and different matching conventions in vendor matching platforms. PSET is not a matching field in vendor platforms - but should be.

Please note that ownership and responsibility for the economic and non-economic information included in the settlement instructions lies with the custodians’ clients. Custodians transmit their clients’ instructions through to the CSD and – as non-discretionary agents - are unable to amend any part of the received instructions without a new instruction from the client.

**3/ Lack of resources**, i.e., reasons for a party having insufficient resources (securities or cash) to settle a trade.

As cash in a single currency is fungible, settlement fails resulting from a lack of cash are very short-lived, and in most cases are resolved during the same settlement day.

In the context of this category, most settlement fails derive from a lack of securities, as securities, represented by different ISINs, are not fungible.

Settlement fails deriving from a lack of securities can be categorised into three subcategories:

- i. Problems deriving from a lack of position availability(i.e., from split positions): in such a case, the trading party has sufficient securities, but the securities are not immediately available for settlement, as they are located in a different place due to the position having been purchased from different sources (exchange / MTF / another broker) and in multiple shapes - meaning the receipts will not always correspond to the client deliveries, hence creating the need for partial settlement.
- ii. Problems associated with failing receipts (i.e., a chain of failing transactions): in such a case, the trading party has arranged to have sufficient securities in order to settle a delivery but has not yet received the securities or (per the above point) has purchased the position in various shapes from various sources (including possibly using different

CCPs) and, as a consequence, may not have the full position available to deliver but will be able to deliver partials.

- iii. Problems associated with a real shortage of securities: in such a case, the trading party has not yet arranged to have sufficient securities in order to settle a delivery due to the instrument lacking liquidity, which may mean that the 'cover position', which is often sourced via a borrow / repo, is failing: this leads to a failing settlement chain of matched fails. Please refer to our response to Question 16 in which 'scarcity' of an instrument is described.

**Structural issues:** In addition to the categories above, there are structural causes for fails that are outside the direct control of custodians and their clients (the trading parties): despite strides made in reducing the barriers to post-trade integration in the region, a number of barriers remain that create challenges timely settlement. At a high-level these issues include:

#### **1/ Lack of harmonised CSD standards / practices:**

- Misaligned: batch times, instruction input and / or settlement cycle cut-offs including misalignment between DVP and FOP batch times which result in fails / inventory not being maximised;
- Derogation for certain CSDs under CSDR to not have to offer partial settlement and hold & release;
- Partial release not offered by all CSDs, which is an essential tool for partial settlement to be used in omnibus accounts;
- Differing use and acceptance of ISO transaction types in settlement instruction messages results in settlement instructions being rejected at the CSD's SWIFT gateway;
- Differing SWIFT message templates used by CSDs including different formats for cross-border settlement creates a myriad of templates required to settle instructions in EEA CSDs; and
- Lack of instrument interoperability – certain ISINs are not eligible to settle in every EU CSD ;

#### **2/ Other barriers:**

- Different CCP cut-offs; and

- Market liquidity constraints.

In summary, we highlight the following:

- Within each of the categories mentioned above, and within each of the sub-categories, there may be many diverse underlying root causes for settlement fails.
- A single settlement failure in a chain of transactions may well lead to multiple settlement fails due to inability to match down the chain.

<ESMA\_QUESTION\_CSDR\_17>

**Q18 What tools should be used in order to improve settlement efficiency? Please provide examples and data, as well as arguments to justify your answer.**

<ESMA\_QUESTION\_CSDR\_18>

As mentioned in our answer to Question 17, settlement fails may have very diverse underlying root causes: a single fail may be the result of a number of reasons - not just one.

One major benefit of the current CSDR penalty mechanism for improving settlement efficiency is that it is an overarching tool that provides incentives for improved behaviour. We do, however, believe that the current CSDR penalty mechanism should be complemented by other more specific, and more targeted, tools and actions that will improve the operating environment to enable timely settlement which may require changes at FMIs, in regulation and to messaging.

The AGC supports the analysis and recommendations produced by AFME in their whitepaper, *Improving the settlement efficiency landscape in Europe*. From a custodian's point of view - sitting as an "intermediary" between the trading parties and the CSDs - the following areas of focus will be beneficial to achieving greater settlement efficiency discipline:

In order to tackle settlement fails arising from **late instructions and from matching problems**, there is a need for improvements to:

- Allocation & Confirmation processes: ensure that timing and processing aligns with CSDR RTS Article 2: matching criteria should align with the CSDs' matching criteria in order to avoid undue latency and exceptions in downstream processes such as settlement instruction and CSD-level matching;
- Reference Data: ensure that reference data is set up ahead of trading:

- Client accounts to be set-up and include all pertinent data required to book / allocate a trade and send settlement instructions;
  - SSIs: make use of SSI repositories to automate the use and population of SSIs to avoid manual templates and call-backs;
  - ISINs: to be set up by trading parties ahead of trading to prevent booking issues - CSDs and custodians to set up ISINs to ensure that settlement instructions can be sent and accepted without rejection;
  - Review of standardised settlement instruction templates without optional fields to create a single standard for each CSD / X-Border CSD relationship;
  - Holiday calendars to be shared by CSDs and set-up in trading party and custodian systems ahead of the next calendar year;
- Vendor matching platforms to match to the same standards as the CSDs to avoid 'false matches' and pushing the identification and resolution of issues down to the 'settlement matching' level at the CSD. AFME is currently working with vendors to improve 'upstream' matching processes – the AGC supports these efforts; and
  - It is important for settlement instructions to be sent real-time / intra-day rather than in batches in order to ensure that instructions are cascaded through to the CSD on trade date so that matching discrepancies are visible to trading parties via their custodians as early as possible. The use of 'on hold' should be leveraged by custodians and other CSD participants to enable matching and the early identification of exceptions without committing the instruction to settlement (until cash / securities are in place). AGC members are collaborating with AFME on this subject.

In order to tackle **structural issues**:

- We direct ESMA to the work currently being conducted by the ECB Ami-SeCo on identifying the remaining barriers to post trade integration - findings by ESCDA and AFME for example are publicly disclosed;
- We also would welcome the removal of CSD derogations for partial settlement and hold and release during the re-drafting of the CSDR RTS on Settlement Discipline and welcome the introduction of mandatory offering of partial release through the same re-drafting to ensure that auto-partialling can be used in omnibus accounts;
- At the CSD level, a review is required to ensure that all CSDs are meeting the requirements of Article 5 of the CSDR RTS, which requires CSDs to "provide to

participants a functionality that supports fully automated, continuous real-time matching of settlement instructions throughout each business day”;

- CSD cycles and market cut-offs should be widely aligned, including partial settlement cycles which currently differ substantially, and a simplified and harmonised process for realignment of assets between CSDs should be established. This helps to optimise settlement of available inventory, reduce settlement fails and the associated costs of cash penalties, capital charges and additional funding costs.

In order to tackle settlement fails resulting from a lack of **lack of resources**:

- Increased CSD interoperability and standardisation to achieve a single market and enable the seamless flow of securities cross-border;
- Proactive realignment to ensure positions traded into CSD A are available in CSD B / C etc where required;
- Shaping and splitting to align the nominals of deliveries to the nominals of the receipts (AGC refers to ICMA ERCC recommendations for shaping); and
- Further to the requirements for all CSDs in the region to provide all functionality required for partial settlement, market standards are required for CSD participants and their clients to support and use partial settlement.

<ESMA\_QUESTION\_CSDR\_18>

**Q19 What are your views on the appropriate level(s) of settlement efficiency at CSD/SSS level, as well as by asset type? Please provide data and arguments to justify your answer.**

<ESMA\_QUESTION\_CSDR\_19>

Regarding the appropriate level of settlement efficiency, our starting position is that this is a near impossible question to answer, however, we believe a fair view is that - everything else being equal - a higher rate of settlement efficiency is better than a lower rate.

As set out in our answers to questions 16, 17 and 18, we believe that there is scope to improve settlement efficiency in Europe.

Yet, at the same time, we do not believe that public authorities should set out explicit targets for settlement efficiency.

ESMA themselves note that not all fails are equal and that achieving 100% settlement efficiency is not possible. This is because settlement efficiency rates are dependent on a whole series of factors, many of which are external to individual capital market participants, and because any explicit settlement efficiency targets may have perverse effects.

Settlement efficiency rates are affected by such factors as:

- CSD functionalities
- CSD daily timetables (i.e., the period of time that a CSD is open for settlement)
- Liquidity of a security
- Increased participation in capital markets by issuers and investors (as new types of issuers will tend to issue less liquid securities, and new types of investors will have lower average volumes and will tend to be less automated)
- External shocks

In the event of a significant external shock to the European financial system, it is important that markets remain liquid, and that trading continues, even though the shock reduces overall rates of settlement efficiency. An explicit settlement efficiency target for market participants could dissuade market participants from continuing to trade and would thereby reduce the resilience and shock absorption capabilities of the financial system as a whole.

Rather than setting explicit targets for settlement efficiency, we believe that public policy action should focus on:

- improving the functioning of the markets and of market infrastructure;
- creating an overarching framework to incentivise improvements to settlement efficiency; and

Enhancing the quality of data on settlement efficiency and fail rate KPIs that are publicly available for a more granular understanding of the most relevant operational and structural problem areas (by market, by asset class, by transaction type, by ageing, etc., as also described in our answers to Questions 15 and 21).

<ESMA\_QUESTION\_CSDR\_19>

**Q20 Do you think the penalty rates by asset type as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389 are proportionate? Please provide data and arguments to justify your answer.**

<ESMA\_QUESTION\_CSDR\_20>

The AGC-EFC considers the existing regime to be adequate for what is still a relatively new regime and one which was introduced with some notable headwinds such as market volatility, early ‘teething issues’, which lasted some 6 months (some issues remain today), and a lack of measurement due to the differing data and reporting methodologies used.

In weighing up what a proportionate regime should look like it is essential that the cash penalty rate is proportionate to the root cause of the settlement fail and – consistent with ESMA’s own statements as well as our responses to the preceding questions - ‘not all fails are equal’. For example, it is not appropriate or proportionate to increase the cash penalty rate for instruments where there is a lack of liquidity as this will add strain. Similarly, it is not appropriate or proportionate to increase penalty rates for fails that are a direct consequence to the structural issues in the region that impede timely settlement. As was identified in the September 2023 Settlement Efficiency workshop hosted by ESMA, there is still much work to be done across the industry and regulatory community to i) identify the root causes of settlement fails and implement solutions which will require changes to regulation as well as to CSDs’ operations and market participants’ operations and ii) ensure an appropriate data and reporting methodology that accurately captures settlement fails and does not inflate the numbers by ‘double counting’ (the AGC-EFC welcomes the upcoming ESMA consultations on preventing settlement fails and data quality / reporting).

Any changes to the cash penalty methodology including the introduction of progressive penalty rates will be a significant and costly undertaking not only for CSDs but also for the wider industry, including custodians. Since it would require changes to the CSDs’ cash penalty processes, testing would be required prior to deployment. The need for testing is essential to avoid any detrimental impact to the CSDs’ operating environments and to ensure that the daily and monthly cash penalty calculation and reporting processes are seamless. Lessons should be learned from the 1<sup>st</sup> February 2022 implementation in this regard. Furthermore, any changes to CSD systems will come at a cost, which will be passed onto CSD participants - adding to the regions high-cost profile.

The AGC-EFC believes that the settlement discipline regime as a whole should be proportionate and that the goal of the cash penalty regime should be to create a behavioural incentive for market participants to prevent / remediate settlement fails and minimise penalty debits. We believe the regime does this today based on the downward trajectory of settlement fails (as described in our responses to Questions 15 and 16 above).



However, we recognise that the regime should be relatively dynamic and may require adjustment should fails increase and threaten financial stability (per the CSDR ReFIT justification to maintain MBIs). However, any such adjustment requires definition, assessment and quantification, which have not been presented in this consultation.

Any change to cash penalty rates should be proposed with clear supporting evidence that justifies an increase: we note that this consultation is not supported by economic data and analysis. Furthermore, the methodology and data that underpin the monitoring and reporting of settlement fails by the CSDs to the NCAs and ESMA must be based on a single data methodology which does not distort the level of settlement fails – we note that ESMA will be consulting on data quality and reporting, a consultation that we believe should have been the first of the three consultations.

Proportionality is also important in the context of trading and market liquidity – it would not be proportionate for cash penalties to materially impact trading decisions / market liquidity.

Lastly, the cash penalty regime should not create an incentive to fail which is counterproductive to a regime that is intended to prevent settlement fails. Please refer to our response to Question 22 which explores this in more detail.

<ESMA\_QUESTION\_CSDR\_20>

**Q21 Regarding the proportionality of the penalty rates by asset type as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389, ESMA does not have data on the breakdown of cash penalties (by number and value) applied by CSDs by asset type. Therefore, ESMA would like to use this CP to ask for data from all EEA CSDs on this breakdown, including on the duration of settlement fails by asset type.**

<ESMA\_QUESTION\_CSDR\_21>

Whilst the AGC-EFC recognises that this question asks for the EEA CSDs to provide data, the question being asked exemplifies our members' concerns that the current dataset and methodology required in the RTS are not sufficiently comprehensive to give the appropriate level of insight, granularity and certainty of settlement efficiency in the region.

As AFME has noted in its position paper, it is evident that current fail reporting parameters and the methodology deployed differ across the CSD community. Taken as a whole, this leads to ambiguity and a distorted view of settlement fails. For example, we have become aware of certain CSDs that count a single trade that fails over a span of 3 days as 3 different fails, rather than a single trade or transaction that fails for a duration of 3 days. As a result, this misrepresents the true picture, as the CSD triples the number of trades that fail.

A common approach to data is needed. This includes application of consistent methodology that includes the following elements across all CSDs:

- Breakdown of settlement instructions by age of settlement fail;
- Breakdown of settlement instructions by instrument type based on MIFID II classifications;
- Breakdown of settlement instructions by transaction type;
- Breakdown of settlement instructions by all ISO fail reasons;
- Breakdown of settlement instructions by country of issuance of the security
- Breakdown of settlement instructions by settlement location;
- Breakdown of settlement instructions by “matching time” (highlighting cases of ‘late instructing’ and ‘late matching’);
- Breakdown of settlement instructions by asset class;
- Breakdown of cancellation instructions relating to both matched (bilaterally cancelled) and unmatched (unilaterally cancelled) per asset class, per transaction type, per settlement location, etc;
- Comparison of settlement rates for domestic instructions vs cross-border instructions;
- Total and average volume and value of CSDR cash penalties issued per day;
- Breakdown of CSDR cash penalties by type (LMFP v SEFP), with segregation by asset class, transaction type, settlement location, etc.

<ESMA\_QUESTION\_CSDR\_21>

**Q22 In your view, would progressive penalty rates that increase with the length of the settlement fail be justified? Please provide examples and data, as well as arguments to justify your answer.**

<ESMA\_QUESTION\_CSDR\_22>

We do not believe that progressive penalty rates are justified. If introduced, we believe that they will have counterproductive and perverse effects.

Progressive penalty rates would damage many of the principles that lie at the heart of the design of the current CSDR penalty mechanism.

These principles are simplicity, transparency, auditability, fairness and operational efficiency.

For the mechanism to work correctly, penalties must be transmitted down the custody chain to the party that is apparently at fault. Each party in the chain down to the end investor must be able to recognise and understand both the source and the applicability of each penalty.

Progressive penalty rates create complexity and would make it more difficult for parties in the chain to recognise and to understand individual penalties.

Progressive penalty rates would damage the immunisation principle, whereby a party in the middle of a chain of failing settlement instructions is “immunised”, as the penalty amount that the party pays is compensated by the penalty amount that the party receives.

As transactions may be instructed and matched on different days, and as failing settlement chains are “dynamic” and may change over time as new instructions are matched, and other transactions settle, there is no guarantee with progressive penalty rates that the penalty rate on a receipt would be the same as the penalty rate on a delivery.

This in itself will generate anomalies, as innocent parties would be responsible for paying net penalties.

The immunisation principle is also important to reduce the risk of double borrowing and to reduce multiple buy-ins in a chain of failing transactions.

We believe that a progressive regime might have other perverse effects, such as creating an incentive for parties not to send settlement instructions until they have the securities available, as the late matching fines would be lower.

A much broader counterproductive effect of progressive rates (particularly in the context of the Capital Markets Union) would be to reduce the attractiveness of European capital markets through increased costs and complexity.

We believe that progressive penalties will increase the number of bilateral claims – further increasing frustration among market participants.

The AGC-EFC believes that taking context into account is important when assessing proportionality: the majority of fails are resolved on ISD+1 and +2, with only a small percentage of trades failing past 3 days (please refer to the T2S CSG tables reported by T2S in the ESMA September 2023 workshop).

As ESMA notes in paragraph 60 of the consultation:

*... Therefore, on the one hand, meaningful, persistent costs in the form of penalties can trigger meaningful investments to avoid them.*

The age profile of fails being resolved between ISD+1 and +3 is testament to this. In addition, Late Matching Fail Penalties offer incentive to instruct and match ahead of ISD.

ESMA however goes on to say in paragraph 60:

*On the other hand, costs on un-avoidable fails will only make the system less efficient and at a competitive disadvantage. .... an additional criterion which the penalty system should potentially take into account will be introduced, i.e. the duration of the fail. Thus, it seems appropriate to consider amending the penalty mechanism by introducing progressive cash penalties that increase with the length of the settlement fail.*

In our view, concerns arising from “un-avoidable” fails due to structural or liquidity issues would be **exacerbated** by progressive penalty rates, which would be unlikely to resolve the fail any quicker but will add more stress to the system, more operational risk and more cost, with negative consequences for the region’s securities markets.

<ESMA\_QUESTION\_CSDR\_22>

**Q23 What are your views regarding the introduction of convexity in penalty rates as per the ESMA proposed Option 2 (settlement fails caused by a lack of liquid financial instruments)? Please justify your answer by providing quantitative examples and data if possible.**

<ESMA\_QUESTION\_CSDR\_23>

The AGC-EFC does not support the introduction of convexity for the same reasons set out in our response to Question 22. There appears to be no economic justification for this: it would be very complex and – we believe - would be highly burdensome for CSDs to implement.

A trade failing for 20 days suggests a structural / liquidity issue rather than an efficiency related issue. The proposed convexity criterion may not increase the chance of the trade settling any sooner but would in our view add friction and cost to the process.

<ESMA\_QUESTION\_CSDR\_23>

**Q24 Would it be appropriate to apply the convexity criterion to settlement fails due to a lack of illiquid financial instruments as well? Please justify your answer by providing quantitative examples and data if possible.**

<ESMA\_QUESTION\_CSDR\_24>

We don't support this proposal for the same reasons set out above: there appears to be no economic justification, it is very complex and would be burdensome for CSDs to implement.

<ESMA\_QUESTION\_CSDR\_24>

**Q25 What are your views regarding the level of progressive penalty rates:**

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

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

<ESMA\_QUESTION\_CSDR\_25>

As set out in our previous answers, and in particular in our answer to question 22, we believe that introducing progressive penalties will be damaging.

The penalty rates set out in Options 1 and 2 are not simply progressive. They also represent major increases in overall penalty rates and significant increases in the complexity and operational costs of running the penalty regime for all intermediaries in the custody chain.

Although we support the principle of a recalibration of penalties in order to contribute to creating appropriate incentives for timely settlement, we have major concerns about the size of the increases set out in Options 1 and 2.

Some considerations:

1/ In many cases, there already are incentives for market participants to settle on a timely basis, e.g., the cash resulting from settlement of a DVP, capital savings on pending transactions, and the operational burden of monitoring and managing fails.

2/ A major increase in penalties creates the risk of unforeseen effects – through, for example, the impact on trading activities, and a potential diversion of activity from central market infrastructure because of the cost, risk and uncertainty generated by the penalty mechanism.

3/ One critical point is that the penalty mechanism of CSDs does not have full information as to the precise causes of a settlement fail. Accordingly, for an individual transaction, a penalty may be imposed on the innocent party. This in itself is not necessarily a problem. If the absolute size of an individual penalty is low, then the individual penalty itself may not matter much, and the penalty mechanism will achieve its effect through the collective impact of penalties on a

pattern of activity. And, of course, any innocent party can correct the penalty mechanism by making a bilateral claim against its counterparty, or against the party at fault. But a major increase in penalty size creates additional burdens and risk, through the increase in bilateral claims, and through the imposition of large penalties on parties that may be innocent.

4/ The fundamental rationale for the penalty mechanism is that it is a mechanism to deal with externalities (as there are costs associated with failing settlement, so that it is appropriate for a misbehaving party to compensate a well-behaving party). Major increases in penalty rates (going beyond the compensation of external costs) will distort the market in a way that departs from the rationale for the penalty mechanism.

<ESMA\_QUESTION\_CSDR\_25>

**Q26** If you disagree with ESMA's proposal regarding the penalty rates, please specify which rates you believe would be more appropriate (i.e. deterrent and proportionate, with the potential to effectively discourage settlement fails, incentivise their rapid resolution and improve settlement efficiency). Please provide examples and data, as well as arguments to justify your answer. If relevant, please provide an indication of further proportionality considerations, detailed justifications and alternative proposals as needed.

<ESMA\_QUESTION\_CSDR\_26>

We have addressed this in our previous responses.

<ESMA\_QUESTION\_CSDR\_26>

**Q27** What are your views regarding the categorisation of types of fails:

a) as proposed under Option 1?

b) as proposed under Option 2?

Do you believe that less/further granularity is needed in terms of the types of fails (asset classes) subject to cash penalties? Please justify your answer by providing quantitative examples and data if possible.

<ESMA\_QUESTION\_CSDR\_27>

We have addressed this in our previous responses.

<ESMA\_QUESTION\_CSDR\_27>

**Q28** What costs and benefits do you envisage related to the implementation of progressive penalty rates by asset type (according to ESMA's proposed Options 1 and 2)? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

<ESMA\_QUESTION\_CSDR\_28>

<b>Progressive penalty rates (by asset type) - ESMA's proposal Option 1</b>	<b>Please see ESMA's proposed Option 1 in Section 5.3 of this CP.</b>	
	<b>Qualitative description</b>	<b>Quantitative description/ Data</b>
<b>Benefits</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Compliance costs: - One-off - On-going</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Costs to other stakeholders</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Indirect costs</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Progressive penalty rates (by asset type) - ESMA's proposal Option 2</b>	<b>Please see ESMA's proposed Option 2 in Section 5.3 of this CP.</b>	
	<b>Qualitative description</b>	<b>Quantitative description/ Data</b>
<b>Benefits</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Compliance costs: - One-off</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

<b>- On-going</b>		
<b>Costs to other stakeholders</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Indirect costs</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_28>

**Q29** Alternatively, do you think that progressive cash penalties rates should take into account a different breakdown than the one included in ESMA's proposal above for any or all of the following categories:

- (a) asset type;
- (b) liquidity of the financial instrument;
- (c) type of transaction;
- (d) duration of the settlement fail.

If you have answered yes to the question above, what costs and benefits do you envisage related to the implementation of progressive penalty rates according to your proposal? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

<ESMA\_QUESTION\_CSDR\_29>

TYPE YOUR TEXT HERE

<b>Progressive penalty rates – respondent's proposal (if applicable)</b>		
	<b>Qualitative description</b>	<b>Quantitative description/ Data</b>
<b>Benefits</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE



<b>Compliance costs:</b> - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Costs to other stakeholders</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Indirect costs</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_29>

**Q30** Another potential approach to progressive penalty rates could be based not only on the length of the settlement fail but also on the value of the settlement fail. Settlement fails based on instructions with a lower value could be charged a higher penalty rate than those with a higher value, thus potentially creating an incentive for participants in settling smaller value instructions at their intended settlement date (ISD). Alternatively, settlement fails based on instructions with a higher value could be charged a higher penalty rate than those with a lower value. In your view, would such an approach be justified? Please provide arguments and examples in support of your answer, including data where available. What costs and benefits do you envisage related to the implementation of this approach? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

<ESMA\_QUESTION\_CSDR\_30>

We believe this approach would be a mistake: similar to what we have stated previously, this would increase complexity, increase operational risk and damage the “immunisation” principle.

<b>Progressive penalty rates – based on the length and value of the settlement fail</b>	<b>Settlement fails based on lower value settlement instructions could be charged a higher penalty rate than those based on higher value settlement instructions</b>	<b>Settlement fails based on higher value settlement instructions could be charged a higher penalty rate than those based on lower value settlement instructions</b>
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	<b>Qualitative description</b>	<b>Quantitative description/ Data</b>	<b>Qualitative description</b>	<b>Quantitative description/ Data</b>
<b>Benefits</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Compliance costs:</b> - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Costs to other stakeholders</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Indirect costs</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_30>

**Q31** Besides the criteria already listed, i.e. type of asset, liquidity of the financial instruments, duration and value of the settlement fail, what additional criteria should be considered when setting proportionate and effective cash penalty rates? Please provide examples and justify your answer.

<ESMA\_QUESTION\_CSDR\_31>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_31>

**Q32** Would you be in favour of the use of the market value of the financial instruments on the first day of the settlement fail as a basis for the calculation of penalties for the entire duration of the fail? ESMA would like to ask for the stakeholders' views on the costs and benefits of such a measure. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

<ESMA\_QUESTION\_CSDR\_32>

We would not be in favour of this: it would increase complexity, increase operational risk and damage the "immunisation" principle.

<b>Use the market value of the financial instruments on the first day of the settlement fail as a basis for the calculation of penalties for the entire duration of the fail</b>		
	<b>Qualitative description</b>	<b>Quantitative description/ Data</b>
<b>Benefits</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Compliance costs:</b> - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Costs to other stakeholders</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Indirect costs</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_32>

**Q33 How should free of payment (FoP) instructions be valued for the purpose of the application of cash penalties? Please justify your answer and provide examples and data where available.**

<ESMA\_QUESTION\_CSDR\_33>

FoP instructions should be valued using the same methodology as that used for against-payment transactions, in order to maintain the “immunisation principle”.

<ESMA\_QUESTION\_CSDR\_33>

**Q34 Do you think there is a risk that higher penalty rates may lead to participants using less DvP and more FoP settlement instructions? Please justify your answer and provide examples and data where available.**

<ESMA\_QUESTION\_CSDR\_34>

No, we do not. We believe the choice of using DvP or FoP is driven by other considerations rather than by the potential impact of fail penalties.

<ESMA\_QUESTION\_CSDR\_34>

**Q35 ESMA is considering the feasibility of identifying another asset class subject to lower penalty rates: “bonds for which there is not a liquid market in accordance with the methodology specified in Article 13(1), point (b) of Commission Delegated Regulation (EU) 2017/583 (RTS 2)”. The information on the assessment of bonds’ liquidity is published by ESMA on a quarterly basis and further updated on FITRS. However, ESMA is also aware that this may add to the operational burden for CSDs that would need to check the liquidity of bonds before applying cash penalties. As such, ESMA would like to ask for the stakeholders’ views on the costs and benefits of such a measure. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.**

<ESMA\_QUESTION\_CSDR\_35>

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

More granular differentiation of instruments based on criteria such as their liquidity can be helpful to provide for better penalties calibration. However, this should be considered against the additional technical implementation costs for and risks taken on by FMIs and intermediaries. We believe that a “golden source” database maintained by ESMA is the key to ensure full transparency and alignment in respect of penalties to be applied for each fail.

<ESMA\_QUESTION\_CSDR\_35>

**Q36 Do you have other suggestions for further flexibility with regards to penalties for settlement fails imposed on illiquid financial instruments? Please justify your answer and provide examples and data where available.**

<ESMA\_QUESTION\_CSDR\_36>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_36>

**Q37 How likely is it that underlying parties that end up with “net long” cash payments may not have incentives to manage their fails or bilaterally cancel failing instructions as they may “earn” cash from penalties? How could this risk**

**be addressed? Please justify your answer and provide examples and data where available.**

<ESMA\_QUESTION\_CSDR\_37>

It is not clear that this is a major problem. A party that misuses CSD functionalities in order to receive an undue cash penalty may always receive a bilateral claim from its counterparty.

Nonetheless, there are steps that should be taken to minimise the risk of any such cases.

Such steps include:

- Encouraging partial settlement
- Advancing the point in time at which matched failing transactions are automatically cancelled (and, if necessary, replaced by a new instruction). Such a cancellation should take place at the latest twenty (or thirty) business days after intended settlement date. Such a change will facilitate increased discipline in the settlement process, as required by a move to T+1, and as also required by elements of the FASTER withholding tax proposal.

<ESMA\_QUESTION\_CSDR\_37>

**Q38 How could the parameters for the calculation of cash penalties take into account the effect that low or negative interest rates could have on the incentives of counterparties and on settlement fails? Please provide examples and data, as well as arguments to justify your answer.**

<ESMA\_QUESTION\_CSDR\_38>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_38>

**Q39 To ensure a proportionate approach, do you think the penalty mechanism should be applied only at the level of those CSDs with higher settlement fail rates? Please provide examples and data, as well as arguments to justify your answer. If your answer is yes, please specify where the threshold should be set and if it should take into account the settlement efficiency at:**

- a) CSD/SSS level (please specify the settlement efficiency target);
- b) at asset type level (please specify the settlement efficiency target); or
- c) other (please specify, including the settlement efficiency target).

<ESMA\_QUESTION\_CSDR\_39>

No. Such a step would be a major step backwards towards inefficient and fragmented European markets.

Although CSD functionalities and opening hours do have an impact on settlement efficiency rates, other important drivers of settlement efficiency include the type of securities, the type of activity, and the actions and internal processes of individual market participants.

Applying penalties only at CSDs with higher settlement fail rates would create fragmentation in European markets, would distort competition between CSDs, and would create particular problems for the application of penalties for settlement activity taking place in CSDs that use the T2S platform.

<ESMA\_QUESTION\_CSDR\_39>

**Q40 Please specify what costs and benefits you envisage regarding the application of the penalty mechanism only at the level of the CSDs with higher settlement fail rates. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.**

<ESMA\_QUESTION\_CSDR\_40>

<b>Application of the penalty mechanism only at the level of CSDs with lower settlement fail rates</b>		
	<b>Qualitative description</b>	<b>Quantitative description/ Data</b>
<b>Benefits</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

<b>Compliance costs:</b> - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Costs to other stakeholders</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Indirect costs</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_40>

**Q41 Do you think penalty rates should vary according to the transaction type? If yes, please specify the transaction types and include proposals regarding the related penalty rates. Please justify your answer and provide examples and data where available. Please specify what costs and benefits you envisage related to the implementation of your proposal. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.**

<ESMA\_QUESTION\_CSDR\_41>

No. This would destroy the immunisation principle, as chains of failing settlement instructions may be made up of transactions of different types.

There might be benefits in excluding market claims and transformations, or “settlement fails ... caused by factors not attributable to the participants to the transaction” (Art. 7.2 in CSDR Refit). Also, CSD-generated instructions should be exempted from LMFPs, since neither party should be penalised for these kinds of late instructions.

<b>Applying penalty rates by transaction types</b>		
	<b>Qualitative description</b>	<b>Quantitative description/ Data</b>
<b>Benefits</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE



<b>Compliance costs:</b> - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Costs to other stakeholders</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
<b>Indirect costs</b>	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_41>

**Q42 Do you think that penalty rates should depend on stock borrowing fees? If yes, do you believe that the data provided by data vendors is of sufficient good quality that it can be relied upon? Please provide the average borrowing fees for the 8 categories of asset class depicted in Option 1. (i.e. liquid shares, illiquid shares, SME shares, ETFs, sovereign bonds, SME bonds, other corporate bonds, other financial instruments).**

<ESMA\_QUESTION\_CSDR\_42>

Please refer to our response to Question 25.

<ESMA\_QUESTION\_CSDR\_42>

**Q43 Do you have other suggestions to simplify the cash penalty mechanism, while ensuring it is deterrent and proportionate, and effectively discourages settlement fails, incentivises their rapid resolution and improves settlement efficiency? Please justify your answer and provide examples and data where available. Please specify what costs and benefits you envisage related to the implementation of your proposal. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.**

<ESMA\_QUESTION\_CSDR\_43>

TYPE YOUR TEXT HERE

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

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_43>

**Q44** Based on your experience, are settlement fails lower in other markets (i.e USA, UK)? If so, which are in your opinion the main reasons for that? Please also specify the scope and methodology used for measuring settlement efficiency in the respective third-country jurisdictions.

<ESMA\_QUESTION\_CSDR\_44>

There are very significant differences in market structure and market practice between the EU and the US. These include:

- no settlement finality legislation in the U.S. (although the rules of the CSD are – in effect - viewed as providing for this);
- settlements are processed in blocks (via a continuous net settlement process) and can be returned to the delivering party after settlement date under the “DK” (“don’t know”) procedure; and
- no tracking of ISD by DTCC.

Anecdotal evidence suggests that the level of DKs is significant (approx. 5-10%, both at DTCC and at FED), so that the publicly-reported settlement efficiency statistics may be grossly overstated versus a broader perspective that encompasses CSD participants and their clients.

As a result, it is very difficult to produce statistics on EU and US settlement efficiency that are comparable.

We are aware of data that suggests that - for some comparable activities - EU settlement rates are higher than U.S. settlement rates.

Furthermore, settlement efficiency rates in the UK market are broadly in line with the EU.

<ESMA\_QUESTION\_CSDR\_44>

**Q45 Do CSD participants pass on the penalties to their clients? Please provide information about the current market practices as well as data, examples and reasons, if any, which may impede the passing on of penalties to clients.**

<ESMA\_QUESTION\_CSDR\_45>

It is a common practice for AGC members to pass on penalties to their clients.

However, it may well be the case that an AGC member, even if it generally passes on penalties, does not pass on penalties associated with a particular type of activity, or with a particular type of client, given the specificities of the type of activity, or the type of client.

We believe that there should be full alignment of debit/credit penalties against the parties are themselves in a position to successfully complete settlement instructions: certain types of parties should not – solely due to the design of the settlement discipline regime – be positioned to always receive penalty credits on a net basis, as this may lead to adverse and inappropriate behaviours.

<ESMA\_QUESTION\_CSDR\_45>

**Q46 Do you consider that introducing a minimum penalty across all types of fails would improve settlement efficiency? If yes, what would be the amount of this minimum penalty and how should it apply? Please provide examples and data, as well as arguments to justify your answer.**

<ESMA\_QUESTION\_CSDR\_46>

There are two possible approaches to a minimum penalty:

1/ Penalties below the minimum do not apply.

2/ Penalties below the minimum are raised to the minimum level.

Approach 1 has some apparent advantages, but also some significant disadvantages, including increased complexity and damage to the “immunisation” principle.

Approach 2 has major disadvantages, as it would in our view create numerous anomalies.

<ESMA\_QUESTION\_CSDR\_46>

**Q47 What would be the time needed for CSDs and market participants to implement changes to the penalty mechanism (depending on the extent of the changes)? Please provide arguments to justify your answer.**

<ESMA\_QUESTION\_CSDR\_47>

Considering the time needed for the industry to fully implement the CSDR settlement discipline regime (approximately two years) before Feb 2022, plus additional months to resolve initial gaps caused by incomplete deployment and testing, it would be natural to expect that any complex changes to the existing penalties regime would require a similar long period of time.

There would need to be sufficient time given for regulatory and other approvals, development, testing and deployment of any change request of significant scale and impact.

<ESMA\_QUESTION\_CSDR\_47>

**Q48 Since the application of the RTS on Settlement Discipline, how many participants have been detected as failing consistently and systematically within the meaning of Article 7(9) of CSDR? How many of them, if any, have been suspended pursuant to same Article?**

<ESMA\_QUESTION\_CSDR\_48>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_48>

**Q49 In your view, would special penalties (either additional penalties or more severe penalty rates) applied to participants with high settlement fail rates be justified? Should such participants be identified using the same thresholds as in Article 39 of the RTS on Settlement Discipline, but within a shorter timeframe (e.g. 2 months instead of 12 months)? If not, what criteria/methodology should be used for defining participants with high settlement fail rates? Please provide examples and data, as well as arguments to justify your answer.**

<ESMA\_QUESTION\_CSDR\_49>

We do not believe that applying special penalties for participants with high settlement fail rates would be justified. In fact, we believe that applying such penalties would create the risk of damage to key elements of the European post-trade system.

This view is based on the following considerations.

1/ Such special penalties are not necessary as, firstly, the rates for late settlement penalties should be calibrated so that all market participants have incentives for timely settlement, and, secondly, supervisory bodies already have existing powers with relation to misbehaving market participants.

2/ Such special penalties would create anomalies, and will damage, or create inappropriate incentives, for parties who are not at fault. This is because a CSD participant may be acting as an intermediary, and the settlement fail rates on a specific CSD account may reflect the activities of multiple underlying trading parties, some of which may be well-behaved, and some of which may have misbehaved. Given that CSDs will not be able to distinguish between well-behaving and misbehaving parties, the application of special penalties creates the risk that well-behaving parties will be unduly penalised, and with no ability to seek effective recourse.

<ESMA\_QUESTION\_CSDR\_49>

**Q50 How have CSDs implemented working arrangements with participants in accordance with article 13(2) of the RTS on Settlement Discipline? How many participants have been targeted?**

<ESMA\_QUESTION\_CSDR\_50>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CSDR\_50>

**Q51 Should the topic of settlement efficiency be discussed at the CSDs' User Committees to better identify any market circumstances and particular context of participant(s) explaining an increase or decrease of the fail rates? Please justify your answer.**

<ESMA\_QUESTION\_CSDR\_51>

Yes. The topic of settlement efficiency is an appropriate topic of discussion at CSD User Committees.

One reason for this is that the settlement efficiency rate of any individual market participant is affected by the settlement efficiency rate of other market participants, so that it is appropriate for there to be broad market discussions on how to improve settlement efficiency.

Another reason is that overall settlement rates are affected both by CSD functionalities and by CSD daily timetables. It is important that CSD User Committees discuss how to change CSD functionalities and CSD daily timetables in order to improve settlement rates.

It is important that CSDs should be required to provide detailed information to their participants about settlement efficiency in their respective SSS. In order to ensure full comparability across FMIs and across markets, this information should be compiled using the same settlement efficiency definitions, data granularity and KPIs across all markets, as noted above in our responses to Questions 15 and 21.

<ESMA\_QUESTION\_CSDR\_51>