



Central Securities Depositories Regulation Settlement Discipline Regime

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1. Overview

The CSDR rules on the Settlement Discipline Regime (SDR) introduce a number of measures to prevent settlement fails by ensuring that all transaction details which are required to effect settlement are provided well in advance of the intended settlement date (ISD), as well as further incentivising timely settlement through cash penalty fines and buy-ins.

In addition, CSDs are required to provide functionality to participants to ensure harmonisation and automation of settlement processes across all European Economic Area markets to improve settlement efficiency.

The go live date for the CSDR Settlement Discipline Regime (SDR) has been delayed until 1 February 2021.

1. General

(a) What are the specifics of the settlement discipline regime?

The SDR introduces two main sets of measures:

- measures to prevent settlement fails by improving matching and settlement rates; and
- measures to address settlement fails: cash penalties and mandatory buy-ins.

| MONITOR  | PREVENT  | ADDRESS  |
|---|--|---|
| <ul style="list-style-type: none">• Transparent settlement efficiency rates• Top 10 lowest reported by CSD monthly | <ul style="list-style-type: none">• Trade confirmations and allocations• Additional fields• Tolerance levels• Partial settlements | <ul style="list-style-type: none">• Mandatory buy-ins• Cash Penalties |

The latter set of SDR measures introduces a cash penalty process for settlements that do not occur on time and mandatory buy-ins for trades that fail to settle after a certain period of time (e.g. ISD+4).

The settlement discipline measures include the following elements:

- Late matching fines
- Late settlement fines
- Mandatory buy-ins

Late matching and late settlement fines are generally referred to as settlement fines or cash penalties.

Mandatory buy-ins occur when prevention measures have failed and the trade remains unsettled.

(b) What is the intention of the new settlement discipline?

The new discipline regime intends to improve settlement efficiency in the market. The onus will be on firms to input, match, and settle transactions in good time, or, be subject to cash penalties as a result of failure to do so.

2. Settlement Fails

(a) What is a settlement fail?

A settlement fail refers to a trade that has not settled on the intended settlement date.

A settlement fail includes total, as well as partial failure, to settle on the intended settlement date due to a lack (in whole or in part) of securities or cash for the settlement to take place.

A settlement fail is deemed to occur irrespective of the underlying cause. The CSDR measures apply regardless of any other default procedure that may be applicable in respect of the underlying transaction and do not depend on the outcome of any dispute associated with the trade.

(b) What instruments are in-scope?

Transferable securities i.e. equities, bonds, depository receipts, exchange traded funds (ETFs), money market instruments, UCITS (excluding issue and redemption of units) and emission allowances eligible for settlement on the CSD which are:

- Admitted for trading or traded on an EU trading venue; or
- Cleared (or eligible for clearing) by an EU central counterparty (CCP).

(c) Are stock borrows in-scope for settlement fails?

Stock loans and returns will be in scope for penalties if not settled on the intended settlement date. There is an exception from the mandatory buy-in regime for loans with a term of less than 30 days.

2. Prevent Settlement Failure

The timely booking and matching of trades pre settlement (i.e. before ISD) will become of the utmost importance.

1. Trade Confirmations and Allocations

CSDR introduces measures to prevent fails, which focus on the trade confirmations and allocation process, to encourage automated settlement based on the availability in advance of all necessary information.

(a) What does the regulation require?

The regulation sets out detailed rules relating to the message flows between the two parties to a trade: (i) the investment firm (defined widely); and (ii) its client, once an investment firm has executed a trade on behalf of its client. The regulation requires that the investment firm include these rules in the contractual arrangements with its client.

Once the investment firm has sent the confirmation of the execution to a professional client, the client is obliged to confirm its acceptance of the terms of the transaction. The client is also obliged to send to the investment firm a set of specific details relating to the allocations of securities or of cash. The client is obliged to send both these messages by a specific deadline (see below in section (b) for details). The client can combine both messages in a single message.

Investment firms have to confirm receipt of the confirmation and allocation messages within two hours of receipt.

Investment firms are under the obligation to offer their professional clients the option of sending the confirmation and allocation messages electronically using international communication standards.

Please note that the term “professional client” is not defined and does not necessarily track the definition used under MiFID. It appears that the term is used to describe anyone that is not a retail client so the rules would also apply to a trade with an entity that is classified under MiFID as “eligible counterparty”. For retail clients, the exchange of this information is still required but the timeline is extended to the following business day.

(b) What is the impact?

Professional clients will need to ensure that they provide the investment firm with the confirmation message, and with all required information in an allocation message **within specified timeframes**. Clients should expect their “investment firm” would request such information and put in place the arrangements to be able to provide it and in turn have their clients provide it to them within the specified timeframes.

- The investment firm should receive the confirmation and allocation messages by close of business on the business day that the transaction took place.
- If the two parties are in time zones with more than a 2 hour difference, or if the order has been executed after 16:00 CET, then there is an extension of the deadline until 12:00 CET on the following business day.

Any contractual agreements between a professional client and an investment firm must include the communication requirements of the confirmation and allocation messages, the information to be provided, what method of communication will be used, and the timeframes by which messages should be sent.

The ESMA guidance (issued by way of FAQs) provides firms with a more flexible approach in achieving compliance with the rules. Firms should also review the exemptions from the requirements to exchange the information as set out within the rules to confirm whether any of those exemptions is available to them where they act as an “investment firm” under the rules. Firms may wish to liaise with their industry associations as they work towards agreeing market practice in several important areas of the SDR that are not covered or addressed in sufficient detail by CSDR itself.

2. Additional Settlement Instruction Fields

(a) What does the regulation require?

CSDs require their participants to populate additional fields in their settlement instructions.

The additional fields are:

- **Transaction type:** The transaction type will become mandatory on settlement instructions to CSDs
- **Place of Trade and Place of Clearing:** In some instances, CSDs will also require participants to instruct the place of trade and the place of clearing

The place of trade will be used to derive the correct cash penalty rate for the relevant financial instrument for Small Medium Enterprise (SME) growth markets. If clients do not notify this, then they may receive a higher cash penalty, as CSDs will default the transactions as not having been executed on a trading venue.

Note: In order for a CSD to apply the reduced SME Growth Market penalty rate, both participants need to have entered the same SME Growth Market in the Place of Trade field.

The latest European Central Securities Depositories Association (ECSDA) Penalty Framework states:

“For the sake of identifying the applicable penalty rate, CSDs need to identify whether the instrument to be settled was actually traded on an EU SME Growth Market by verifying both, the receiving and delivering instruction of the settlement transaction.

Only when both instructions show the same “Place of trading” four-digit MIC (Market Identifier Code) the reduced penalty rate applicable to SME instruments shall be applied.”

You can find the list of SME Growth Markets [here](#).

The place of clearing is used to identify if the transaction was cleared through a central counterparty (CCP). Depending on the outcome of current discussions with ESMA, this may be used to identify who is responsible for managing the collection and distribution of cash penalties (the CSD or the CCP).

(b) What is the impact?

Firms will need to ensure that they instruct all relevant details necessary as this could affect whether their transactions settle on time or become subject to a cash penalty or buy-in.

3. Tolerance Matching

(a) What does the regulation require?

The settlement discipline regime of CSDR contains various measures to prevent settlement failure. CSDs have a functionality to allow matching even if the cash amounts on the two settlement instructions differ.

In such a case, matching will occur providing that the difference in cash amounts is not greater than a standard tolerance level.

There will be two bands of tolerance:

- €2 for up to €100,000
- €25 for over €100,000

For settlement instructions in other currencies, the tolerance level per settlement instruction shall be of equivalent amounts based on the official exchange rate of the ECB, where available.

4. Partial Settlement

(a) What does the regulation require?

CSDs are required to provide participants with functionality to partially settle transactions. Early partial settlement, between intended settlement date (ISD) and buy-in deadline date -1, can reduce the penalty fines payable by the delivering party.

On the deadline date of the buy-in extension period (e.g. ISD +4 for liquid securities), the regulation states that any available stock must be used to partially settle, unless the settlement instruction is on hold.

(b) How do auto-partials work?

If a firm chose to move to a segregated account, they have the option to allow auto-partials (PART). We believe that by moving to auto-partial settlement, firms will increase settlement efficiency and reduce settlement fines. Please note that auto-partial settlements are only available at segregated account level.

The CSD will split the instruction based on the stock position available and the cash consideration will be calculated by as per the new quantity of shares.

| Example 1 Counterpart A sells 1,000 XYZ shares for €1,000 to Counterparty B | |
|--|---|
| Both A & B have the account set to PART | |
| ISD | Counterpart A has a position of 500 shares |
| ISD | Counterpart A delivers 500 XYZ Shares vs €500 to Counterparty B |
| ISD + 1 | Counterpart A has received and has a further position of 500 shares |
| ISD + 1 | Counterpart A delivers the final 500 XYZ Shares vs €500 to Counterparty B |

If the counterparty uses NPAR then partials will not occur.

| Example 2 | |
|---|--|
| <ul style="list-style-type: none"> • Counterpart A sells 1,000 XYZ shares for €1,000 to Counterparty B • Counterparty B Sells 1,000 XYZ Shares to Counterparty C for €1,100 | |
| Both A & B have the account set to PART | |
| Counterparty C has the account set to NPAR | |
| ISD | Counterpart A has a position of 500 shares |
| ISD | Counterpart A delivers 500 XYZ Shares vs €500 to Counterparty B |
| ISD | Counterpart B cannot deliver to Counterparty C |
| ISD | Counterpart B has a long stock balance of 500 Shares Counterpart B will be long of stock and short of cash for one day. Therefore, there will be a financing cost charged by the CSD/custodian if the account is overdrawn. |
| ISD+1 | Counterpart A delivers 500 XYZ shares to Counterparty B vs €500 |
| ISD+1 | Counterpart B delivers 1,000 XYZ shares to Counterparty C vs €1,100 |

3. Address Settlement Failure

1. Cash Penalties

(a) What are the specifics of cash penalties?

The objective of cash penalties is to create a standardised and harmonised regime across the EU to be applied in the event of settlement fails. CSDs are required to establish penalty mechanisms for late matching and failed settlement and will debit failing CSD participants and credit the non-failing CSD participant.

(b) Which type of instructions will be subject to cash penalties?

All settlement instructions, free or against payment, settling at a EU/EEA CSD, which are matched on or after their Intended Settlement Date (ISD), and failing to settle on and after their ISD.

(c) Which type of instructions are not subject to cash penalties?

- Redemptions (i.e. REDM);
- Corporate actions on stock (i.e. CORP);
- Technical instructions (e.g. T2S automatic realignments)

(d) What are the types of cash penalties?

There are two types of fines:

- **Late Matching Fail Penalty (LMFP):** penalty that applies due to the matching taking place after the ISD.
- **Settlement Fail Penalty (SEFP):** penalty that applies due to the non-settlement of a matched transaction on or after its ISD.

Both, a LMFP and a SEFP, can apply on a single instruction; they may be charged to the delivering, receiving or both participants, depending on which of the two participants caused a) the late matching and b) the settlement fail.

However, LMFP and SEFP cannot both apply for the same business day: either LMFP or SEFP can occur, depending on the matching timestamp (being before or after the CSD's settlement cut-off time).

(e) What instruments are in-scope for cash penalties?

Broadly speaking, the instruments in scope for cash penalties are transferable securities i.e. equities, bonds, depository receipts, exchange traded funds (ETFs), money market instruments, sovereign debt, UCITS (excluding issue and redemption of units) and emission allowances eligible for settlement on the CSD, which are:

- Admitted for trading or traded on an EU trading venue; or
- Cleared (or eligible for clearing) by an EU central counterparty (CCP).

The complete list is set out in the legislation and cross refers back to MiFID II as to the definition of 'transferable securities'.

(f) How do cash penalties work?

Fines will be non-profit making for the CSD (although CSDs are charging fees for administering the system) as all credits and debits will be passed, on a trade by trade basis, to the clearing participants at the end of the month on a net basis i.e.

- Debits: Will be passed onto the failing settlement participant
- Credits: Will be passed onto the settlement participant affected

The CSD will apply a net debit or credit to the settlement participant on a monthly basis, along with a gross file to enable reconciliation:

Debits

- Late instructions
- Late matching
- Short positions

Credits

- Counterparty late instructions
- Counterparty late matching
- Counterparty short positions

(g) What are the cash penalty rates?

| Type of Fail | Type of Security | Rate |
|---------------------------|--|----------|
| Lack of securities | Liquid shares | 1.0 bps |
| | Illiquid shares and other financial instruments (such as ETF, certificates, DR etc.) | 0.5 bps |
| | SME growth market and other financial instruments | 0.25 bps |
| | Corporate bonds | 0.20 bps |
| | SME growth market bonds | 0.15 bps |
| | Government and municipal bonds | 0.10 bps |
| Lack of cash | Discount rate per currency with a floor of 0 | |

(h) How will cash penalties be calculated?

Cash penalties are calculated daily and per day as from the ISD until the actual settlement or cancellation date of the instruction:

- For Settlement Fail Penalty: once the instruction is matched, penalties apply earliest from the ISD or the matching date to the date of actual settlement or cancellation of the instruction
- For Late Matching Fail Penalty: penalties apply retroactively from the ISD until the actual matching date.

Example (for illustration purposes only)

- Internal delivery of 100,000 Siemens (SIE.DE) ordinary shares against payment of EUR 10,000,000.
- Settlement status: A settlement instruction is matched, but fails due to lack of securities for three business days after the intended settlement date.
- The applicable daily penalty rate would in this example be **1.0 basis point**.

Let us suppose that the reference price (in this example being the closing price of the shares on the most relevant market in terms of liquidity) to be applied for penalty calculation is as follows:

- Day 1: EUR 100
- Day 2: EUR 115
- Day3: EUR 90

The penalty would therefore be calculated as follows:

- Penalty day 1: 100,000 shares x 0.01% (or 0.0001) x 100 EUR = 1,000 EUR
- Penalty day 2: 100,000 shares x 0.01% (or 0.0001) x 115 EUR = 1,150 EUR
- Penalty day 3: 100,000 shares x 0.01% (or 0.0001) x 90 EUR = 900 EUR

Total penalty amount = 3,050 EUR

The total penalty amount would have to be paid by the customer that is failing to deliver the securities, to the customer suffering from the failure to receive securities.

2. Mandatory Buy-Ins

(a) What does the regulation require?

CSDR imposes a mandatory buy-in process on any financial instrument which has not been delivered within a set period after the intended settlement date (ISD). CSDR places an obligation on the Receiving Trading Party (RTP) to invoke a buy-in within set timeframes and sets out 3 different processes for buy-ins to occur, dependent upon where the transaction is cleared and how it is executed.

(b) What is a buy-in?

In the event of a settlement fail, a buy-in process provides a buyer of securities with the right to source the securities elsewhere, cancel the original instruction(s), and settle between the two original counterparties any differences arising from the net costs of the original transaction and the buy-in transaction.

(c) What are the specifics of buy-ins?

CSDR creates a regime of mandatory buy-ins for non-settled securities transactions after a certain number of days following the ISD:

- Liquid stock is: instructing buy in on ISD + 4 and execution of the buy in on ISD + 5
- Illiquid stock is: instructing buy in on ISD + 7 and execution of the buy in on ISD + 8

(d) Is there a defined timeframe where buy-ins have to be initiated?

Yes, CSDR requires that in the event of a settlement fail, a buy-in process is initiated as follows:

- ISD + extension period, then buy-in period, then deferral period or cash compensation
- For liquid shares: ISD + 4, then 4-day buy-in period

- For Illiquid instruments: ISD + 7, then 7-day buy-in period
- For SME growth markets: ISD + 15, then 7-day buy-in period

(e) What transactions are in scope for buy-ins?

- OTC transactions
- Transactions cleared through a CCP
- Transactions on a trading venue which are not cleared through a CCP, which are the result of a trade either free of payment or versus payment between two parties which:
 - Are matched in an EU CSD or ICSD and
 - Are not settled because the seller is short of securities or put its instruction on-hold

(f) What instruments are in scope for buy-ins?

Only securities which are listed in the ESMA database registers are in scope instruments. These financial instruments can be found [here](#).

(g) Who is responsible for initiating a buy-in?

The 'Trading Party' that is failing to receive the securities due to the delay of a counterparty, which for transactions on a venue is the trading venue member, (except for transaction cleared via a CCP where the CCP will execute the buy-in).

(h) When will a buy-in be required?

A buy-in process will be required when the failing participant does not deliver securities to the receiving participant within four business days (for liquid stocks) after the intended settlement date, those securities will be purchased in the market and made available for settlement and delivered to the receiving participant (the buy-in process).

(i) What actions will a firm need to take in relation to buy-ins?

The trading party/trading venue member who is the receiving party will be responsible for initiating a buy-in when settlement is failing for more than a regulatory defined number of days. This will involve:

Allowing Partial Settlement

On the last day of the extension period (i.e. ISD +4, ISD+7, ISD+15), the Failing Trading Party (FTP) must offer partial delivery of any available securities to the Receiving Trading Party (RTP), which cannot refuse this delivery.

Verifying that a buy-in is possible

On the next business day of the extension period (i.e. ISD +5, ISD+8, ISD+16), the Receiving Trading Party (RTP) must verify that a buy-in is due to be initiated by checking the following:

- Security is on list of in-scope instruments (see ESMA database)
- Transaction is settling through an EU/EEA CSD
- The nature of the trade (i.e. Transaction Type) is an actual trade

If a buy-in is possible, appoint a buy-in agent

The Receiving Trading Party (RTP) must appoint a Buy-in Agent and inform the Failing Trading Party (FTP) of the appointment. The Failing Trading Party sets its instruction on hold and inform its

CSD participant. Buy-In Agent confirms the appointment for “guaranteed delivery” and goes to the market to purchase the instruments subject to buy-in.

Sending a buy-in notification to the failing delivering party informing them that you are buying them in

The buy-in agent must confirm their appointment to the receiving trading party. Subsequently, the receiving trading party should issue a buy-in notice to the failing trading party, which should include the identity of the buy-in agent.

The method of sending this notice is at the discretion of each firm. AFME recommends that this should be via an electronic channel to ensure a clear, time-stamped audit trail.

The below information/field should be included in the buy-in notification

Minimum Information

- Failing Trading Party
- Receiving Trading Party
- Intended Buy-in Date
- Original Trade Date
- Intended Settlement Date
- Security Identifier
- Total Quantity
- Non-delivered Quantity
- Original Trade Price
- Net Consideration
- Currency

Settlement Information

- Delivering Agent (DEAG)
- Seller (SELL)
- Place of Settlement (PSET)
- Receiving Agent (REAG)
- Buyer (BUYR)

Additional Information

- Instrument Type (CFI Code)
- Transaction Type
- Liquidity Type
- Pass on
- SME Growth Market

Notifying the relevant CSD that a buy-in has taken place

Match and settle the buy-in transaction versus the buy-in agent

Cancelling the original failing settlement instructions

Upon the delivery of securities from the buy-in agent, the Receiving Trading Party (RTP) instructs the failing party to cancel the original instruction and cancels their own settlement instruction. After the buy-in has settled, the Receiving Trading Party (RTP) issues an invoice on buy-in costs to the Failing Trading Party (FTP).

Recovering buy-in costs and/or cash compensation from the failing delivering party

All buy-in costs and/or cash compensation arrangements should be agreed between the trading parties. Cash compensation may include the buy-in agent fee, price difference where the Receiving Trading Party was disadvantaged, FX rate change, and corporate event entitlements due to the Receiving Trading Party.

NOTE: Detailed discussions are ongoing through relevant industry associations to firm up the practical model for the operation of the buy-in regime between all impacted market participants (such as trading parties, settlement participants etc.). The information set out above may change in accordance with any market consensus/practice which is agreed following on from such efforts and might differ between jurisdictions.

For more information, please contact us:

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