

Post Trade Settlement Committee Task Force on Settlement Discipline

Settlement Discipline: Issues and Proposals

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Background

AFME is a trade association whose members conduct domestic and cross-border securities operations in the EU/EEA area in their capacity as financial institutions, in a wide range of banking activities for their customers and for their own account. AFME's members are securities account providers in the context of European and national regulated activities. The AFME Post Trade Division is the European post trading centre of competence of the Association for Financial Markets in Europe (AFME). Its members are the major users of international securities markets. The Post Trade Division acts as an agent for change, providing and supporting solutions in securities clearing, settlement and custody, to reduce risks and increase efficiency for market participants, representing its members' views towards market infrastructure organisations and public authorities.

Of the broader AFME membership (see www.afme.eu) the following members – investment banks, regional and global custodians and wealth management / private banking – actively participate in the Post Trade Division: Bank of America Merrill Lynch; Barclays; BNP Paribas; BNY Mellon; Citi; Credit Suisse; Deutsche Bank; Goldman Sachs; HSBC J P Morgan; Morgan Stanley; Nordea; RBS; UniCredit; UBS.

This paper was prepared by a Task Force of the Post Trade Settlement Committee.

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1. Introduction

The AFME Post Trade Division's primary objective is to develop constructive and practical proposals that result in the elimination of the current fragmentation in Europe, ensure safety and soundness, and reduce risk, whilst increasing efficiency. In doing so we hope to contribute to an increase in the attractiveness of the European market place to cross-border investors, regardless of their location.

In the context of market discipline, one of AFME's predecessor organisations, ESSF (The European Securities Service Forum) published a paper on 6 June 2009, *Proposal to harmonise and standardise buy-in rules in European securities markets*, which addressed the issues of inconsistency in buy-in regimes across Europe. A subsequent AFME working group submitted a paper based on this work to CESAME's working group on settlement discipline, which many of our members worked on. This paper builds on the principles established in those pieces of work to develop what we consider to be an effective model for the current and future situation.

Our aim is to develop a settlement discipline framework for all European Union financial markets that can apply to all liquid asset classes, and be consistently applied across all relevant market infrastructure. We believe that wherever possible these proposals in their entirety should be implemented in advance of T+2 and T2S (Target2Securities) being put in place; and in the case of existing CCPs see no reason why the standard process could not be in force by the end of 2012.

2. Background

The securities industry and European public sector authorities share the common objective of creating a sound, integrated and efficient post trading system. To this end important public sector legislative actions are underway, such as the process of dismantling the Giovannini Barriers to improve and streamline operational processes, driving pan-European harmonisation, as well as public sector reviews of the legal, regulatory and fiscal framework. The AFME Settlement Committee is keenly interested in the Commission's forthcoming CSD Regulation, which will describe market discipline proposals at level one, for level two detailed recommendation and implementation by the relevant authorities, primarily ESMA. In the broader settlement context, the implementation of the European Central Bank's T2S (Target 2 Securities) initiative in 2015 is a core milestone of particular interest to the AFME Settlement Committee, and it too is an important driver for this paper.

Settlement discipline regimes are any means by which a market infrastructure body (Exchange, CCP or CSD, depending on the market) seeks to maximise the settlement rate of its participants by incentivising settlement on contractual settlement date, or dis-incentivising settlement fails and aged fails, using tools such as daily fail fines, defined buy-in timeframes and the censure of members. AFME members recognise the importance of rules and discipline in enforcing and maintaining standards of settlement performance in the securities industry. We are supporters of post-trade penalty regimes that promote good, efficient and risk-reducing behaviour, in particular where they incentivise excellence and identify and penalise poor performers.

However, there are currently many different penalty regimes in place across the European Union. Whilst they may all have some beneficial effects, they do not necessarily all address the root causes of settlement performance issues; nor do they necessarily identify and specifically penalise the culprits. The disparity of regimes is unhelpful, and will be unsustainable as we continue the path to greater harmonisation of post-trade processes in Europe. There is also a gap in agreed performance standards for non-CCP processed OTC transactions. This paper therefore sets out to identify the positive characteristics of an effective penalty regime, and to propose a model which could be beneficial across the European market place, in particular if it were endorsed by public authorities and implemented consistently across the EU and wider European Economic Area.

It has been noted that there is no common definition of failed settlement in Europe. AFME members suggest that any formal definition that is adopted should be as simple as possible. Our proposal is that a failed settlement is any settlement that remains unsettled at the close of contractual settlement date.

3. The Current Landscape and Drivers for Change

Market infrastructures use a number of different tools to impose discipline on their participants, including straightforward fines regimes, mandatory failed lending programs, partialling, buy-ins, suspension, withdrawal of licenses and so on. It is our view that a single, consistent, aligned approach to settlement discipline would help to significantly improve compliance and performance by all market participants. This drive towards consistency is an integral principle for the effective delivery of a single capital market for Europe; in practical terms, it is inconceivable that a pan-European settlement platform, T2S, could be delivered without such standards being agreed; or that T+2, a proposal promoted by member states that we expect to be incorporated in the Commission's CSD Regulation, could be successfully implemented without such a regime already being agreed and implemented.

Our favoured approach would be the introduction of **consistent settlement matching standards** and the imposition of a **standard buy-in regime** across Europe. This would involve the introduction of standard targets for the management of the settlement matching process, and a common timeframe and rules for the buy-in process, including execution timeframes, consistent penalties, delivery fail fines and other measures.

Within such a consistent discipline regime, we expect that the spirit of the implementation of the rules would also be consistent. The objective is the maximisation of the settlement rate, and an ongoing improvement in settlement performance, not generation of revenue for the market body running the regime. We firmly believe that discipline regimes should be run on a not-for-profit basis. Revenue generated from any such regime should be reinvested in system improvements and other infrastructural measures that will improve performance and measurement capabilities for all participants; consideration should be given to mechanisms that will return any excess profit to good performers.

4. Scope and Principles

When it comes to settlement, the overriding objective of market participants and post trade infrastructures is to ensure that settlement is achieved on-time. Performing according to the standards set by the market and agreed between participants demonstrably reduces risk and improves the attractiveness of the market. Nonetheless, statistics on settlement performance published by CCPs and CSDs show that settlement rates rarely reach 100%, and depending on the market and instrument may range between 85% and 98%. There are a number of reasons for this. Some instrument types may be subject to increased levels of processing complexity and require additional time to achieve settlement; in other cases, lack of adherence to the 2006 ESF / ECSDA Matching Standards, in particular CSD implementation of hold and release mechanisms, make effective management of the process by participants much more difficult.

There are a number of pre-settlement processes that contribute to improved settlement performance; these were clearly defined by CESAME in their work on T+2, and we do not propose to repeat those arguments in this paper. Our focus is the final stages of the settlement process, in particular the steps to be taken when settlement fails.

It is our firm belief that market participants need to be incentivised to improve their settlement performance. This can be achieved through a combination of measures, notably **transparent reporting on settlement performance; setting clear standards of performance; and, where responsibility can be demonstrated, financial penalties**. We propose that all settlement failures meeting the criteria described in this paper should be subject to the proposed standards, irrespective of the causes of fails.

4.1. In Scope

Transactions

- On-exchange transactions whether or not cleared by a CCP system
- OTC transactions whether or not cleared by a CCP system

Involved parties

Involved parties include three types of player, some imposing the regime, many directly affected, and others involved (usually in setting standards and imposing discipline) but not directly affected.

Imposing parties

- CCPs, for on-exchange trades and any other trades routed via a CCP
- Market counterparties party to the contract, for non-CCP OTC transactions

Directly affected parties:

- Market users
 - Trading counterparties in wholesale securities markets
 - Agent banks and custodians
- Securities exchanges (regulated markets) and MTFs
- CCPs
- (I)CSDs

Others involved but not directly affected:

- Legislators, e.g. European Commission, national Governments
- Regulators
- European bodies, e.g. ECB

4.2. Out of Scope

It is proposed that best-practice guidelines should be developed by the relevant experts for the following out-of-scope activities:

- Illiquid securities, on a list to be independently defined and centrally maintained by the relevant domestic exchanges
- Securities financing transactions (i.e. repo and securities lending transactions that are not cleared by a CCP)
- Corporate actions
- Cross-border transactions (to be reviewed post-T2S)
- Non-CSD eligible physical securities

4.3. Guiding Principles for Post-trade Discipline

- Discipline regimes should contribute to post trading efficiency rather than being a source of profit.
- The manager of the discipline regime is responsible for identifying the failing party and imposing the regime on that party only.
- Any profits earned from a discipline regime should be redistributed to innocent parties and/or used for market developments that improve settlement rates and reduce fails.
- The cost of discipline regimes should reflect actual market costs without additional penalties.

- Regimes should be defined and implemented in accordance with one set of pan-European standardised processes.
- Standard regimes should reduce the costs and inefficiency currently caused by managing diverse regimes; therefore standards should be simple, easy to apply and stringent.
- Securities lending facilities to avoid fails should be promoted; this includes legal and regulatory action, where required.
- Passing-on of buy-in or other discipline liabilities where a market participant is failing to receive securities (e.g. in the case that the market body cannot indentify every party in the chain) should be allowed in order to target an underlying party at fault, but notice must be given with sufficient time to source inventory.
- In the case of market disruption, including systems issues at market infrastructures, discipline regimes should be suspended.

5. Settlement Performance: Measurement, Standards and Penalties

Drawing on the work of CESAME's Sub-group 4 on Market Discipline AFME members considered the possibilities for imposing discipline at the various stages in the settlement process. In order to be effective, the process must be easily measurable. This means that the settlement matching process and overall participant settlement rates are potential candidates for the imposition of strict standards of performance, with the possibility for penalties should these standards not be met. It is assumed, where involved, that market infrastructures processing the trades in question should be responsible for imposing the regime. The members of the working group recognised the specific challenge of non-CCP cleared OTC, where there is a strong desire to improve performance but not necessarily an obvious market infrastructure to implement a regime. In this case, bilateral proposals are made.

5.1. Settlement Matching Standards

There is a strong relationship between matching and settlement, and low matching rates can be an indication of potential problems with settlement. However, since late matching does not necessarily mean that settlement will fail, we do not believe that fines are appropriate. We propose that **matching targets** should be set, and **performance statistics published on matching rates**. Publication of performance statistics will provide strong incentives for improving performance; whilst detailed reporting will provide the information necessary to focus participants' efforts on making relevant improvements to their own processes.

Matching in this case is defined as either pre-matching, where the settlement platform supports it, or binding/irrevocable match where it does not distinguish different matching levels.

Proposed Settlement Matching Standards

1. **CCP (incumbent exchange) target:** 100% to be matched on T.
2. **CCP (MTF) target:** Matching should be achieved by c.o.b. on S-1, and a target of 100% should be set.
3. **OTC target:** Matching should be achieved by c.o.b. on S-1, and an initial target of 99% should be set.
4. **OTC CCP/Buy-side Matching target:** Matching should be achieved by c.o.b. on S-1, and a target of 100% should be set.¹

¹ For clarification, this refers to a proposed model for off-exchange electronic matching in which transactions are matched via central utilities and, where eligible for CCP clearing, are novated to the relevant CCP.

5.2. Late Matching Penalties

Late matching by one party has a serious detrimental impact on the performance of the other: the overall outcome defaults to the level of the worst performer. We propose that there should be a **fixed penalty for late matching**, regardless of trade size/value. We firmly believe that a fixed penalty is most effective, as it targets systematic behaviour and consistent poor performance, and does not over-penalise occasional failure.

The penalty should be applied to the second party to the match only (i.e. the party responsible for the late match). This party should be identified after matching has taken place, and the fine imposed if and when settlement has failed.

Proposed Standard Late Matching Reports

- **Unmatched settlement:** MIS reports on unmatched settlements should be provided at c.o.b. on S-1, and should include information on the last party to enter the match.

Proposed Late Matching Penalties

- **Late matched settlement failure:** The last party to match (i.e. the party that caused the fail) should be penalised when the late match can be demonstrated to have resulted in settlement failure. Should both parties instruct after S, both will be fined.

5.3. Settlement Performance

As laid out above, subject to successful matching and availability of resources, transactions will settle. Whether they do so on time depends on participant performance at the various stages of the process. It is important to remember that there are two parties to each transaction, and overall performance defaults to the poorest performer. In other words, one side can adversely impact the performance of the other, so it is crucial to understand the underlying cause of the fail and identify the responsible party.

It is critical to have detailed and accurate MIS available at all stages of the settlement process to enable participants to benchmark their performance and identify weaknesses and potential problems. The CSD or Settlement Platform, which holds all of the relevant information, should provide this data to its participants. It should also analyse the underlying causes of failed delivery before imposing penalties, and penalise the participant(s) in the chain that can be demonstrated to have caused the fail only. Should both parties instruct after S, both will be fined.

Standards should be set for acceptable settlement performance.

Proposed Settlement Performance Standards

- **CCP target:** 99% of trades should be settled on S²
- **OTC target:** 99% of trades should be settled on S³

Proposed Failed Settlement Penalties

- **Settlement failure – on-exchange / CCP cleared:** The last party to match (i.e. the party that caused the fail) should be penalised on S+1 when the late match can be demonstrated to have resulted in settlement failure. Should both parties instruct after S,

² The ultimate aspiration is to settle 100% on S.

³ The ultimate aspiration is to settle 100% on S.

both will be fined. Where settlement failure continues beyond a fixed number of days, a buy-in process should be initiated (see section 6 for details).

- **Settlement failure – OTC:** The last party to match (i.e. the party that caused the fail) should be penalised on S+4 when the late match can be demonstrated to have resulted in settlement failure. Should both parties instruct after S, both will be fined. Where settlement failure continues beyond a fixed number of days, a bi-lateral buy-in process should be initiated (see section 6 for details).

6. Buy-in Regime Proposal

We propose the imposition of one pan-European, harmonised and standardised buy-in process, including hard performance targets and the imposition of penalties should these not be met. This should be applied to all liquid markets. Some instruments, which are defined as highly illiquid (see out of scope section), should be considered for exclusion from these proposals.

In the case of OTC transactions, and in the absence of a central infrastructure to manage the process, the buy-in process should also apply, managed bi-laterally between the counterparties.

6.1. Proposed Buy-in Standards

It is proposed that all buy-in notifications and executions should be subject to a standardised format; method of delivery; and timetable; adhering to the following common standards.

6.1. a. Key dates

Standard 1: The buy-in notification date⁴ should be 2 business days after intended settlement date (S+2). Any onward notification should be handled on a bi-lateral basis.

Standard 2: The last buy-in OTC pass-on notification date should be one complete settlement cycle prior to the buy-in execution date⁵.

Standard 3 (on-exchange/CCP): The buy-in execution date⁶ in a T+3 environment should be 7 business days after intended settlement date (S+7); in a T+2 environment it should be 4 business days after intended settlement date (S+4); in a T+1 environment it should be 3 business days after intended settlement date (s+3); for T+0, it should be 2 business days after intended settlement date (S+2). The buy-ins should be issued at an agreed time of day (per market).

Standard 3 (non-CCP/OTC): The buy-in execution date⁷ in a T+3 environment should be 11 business days after intended settlement date (S+11); in a T+2 environment it should be 8 business days after intended settlement date (S+8); in a T+1 environment it should be 7 business days after intended settlement date (s+7); for T+0, it should be 6 business days after intended settlement date (S+6). The buy-ins notifications should be issued at an agreed time of day (per market).

Standard 4: The cash settlement date⁸ should be the day after execution of the buy-in i.e. S+buy-in cycle+1.

Standard 5: The value date for both a buy-in transaction and a cash settlement transaction should be same-day.

⁴ The date at which the executing party notifies the defaulting party of the buy-in to take place at the buy-in date.

⁵ This gives failing OTC counterparties sufficient notification to source stock and mitigate the buy-in prior to execution.

⁶ The date at which the executing party endeavours to buy the non-delivered securities in the market.

⁷ The date at which the executing party endeavours to buy the non-delivered securities in the market.

⁸ The date at which the executing party calculates the amount payable by the defaulting party in case the buy-in at buy-in execution date was unsuccessful.

6.1. b. Execution of buy-in transactions

Standard 6: For CCP cleared transactions (on exchange or OTC), the CCP of the defaulting party should be the executing party⁹.

Standard 7: For on exchange transactions not cleared by a CCP system, the respective securities exchange should be the executing party unless it has agreed with a (I)CSD that such (I)CSD should be the executing party. For OTC transactions, the non-defaulting counterparty should be the executing party.

Standard 8: Execution of buy-in transactions and the calculation of the cash settlement amount should only take place on the buy-in execution date or the cash settlement date respectively.

6.1. c. Pricing

Standard 9: Buy-in transactions should be priced as per prevailing market conditions at the buy-in execution date in accordance with the rules of best execution or as per the agreed price of the original transaction¹⁰, whichever is higher.

Standard 10: The cash settlement amount should be determined by applying (i) the quoted offered price as at close of trading on buy-in execution date or, if such quoted price is not available, the last traded price of the relevant security or (ii) the agreed price of the original transaction, whichever is higher.

Standard 11: The non-defaulting party should be entitled to be compensated by the defaulting party for any forgone financial benefits (including fiscal benefits) that arise.

Standard 12: Fees levied by the executing party compensating it for incurred costs should be made transparent in accordance with the principles in the Code of Conduct on Clearing and Settlement.

Standard 13: No additional fines or penalties should apply to buy-in or cash settlement transactions.

Standard 14: Failed buy-ins should be charged at current market price plus any specified administrative charges.

7. Conclusions

Based on this paper, AFME members recommend the following:

1. AFME members fully support the use of consistent and harmonised settlement discipline regimes as a tool to maximise the settlement rate of market participants. Level one proposals from the Commission and level two technical implementation by ESMA should be established in the forthcoming CSD Regulation, endorsed by public authorities and implemented across the EU and wider European Economic Area.
2. No penalty regime should be run on a for-profit basis. The body running the regime should not be permitted to view fines and discipline regimes as a revenue source.
3. The penalty regime should consist of consistent matching standards and a standard buy-in regime. In some cases, different standards should be applied to on-exchange and OTC transactions. Exceptions should be granted to certain highly illiquid securities, securities finance transactions, corporate actions and non-CSD eligible transactions, as well as cross-border transactions (to be reviewed post-T2S).

⁹ The executing party is defined as the party responsible for (i) issuing the buy-in notification, (ii) executing the buy-in transaction or (iii) calculating the cash settlement amount.

¹⁰ The original transaction is defined as the transaction that failed to settle on intended settlement date and gave rise to the buy-in transaction.

4. There should be a fixed penalty for late matching, regardless of trade size/volume, applied to the last party to match.
5. In the case of settlement failure, the last party to match should be penalised; where both instruct late, both should be penalised. When failure continues beyond a fixed number of days, a buy-in process should be initiated.
6. Full and transparent reporting on matching and settlement performance should be supplied to participants by the responsible infrastructure.
7. The principle that the failing party should be the party subject to any penalty and its associated costs should be established. CSD participants must be permitted to pass on fines to counterparties responsible for a failure to deliver.