15 December 2023
ESMA74-2119945925-1704

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 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* 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 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 for Financial Markets in Europe (AFME)
Activity	Associations, professional bodies, industry representatives
Are you representing an association?	☒
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>

AFME members do not believe there is any reason to change the current methodology. Denmark will be the only market for which such a solution will apply as Bulgaria will adopt the Euro in 2025. Given the very limited proportion of transactions that would be in scope of the proposed change (i.e. fails due to lack of cash in DKK), we do not believe it is appropriate or necessary to implement a change in methodology that would require CSDs, T2S and all market participants to change their systems and test the changes which will require investment that is not proportionate to the benefits.

Of the options outlined, Option 3 would be the most preferable, since that is the option most closely aligned with the current process in Denmark and will not impact the T2S cash penalty mechanism unlike Options 1 and 4 which will require a functional change to T2S. However, our recommendation is to retain the current methodology in place today which is consistent with the treatment of EUR for fails due to insufficient cash.

We consider that Option 4 would be the least preferable, by a considerable margin. This would greatly increase the complexity of the calculation and reduce transparency, as well as resulting in significantly disproportionate penalty amounts.

<ESMA_QUESTION_CSDR_1>

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

<ESMA_QUESTION_CSDR_2>

As noted in our response to Q1, we suggest that the current methodology is retained.

<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**
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

Compliance costs: **- One-off** **- On-going**	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

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>

We acknowledge that certain instructions are entered with a very old intended settlement date (ISD). As noted by ESMA, this represents a tiny proportion of overall instructions, nevertheless we acknowledge that the existence of very old instructions creates problems.

As well as the reference data challenge identified by ESMA, such late instructions 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 the records in the custody chain 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.

To the question of what the reasons are for very late settlement instructions, 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 potentially, of the FASTER tax measures, will contribute to reducing the number of late instructions.

More generally, we consider that the ‘gold standard’ for settlement efficiency should be that instructions are entered and matched at the CSD on trade date, to enable the identification and resolution of any discrepancies prior to ISD.

In the AFME report 'Improving the Settlement Efficiency Landscape in Europe'[1] published in 2023, we further explored the causes of late matching in this context, which we categorised into three types:

- Economic mismatches: discrepancies between the core values of a transaction (e.g. trade date, net cash amount, security identifier);
- Non-economic mismatches (e.g. a difference in the standard settlement instructions (SSIs) or place of settlement (PSET));
- Late instructions

The primary causes of these types differed. Non-economic mismatches appeared to be primarily caused by incomplete or inaccurate data and a lack of market standards. Economic mismatches appeared to be equally driven by workflow management issues, a lack of market standards and lack of timely and accurate provision of data by clients or counterparties. Lastly, late instructions appeared to be mainly caused by lack of timely and accurate provision of data by clients or counterparties.

However, it must be noted that not all 'late instructions' are due to late bookings; late instructions can also be due to amendments to resolve an exception and achieve a 'match' or to change the place of settlement, although ideally this should take place ahead of market cut-off on ISD.

Late matching can also occur when a previously matched – but failing due to lack of securities – settlement instruction is 'manually partialled'. This typically occurs in the absence of auto-partial or partial settlement functionality and partial-release functionality (omnibus accounts), which means that trading parties will have to cancel a matched instruction and input new instructions to reflect the partial amounts. We provide more details on these scenarios in Q16.

In the report, we outline some of the potential measures to reduce the number of unmatched settlement instructions, including:

- The pre-settlement criteria used on central platforms or bilateral exchanges should be reviewed to ensure it is consistent with CSD-level settlement matching criteria, including PSET and SSIs.
- Where possible, market participants should use centralised industry platforms for pre-settlement matching and allocation processes. Market participants who cannot utilise

[1] https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME_SettlementEfficiency2023_07%20final.pdf

such platforms should follow agreed industry standards for exchanging information in an STP format.

- Place of Settlement (PSET) should be a mandatory pre-settlement matching field in all allocation and pre-settlement matching tools.
- Reference data, such as SSIs, should be provided in advance and any changes communicated as soon as possible.
- Firms' thresholds for matching the net cash amount on a transaction should be identical to the CSD thresholds, noting that in the CSDs subject to CSDR, the thresholds are: 2 EUR on settlement amounts up to 100,000 EUR; or 25 EUR on settlement amounts over 100,000 EUR.
- The cash tolerance used for matching in vendor platforms should align with market convention and match to the same tolerance as the CSD (again noting the CSDR tolerances) to avoid matching issues at the CSD.
- As outlined in our response to CSDR Refit proposals, the creation and maintenance of a central golden source of reference data or settlement instructions which can be accessed by all market participants would reduce the possibilities of changes on settlement instructions on settlement date.
- All CSDs should support partial settlement functionality, including auto-partial and partial release. All CSD participants should support this functionality to achieve a seamless flow of inventory. A solution for the CSDs to conform with ESMA Level 3 guidance to prevent duplicate LMFPs is also required.
- Firms should consider opportunities to explore how to leverage the benefits of using a Unique Transaction Identifeir (UTI) to enhance post-trade processes, working with vendors to define what market best practice could look like.
- The implementation of Settlement Finality Directive across the markets needs to be harmonised in order to ensure that adequate protection exists for settlement agents and intermediaries in order not to discourage early matching.

<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>

While accurate reference data are essential in calculating penalties and in particular LMFPs, we understand that maintaining active data with no limit in the past may negatively impact the functioning of the SSS / penalty mechanism. Therefore, we agree with ESMA's proposal to allow CSDs to use a threshold.

However, we understand that only CSDs using the T2S penalty mechanism have experienced issues on performance. As this is not an issue for all CSDs, we do not recommend establishing a mandatory threshold for those CSDs that currently do not use the T2S penalty mechanism; it should be left to the discretion of such CSDs.

We consider that the adoption of a threshold would be a pragmatic, short-term solution, and is not fully aligned with the overarching CSDR objective of having a harmonised pan-European process. Further consideration is required to determine a longer-term structural solution.

<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>

As mentioned on paragraph 34 of ESMA's consultation, the percentage is extremely low after 40 days in a T2S environment. However, this does not mean the situation will be the same for

non-T2S CSDs. Thus it should be left at the decision of each CSD to apply a threshold and define its value.<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. We agree that issuer CSDs should be responsible for confirming the relevant data to be used for the calculation of cash penalties and for the information to be shared in a timely manner with the other CSDs -e.g., Investor CSDs –, whilst ensuring that there are no breaks or latency

<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>

We consider that a standardised approach across all CSDs is essential, to ensure a clear and consistent process. CSD participants should have certainty of what the criteria for calculating the penalties are, without being subject to any discrepancies depending on different CSDs. This is particularly key for custodians sitting in-between the CSDs and their clients to calculate / predict / investigate in a timely manner in what is still an incredibly time-sensitive regime. Optionality, in any form, removes predictability, breaks standards and can result in discrepancies and inefficiency.

As suggested in our response to the CSDR Refit proposals we would welcome ESMA to create and maintain a central ‘golden source’ database, containing all information necessary to calculate cash penalty amounts.

<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>

As noted in our response to Q6 and Q7, we believe that a long-term structural solution is required to resolve these challenges.

<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 strongly support the principle of proportionality, whilst also maintaining the principles of fairness, transparency, simplicity and consistency. Any changes to the current penalty mechanism – which has been in operation for only 2 years - should avoid creating unnecessary additional costs or complexities that would outweigh the benefits that changes may seek.

<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**
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: **- One-off** **- On-going**	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	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>

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

We note that, according to data collected by ESMA[2], the current penalty rates appear to have had a broadly positive impact on reducing settlement fails, in particular for Equities. Fail rates in sovereign debt instruments, which represents well over 50% of the total value of settlement instructions processed by EU CSDs, remain relatively low and stable.

When carrying out an evaluation of the impact that the cash penalty regime has had with respect to settlement efficiency ratios in the EU, it is necessary to point out that the period to be analysed should range from a date prior to its go-live (i.e., 1 February 2022), as most industry participants were already carrying out initiatives to improve settlement efficiency in the months leading up to entry into force of cash penalties provisions.

We agree with ESMA's statement on point 45 of this consultation noting that there is a "*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*".

To this extent, we emphasise the need to have consistent and meaningful data prior to making any decisions in regard to implementing any changes to the cash penalty mechanism. Current public data on settlement efficiency rates, such as those provided in ESMA's Trends, Risks and Vulnerabilities Report ("TRV") or the ECB's T2S Annual Report, is limited in scope and detail. Moreover, we note that the methodology for calculating settlement efficiency rates in the latest ESMA's TRV report[3] has differed from the one used to produce previous versions. However, according to the most recently published data, the settlement fail rate at the end of 2023 was lower than in February 2022 for each asset class that ESMA included in the report. Previous versions of the TRV report[4] also reflected a gradual reduction in settlement fails in the period leading up to February 2022.

In addition, judging from the information made available by CSDs and the ECB to their participants, it is evident that current fail reporting parameters and the methodology deployed

[2] https://www.esma.europa.eu/sites/default/files/2024-01/ESMA50-524821-3107_TRV_1-24_risk_monitor.pdf
[3] https://www.esma.europa.eu/sites/default/files/2024-01/ESMA50-524821-3107_TRV_1-24_risk_monitor.pdf
[4] https://www.esma.europa.eu/sites/default/files/library/ESMA50-165-2438_trv_1-23_risk_monitor.pdf

differs across the CSD community, even between CSDs belonging to the same group. Collectively, this leads to ambiguity and a distorted view of settlement fails

AFME has conducted a review of the available data from the CSDs' annual public disclosure of settlement fails. [Note - we haven't included CBL in our analysis as we understand that last year's figures were distorted due to an anomaly whereby a small number of transactions in debt instruments quoted in UNIT were erroneously instructed, leading to the multiplication of the actual fails value by 1,000.] We further note that many CSDs have not yet published their data for year 2023, therefore this analysis is limited to a subset of 10 CSDs.

CSDs	Country	Settlement Fail Rate (Value)		Settlement Efficiency Change (Value)
		2022	2023	
OeKB	Austria	7.69%	7.35%	+0.34%
SKDD	Croatia	0.34%	0.62%	-0.28%
CBF	Germany	8.57%	5.22%	+3.35%
Athex CSD	Greece	0.13%	0.08%	+0.05%
KELER	Hungary	13.13%	2.77%	+10.36%
Euronext Milan	Italy	7.30%	6.05%	+1.25%
KDPW	Poland	1.28%	0.61%	+0.67%
CDCP	Slovakia	9.10%	9.69%	-0.59%
KDD	Slovenia	6.16%	10.53%	-4.37%
Iberclear	Spain	6.71%	4.48%	+2.23%

Aggregate Total across the 10 CSDs analysed		
Year	**2022**	**2023**
Value (EUR) of settlement instructions during the period covered by the report	310,826,655,429,495	406,593,648,771,938
Total value (EUR) of settlement fails (covering both settlement fails for lack of securities and lack of cash)	21,213,662,936,056	11,619,773,302,986

Rate of settlement fails based on value of settlement instructions	6.82%	2.86%

Source: AFME, CSDs annual public disclosure of settlement fails

We observe that settlement efficiency has generally increased across the analysed CSDs, with an overall improvement of **3.96 percentage points**.

The different settlement efficiency levels across the 10 CSDs in the table above suggest that the fails are not solely attributable to market participants behaviour. If it was solely behavioural -related, we anticipate that the rates would have greater alignment (i.e., market participants operating in multiple markets typically do not have a more efficient process in CSD A over CSD B). These differences suggest that settlement fails are driven, at least in part, by structural factors. We call for further regulatory focus on the structural reasons for settlement fails and recommend measures for their remediation, which may require regulation. AFME and its members recommend collaboration across the industry and with the ECB AMI-SeCo, who are reviewing the remaining barriers to post-trade integration.

We further note that of the three CSDs where settlement fails have increased in 2023 (SKDD, CDCP and KDD), none of these offer the functionality of partial settlement. AFME emphasises the need for all CSDs to offer partial settlement and hold & release, as essential CSD functionality to aide settlement efficiency and suggest that the derogations afforded under Article 12 of the delegated regulation are removed.

T2S data on settlement efficiency for years 2022 and 2023[5], also demonstrates a notable reduction in settlement fails since the introduction of the penalties regime.

Period	Settlement Fail Rate
Q1 2022	6.50%
Q2 2022*	7.17%
Q3 2022	6.47%
Q4 2022	6.73%
Q1 2023	5.37%
Q2 2023	4.90%
Q3 2023	3.53%

* Period of high market volatility following Russia's invasion of Ukraine

[5] https://www.ecb.europa.eu/stats/payment_statistics/transactions_processed_by_t2s/html/23_tableT2S.en.html

This view is further supported by data provided by 11 AFME member firms. All respondents have reported an improvement of settlement efficiency rates since the introduction of cash penalties, with figures that range between 1.0-6.5 percentage points, with an average of 3.18 percentage points, with some firms observing that their rate of settlement fails has halved from Q1 2022 to Q4 2023. Some members have noted more significant improvements on Equities compared to other asset classes.<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>

We broadly agree that the current penalty mechanism is deterrent and proportionate, but a minor recalibration of the levels of penalty rates applicable to each asset class could be merited, supported by further changes to promote settlement efficiency.

Liquidity Considerations

We note that liquidity considerations played a key part in the original design of the cash penalties mechanism, with the application of different penalty rates for different asset classes based on liquidity calibrations. It is generally agreed that the more liquid[6] a financial security is, the more likely it will be to settled, and therefore, the higher the penalty rate should be. This principle is broadly reflected in the current penalty mechanism.

The end objective of penalty rates should be reducing risk whilst maintaining adequate levels of liquidity in the market. Therefore, we recommend that EU regulators duly consider that a potential increase of penalty rates should not negatively impact the liquidity of affected instruments, by having punitive penalties impacting bid-ask spreads, and the willingness of market makers to offer liquidity. This would impact investors and the price at which they can do business, and the industry could end up in a vicious circle whereby the proposed penalties would negatively impact the availability of securities for trading, which then in turn would lead to a degradation in settlement efficiency, creating the opposite effect of what was intended.

[6] Note: We refer to Liquidity in accordance to ESMA's definition, as median of the bid-ask price percentage difference for the current EEA30 constituents of STOXX Europe Large 200, in bps.

Investment in Reducing Fails

We emphasise that the introduction of cash penalties directly led to significant attention and investment from AFME members. From surveying AFME members, all respondents have acknowledged investing monetary resources to improve settlement efficiency, with a majority of responding firms quoting investments above 5M€. This includes both:

Technological resources: Overall, AFME members have invested in technological resources, such as:

- developing systems to support functionalities that improve settlement efficiency (i.e., hold and release, partial settlement and partial release),
- enhanced data analytics, fail calibration and pre-settlement reporting
- amendments to processing batch times and instruction priorotisation changes
- the development of platforms for verifying and reconciling penalty amounts received from the CSDs with the failed instruction
- cash penalty validation, reporting and payment solutions for custody clients
- cash penalty allocation tools e.g. to trading desks
- implementing solutions for automatic update of static CSDR codes for all securities ISIN codes
- automatization of the mechanism to replicate potential penalties
- adoption of various workflow tools to help monitor and manage potential and actual CSDR penalties, along with identifying high-value trades which have the potential to trigger high-value penalties.

It is worth noting that due to CSDs having different models / practices it means technical builds are not uniform effectively, it was a market by market deployment

Staffing resources: 80% of the respondents have noted investing in additional staff, notably increasing the headcount in the areas of Back Office / Operations.

As referenced in our response to Question 15, the available public data on settlement fails shows that there has been a marked improvement in settlement efficiency in the EU. The analysed timeframe has also coincided with a period of higher interest rates, which act as an additional cost of failing. Further to this – as outlined in the AFME report on Settlement Efficiency published in October 2023 – we note the continuous focus and ongoing industry

efforts to improve settlement efficiency rates. Therefore, based on the aforementioned evidence and in the current scenario of higher interest rates, we consider that penalty rates are working towards the desired objective of improving settlement rates, and led to substantive focus and investment from the industry in this area.

Adverse Effects of CSDR Cash Penalties

In AFME's report 'Improving the Settlement Efficiency Landscape in Europe'[7] we note that there are particular scenarios (e.g., cancel/rebook, manual partials, etc.) where the CSDR cash penalties regime actually creates the opposite effect and can lead to delays in resolution of settlement fails.

- Example 1: Party A and Party B execute a transaction. Party A instructs the transaction for settlement in CSD 1. Party B instructs for settlement in CSD 2. In order for the transaction to settle, one party must cancel their original instruction, and rebook to a different CSD. If the discrepancy is not identified and resolved prior to Intended Settlement Date (ISD), the rebooking will incur a Late Matching Fail Penalty (LMFP). Depending on the size of the penalty, this can discourage either party from wanting to rebook their instruction, at least without agreement that the penalty amount can be reclaimed from their counterparty. This leads to delays and inefficiencies in the settlement process.

- Example 2: A similar scenario can occur in relation to manual partials. If the seller has available inventory, but not the full amount, a partial delivery should be offered by the seller and accepted by the buyer. Ideally, this happens on an automated basis. If either party, or the CSD, cannot facilitate an "auto-partial", this will need to be instructed manually. Cancelling and rebooking the original instruction into two separate instructions10 with a back-dated ISD will incur LMFPs for whichever party is last to input the new instructions. Again, this creates a disincentive for parties to agree a timely resolution to the issue.

ESMA guidance[8] 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". However, there is currently no systematic means for CSDs to identify and exclude such

[7] https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME_SettlementEfficiency2023_07%20final.pdf
[8] https://www.esma.europa.eu/sites/default/files/library/esma70-708036281-2_csdr_qas.pdf

instructions from the application of penalties. Finding a solution to these issues will further improve the effectiveness of the cash penalties regime.

Partials are an essential vehicle to optimise settlement and liquidity and reduce available inventory from being locked up. Partials should be considered central to improving settlement efficiency and reducing settlement risk. It is required an adequate operating environment that mandates for hold and release, partial settlement and partial release to be offered by all CSDs in the Union to ensure that cash penalties are a deterrent rather than an income.

<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>

We understand that the outlined categories of "fail to deliver securities", "fail to deliver cash" or "settlement instructions being on hold" do not reflect the root causes leading to settlement fails, but the outcomes which are resulting from the actions of market participants (i.e., a "fail to deliver securities" is contingent on a broader chain of failing transactions involving intermediaries, CCPs, etc.).

In 2023, AFME conducted a comprehensive review on the main causes responsible for driving settlement fails, which were outlined in AFME's report 'Improving the Settlement Efficiency Landscape in Europe'. The main categories identified were:

Inventory management

There can be several possible reasons behind the seller being unable to deliver the securities. This may be due to a lack of trading-level liquidity in the instrument, for example where a market-maker is unable to source the securities. However, it may also be as a result of internal operational issues, such as a failure to realign securities between different locations or accounts in sufficient time, or external factors, including scenarios where the seller's delivery was contingent on the settlement of a separate receiving transaction on the same instrument.

Data quality

The post-trade ecosystem is a complex network of interconnected market participants, exchanging large amounts of information necessary to process and settle transactions. Ideally, reference data should be sourced by all parties from a common, central data source to minimise the risk of a mismatch between two parties. Issues can arise across the trade lifecycle on a variety of types of information. Common examples include:

- Changes in Standing Settlement Instructions (SSIs) not being communicated or updated in relevant systems in good time.
- Delays relating to instrument static data – e.g. new ISINs not being available in trade capture systems.
- Incorrect mappings in internal systems resulting in mismatches – e.g. a system not configured to identify a market settlement holiday resulting in transactions being processed with the wrong settlement date.
- Incorrect or incomplete static data resulting in incorrectly formatted instructions, leading to rejections at the Swift gateway or by an intermediary or the CSD.
- Lack of clarity over whether an instrument should be settled in "units" or "nominal".

Counterparty behaviour

Information that is necessary for the timely processing and settlement of a transaction is provided by the counterparty: in a non-standard format; in an incomplete or inaccurate manner; or late.

Anecdotal evidence suggests that, for most firms, a small number of counterparties have an outsized impact on levels of straight-through-processing (STP) in a timely manner. Whilst the majority of transaction volumes can be processed on time and in an automated manner, requiring minimal intervention, issues can typically arise from two types of counterparty:

- ***"Manual" counterparties*** who are typically less-sophisticated market participants with relatively low levels of market activity. Issues can typically arise at the allocation and matching stage, where allocations are not provided in an STP format or through standard channels (e.g. via email).
- ***"Non-domestic" counterparties*** who are located in a different timezone, specifically the Asia Pacific region, and often are only able to provide allocations on T+1, leading to processing delays.

Workflow management

Delays or fails attributed to internal workflow inefficiencies, non-straight through processing (STP) processes, manual booking errors or technology issues that occur within an internal system.

Market standards and regulation

Delays or fails that could be resolved by the creation of new market standards / regulation, or enhancements to existing market standards / regulation.

Structural issues (i.e. matters out of the direct control of market participants

Despite significant effort having been made to reduce the barriers to post trade integration in the region, there are still a number of barriers that exist that challenge timely settlement. At a high-level these issues include:

- 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 and inventory not being maximised
- Derogation for certain CSDs under CSDR Level 2 Article 12 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 by CSDs 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
- Lack of instrument interoperability - certain ISINs are not eligible to settle in every EU CSD
- Different CCP cut-offs
- Market liquidity constraints

Case study: Broker predicament

The nature of how trades are executed means that the broker sits in-between the 'market leg' which could be executed on venue(s) potentially in multiple shapes, from another broker or via a borrow. This means that the total position required to deliver to the buy-side client will be contingent on numerous settlements, potentially from numerous sources, including from CCPs which may settle in different CSDs to where the buyside client wants to take receipt.

The outcome is that the broker will be dependent on the purchases settling in order to deliver to the buyside client. If any of its purchases fail to settle in full or in part it might look, on the surface, that the broker is short when technically speaking it is not. The broker may also end up sitting on inventory that it is unable to turn around if the buyside client does not or is unable to accept a partial.

Furthermore, if the position is sourced by a borrow which settles FOP there is a risk that the borrow settles after the DVP cut-off at the relevant CSD. This results in the broker being left with a position that it is unable to turn around incurring costs it can't pass on in the process.<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>

We note that the application of cash penalties should not be the exclusive tool used to improve settlement efficiency and it should be considered as part of the toolkit alongside other measures.

AFME suggests the following tools should be considered in order to improve settlement efficiency:

Partial Settlement

AFME members support the idea of mandating through regulation that CSDs provide partial settlement functionality, along with a mandate for market participants to accept partial deliveries and receipts within certain parameters.

Our longstanding position has been supportive of partial settlement as one of the essential tools for improving settlement efficiency in the EU, as it helps mitigate settlement risks by allowing transactions to be settled partially, thereby reducing exposure to market and credit

risks associated with delayed or failed settlements. Partial settlement can streamline the settlement process by facilitating the timely completion of transactions, reducing the operational burden on market infrastructures, clearing houses, and intermediaries. In the context of cross-border securities transactions within the EU, partial settlement mechanisms can facilitate the efficient and timely settlement of transactions involving securities issued in different jurisdictions, thus promoting market integration and liquidity.

Making partial settlement mandatory could effectively counteract the increase in fails that is likely to occur as a consequence of a compressed settlement cycle in the event of an EU adoption of T+1. As a matter of fact, the optionality provided for by the CSDR regulatory framework when it comes to partial settlement has diminished, so far, the degree of effectiveness of this measure. To maximise the benefit it may be necessary for ESMA to consider the use of partial settlement. We recommend that this is a topic for the future discussion on the measures to prevent settlement fails

From an operational standpoint, it must be emphasised that partial release plays a decisive role in the extent that partial settlement can be used. In omnibus accounts, partial settlement and 'on hold' functionalities are not sufficient, as the omnibus account owner – who will typically be a custodian – will need to ensure that said securities belong to the correct underlying client. To operate partial settlement seamlessly, the omnibus account owner will need to use the 'on hold' functionality and release a partial of securities rather than the full amount. Moreover, it is also worth underlining that the procedures governing the way the "Hold" is managed cannot and should not be modified as far as omnibus – client accounts managed by "third-parties" such as custodians – are concerned, since this would otherwise i) create the potential for so-called "drawing from the pool" or ii) raise the need to open segregated accounts which would increase the costs for participants and by default their clients.

From a regulatory standpoint, the above-mentioned recommendation would turn into a deletion of Article 12 of the Regulatory Technical Standards on CSDR settlement discipline (Commission Delegated Regulation (EU) 2018/1229), which provides for a derogation for certain CSDs from the requirements to provide a partial settlement and hold and release mechanism.

Furthermore, we note that, in the event of an increase in cash penalty rates, there could be an incentive for some market participants to not accept a partial delivery and instead profit from receiving the income from the higher penalties. A regulatory mandate to accept partial settlement of securities would neutralise these scenarios.

Case study: Euroclear Sweden

We note that EU markets have shown signs of improvement in settlement efficiency since the introduction of the CSDR cash penalties regime, most notably in equities transactions. One

market in which there has been a more eye-catching success in addressing settlement fails is Sweden. For equities, the settlement efficiency rate has improved significantly: from 84.93% in Q1 2021, to 96.38% in Q3 2023.

In Q1 2021, Euroclear Sweden first enabled participants to instruct a partial settlement of positions held in omnibus accounts. This functionality was further refined in Q4 2021, as well as enabling the simultaneous partial settlement of multiple instructions in a chain of linked transactions.

Euroclear Sweden note that between 2020 and 2023, the portion of valued settled through use of partial settlement approximately tripled. The impact was particularly noticeable in non-cleared OTC transactions. For this flow, over 9% of the value settled involves some degree of partial settlement in 2023, compared to below 1% in 2020.

Allocations and confirmations

Allocations and confirmations are foundational in the post execution flows. Without the allocations the broker cannot confirm, book and instruct its settlement instructions. The buy-side client may require the broker's confirmation before they instruct their global custodian and commit their funding adding latency to their processing. Whilst CSDR Article 6 and Article 2 of the delegated regulation create a framework, perhaps there should be greater consideration of what can be improved in this key post-execution / pre-settlement stage.

The use of vendor tools which compare and match buy-side allocations with sell-side confirmations, allows market participants to exchange and match economic and non-economic details of a transaction prior to instructing the CSD. Pre-settlement, or trade-level, matching can be used to identify and resolve potential issues early in the trade lifecycle.

There are a number of dependencies for this practice to be truly effective:

- Timely advice of allocations by the buy-side client
- Timely confirmations by the broker (in accordance with CSDR RTS Art.6 and MiFID II).
- Vendor platforms to match PSET and to the same cash tolerance as the CSD as required under CSDR Level 2 to ensure that trade level matching is held to the same standards as settlement matching to avoid preventable matching exceptions at the CSD and risk of settlement fails.

Timely matching

We reference our response to Question 6, where we outline some of the potential measures to reduce the number of unmatched settlement instructions.

Pre-matching should be encouraged to avoid economic and SSI mismatches manifesting at the CSD layer. Further to the above point on allocations and confirmation matching, central platforms are important tools to identify economic and non-economic matching discrepancies and ideally resolve prior to the settlement instruction being instructed through the chain of custody to the CSD to avoid the risk of fails and duplicative instruction costs due to cancellation and re-instruction to resolve booking errors.

It is important to note that not all transactions are submitted to a central platform for pre-settlement matching and similarly it is important to note that what may look like a match in the vendor tool may not result in a match at the CSD if the matching criteria in the vendor tool equates to the criteria in the CSD. AFME is committed to working with vendor platforms to ensure that their solutions are optimal in the context of settlement efficiency.

It is important for settlement instructions to be sent real-time / intra-day rather than in batches 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 (where used) as early as possible. The use of 'on hold' should be leveraged by CSD participants to enable matching and the early identification of exceptions without committing the instruction to settlement (until cash / securities are in place). Further consideration could also be given to the use of UTIs.

At a CSD level a review is required to ensure that all CSDs are meeting the requirements of Article 5 of the CSDR regulatory technical standards, which requires CSDs to "provide to participants a functionality that supports fully automated, continuous real-time matching of settlement instructions throughout each business day." In addition, 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.

Industry data[9] provided by technology vendor Access Fintech indicates that there is a correlation between early matching (i.e. on trade date) and higher levels of settlement efficiency. We generally consider that use of pre-settlement matching platforms can reduce the probability of a settlement fail. According to Access Fintech's data, transactions matched in their platform on trade date had a 45% lower settlement fail rate compared to transactions matched on T+1.

[9] Data Scope: analysis is based on data from 3 organisations, published over a 30-day period (January/February 2024)

<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>

AFME members agree with ESMA's statement that achieving the goal of 100% settlement efficiency on the intended settlement date may not be a realistic objective. Furthermore, the duration of settlement fails should be one of the major factors to consider when looking at settlement efficiency rates (i.e., if it is to be expected that some fails will occur, analysing the speed at which these get remediated is a relevant factor).

The core principle of the definition of optimal levels of settlement efficiency should be focused around reducing risk and understanding at what point high levels of settlement fails will start creating a systemic risk for the EU. It would be critical to first determine the factors relevant to determining the appropriate level of settlement efficiency to avoid the imposition of arbitrary targets. Furthermore, any exercise to define the appropriate levels of settlement efficiency would need to be sufficiently flexible to take into account any arising externalities (e.g., Covid 19, Ukraine war) that typically result in a temporary reduction in levels of settlement efficiency.

We agree with ESMA that settlement efficiency levels will vary according to each asset type. Aspects such as volume of trading, value of the market, liquidity, cost and availability of borrowing securities, are all relevant to the 'equilibrium' settlement efficiency rate of each asset type and its systemic importance.

Theoretically, there are no reasons to believe that a particular CSDs could only achieve a lower rate of settlement efficiency compared to other CSDs; therefore, we do not agree with the idea of setting out different definitions of appropriate levels of settlement efficiency based on CSD or SSS. Should any of these scenarios exist in practice, it will be required to conduct a detailed analysis to understand the underlying causes (e.g., legal context, extensive use of segregated accounts vs omnibus accounts, etc.) driving the lower performance of a particular CSD/SSS.

Lastly, when determining appropriate levels of settlement efficiency, it is important to determine what constitutes an optimal equilibrium, where the cost of further improving settlement efficiency would start to outweigh the benefits. In this perspective, it is important to calibrate penalty rates so they will not have a marked negative effect on market liquidity and bid-ask spreads. It is also important to benchmark settlement levels against other major capital markets (see our response to Question 44).

<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>

We refer to our comments provided in response to question 16 in regard to the proportionality of cash penalty rates.

We note that the CSDR Settlement Discipline Regime's cash penalty mechanism was only implemented two years ago, thus it is necessary to allow for a longer period of time before undertaking a significant overhaul of cash penalties.

As 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 cause of settlement fails and implement solutions which will require changes to regulation and CSDs' operations in addition to market participants own operations, and ii) ensuring an appropriate data and reporting methodology that accurately captures settlement fails. AFME welcomes the upcoming ESMA consultations on preventing settlement fails and data / reporting.

<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>

We understand that responding to this question should be deferred to the CSDs, whilst we emphasise the importance of these data being provided with the corresponding breakdown (i.e., by age of settlement fail, by asset class, by instrument type based on MiFID II classifications, by transaction type, by country of issuance of the security, by settlement location, by liquidity profile, 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>

No. AFME does not support the introduction of progressive penalty rates. Progressive penalty rates are not justified as market participants are already incentivised to avoid failing.

Firstly, this proposal introduces significant additional complexity to the structure of the penalty mechanism. T2S and CSDs invested significant time and resource towards building the current mechanism for calculating and applying penalties. Industry participants likewise invested significantly to ensure that they could validate, consume and attribute penalties reported by the CSD. A radical overhaul of the structure of the penalty mechanism, only two years after its application, would not be a proportionate reaction by authorities. It would result in significant additional costs for the industry and we understand that it would be a multi-year implementation project for market infrastructure and their users. This would significantly undermine its effectiveness and impact.

Furthermore, it is not clear whether there is any evidence to support that this proposal would be effective. We note that data reported by CSDs to their national competent authorities, and subsequently ESMA, does not include an assessment of the duration of settlement fails. The current reporting methodology treats each day of a settlement fail equally. In other words, a 3-day settlement fail is reported in the same way as three separate one-day settlement fails for the same quantity/notional value.

We therefore query on what basis ESMA can analyse the impact of a proposed progressive penalty rate. What proportion of instructions would this impact? How does ESMA intend to track the effectiveness of a progressive penalty regime, should it be implemented?

ESMA state that “not all settlement fails are the same and that a one-day settlement fail is not as impacting as a 20-day settlement fail.” We highlight that the existing penalty regime takes this into consideration. Under current rules, a 20-day settlement fail will result in a penalty 20 times greater than for a one-day settlement fail. AFME members consider the current approach to be proportionate and logical. Using liquid shares as an example: under proposal 1, a 20-day settlement fail will result in a penalty 72 times greater than for a one-day settlement fail; under proposal 2, a 20-day settlement fail will result in a penalty 41.4 times greater than for a one-

day settlement fail. It is unclear on what basis ESMA have determined that a 20-day fail is 41.4 or 72 times more impacting than a one-day settlement fail.

Additionally, a progressive penalty rate, which penalises older fails on a non-linear basis, does not consider that 'younger' short-term fails are more likely to be avoidable due to behavioural issues than older fails which are more likely caused by factors outside of the failing party's control. Progressive penalties would therefore heavily and unduly impact "unavoidable" fails than "actionably avoidable fails", and will therefore have an outsized impact on market liquidity and pricing in less liquid securities.

Finally, we note that this proposal could undermine the "immunisation principle" and could have potentially distortive impacts. ESMA notes that, to be effective, cash penalties should be "certain in terms of calculation and forecasting, to facilitate cost/benefit calculations in terms of remedial investments". This proposal does not uphold that principle. For example, a trading party may book a borrow to cover a failing securities delivery, with an intended settlement date one business day after the original delivery. Currently the party has certainty that its penalty exposure is equal to the daily penalty rate for one business day. Under a progressive regime, the party cannot accurately measure their penalty exposure as the daily rate is not constant.

We therefore strongly recommend that ESMA do not give further consideration to a progressive penalty regime. This would require substantial industry investment which would be better used on addressing structural causes of settlement fails, with no meaningful way to measure the effectiveness of the change.

ESMA note in paragraph 60: *that "meaningful, persistent costs in the form of penalties can trigger meaningful investments to avoid them."*

We observe that the fact that the majority of fails are resolved between ISD+1 and ISD+3 is testament to this.

ESMA further note:

"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."

Unavoidable fails due to structural or liquidity issues would be significantly impacted by the progressive penalty rates, which will be unlikely to resolve the fail any quicker, but will add more stress to the system and more cost, which will impact the region's securities markets.

Overall, we would like to reiterate the message conveyed in answer to question 20 above i.e. as a first and fundamental step, it is necessary to improve the current settlement ecosystem; second, the implications of T+1 will have to be very carefully considered. In the end, we believe that regulatory initiatives at the EU level should strive for prompting more stability in the settlement space and not additional complexity.

<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>

AFME does not support the introduction of convexity in penalty rates. As per our response to Q22, this proposal would also introduce unnecessary complexity, and there has not been sufficient analysis of current settlement fails to determine that this would be effective. Introducing convexity in penalty rates would require significant investments and resourcing that would challenge the resilience of the cash penalty regime. Any changes to the calculation methodology would also have an impact on intermediaries, who will have to replicate some of the logic in their own systems when the penalties are passed on.

The implementation of complex changes to the current penalty mechanism will have knock-on effects on the available resources across the industry, as these would have to be diverted from other areas, such as improving settlement efficiency or preparation for a potential EU adoption of T+1.

Additionally the same reasoning would apply for convex penalties as for progressive penalties, in terms of unduly impacting longer term fails which cannot be addressed by behavioural changes (see above).

Furthermore, we note that the proposed Option 2 suggests that debt instruments issued by a sovereign issuer should be subject to the ***highest*** penalty rates. This contradicts with the provisions of Recital 7[10] CSDR RTS for the calculation of cash penalties for settlement fails, which states that "*The level of cash penalties for settlement fails of transactions in debt*

[10] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0389

*instruments issued by sovereign issuers should take into account the typically large size of these transactions and their importance for the smooth and orderly functioning of the financial markets. Settlement fails should therefore be subject to the **lowest** penalty rate. Such a penalty rate should nevertheless have a deterrent effect and provide an incentive for timely settlement.*"

<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 reiterate that we do not support the application of a convexity criterion to any asset class.

Typically, illiquid financial instruments are more reliant on market-makers to support liquidity. This is reflected in the current levels of penalty rate, which are lower for illiquid instruments than liquid instruments. For fails over 5 business days, Proposal 2 suggests higher penalty rates for illiquid instruments than liquid instruments. The rationale for this proposal is not clear to AFME members, and would not be supported.

For a trade to fail for 5 days, it suggests that there is a structural / liquidity issue rather than an efficiency-related issue. The proposed convexity criterion may not increase the chance of the trade settling any quicker, it will just add friction and cost to the process.

Although we are opposed to any application of a progressive penalty rate, with or without convexity, we reiterate that protection of liquidity in less-liquid instruments should be a critical consideration when implementing any change to the penalty regime. The application of higher penalty rates for less liquid securities could create disincentives for market makers to provide liquidity in the market, thus leading to a further reduction of the liquidity pool in the Union; this would have particularly negative effects on less liquid instruments. Ultimately, the attractiveness of EU capital markets would risk being diminished, thereby contradicting the overarching objective.

<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>

We do not support the levels of penalty rate proposed under Option 1 or Option 2. Both proposals represent drastic increases to current levels which we do not believe are merited based on available data. Recital 16 of CSDR sets out that penalties should be configured in a way that "maintains and protects the liquidity of the relevant financial instruments. In particular, market-making activities play a crucial role in providing liquidity to markets within the Union, particularly to less liquid securities. Measures to prevent and address settlement fails should be balanced against the need to maintain and protect liquidity in those securities."

We strongly believe that the levels proposed by ESMA are contradictory to the abovementioned principle and would cause significant damage to liquidity, ultimately damaging the competitiveness of EU securities markets.

As outlined in our response to Question 15, there are clear signs of positive improvement to settlement efficiency rates, in particular for certain asset classes which started from a higher level of fails. This suggests that the current level of penalty rates may have had some positive impact on addressing settlement fails caused by behavioural issues, and towards achieving the objective set out in the CSDR Refit of achieving a "long-term, continuous reduction" in fails.

AFME has been a long-standing supporter of the penalty regime as a flexible, dynamic tool to create behavioural incentives to settlement efficiency. We agree that there is scope for a recalibration of current penalty rates, based on a number of important factors outlined in our response to Q26.

Further to this, we note anecdotal evidence of how the current penalty regime does not function as intended and can disincentivise timely resolution of settlement fails. Significantly increasing penalty rates would amplify these disincentives.

For example: Party A instructs in CSD1, Party B instructs in CSD2. Should the mismatch not be resolved by intended settlement date, both parties are disincentivised to amend their instruction to match, as the party which amends will be debited the late-matching penalty. According to 2022 data, the average value of a transaction processed in T2S was approximately 1mn EUR. Therefore the average current penalty 'delta' (difference between credit and debit) is 200 EUR, assuming a one-day penalty for a liquid equity. Under proposal 1, the delta would be increased to 1200 EUR, creating a much stronger disincentive to resolve the fail.

<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>

ESMA notes that the purpose of the penalty regime is to incentivise rapid resolution of settlement fails, as well as to discourage them. To this point, we strongly recommend that public authorities collect more granular data on the average duration of settlement fails. We note that ESMA acknowledges not having sufficient break down of data from the information that is provided by the CSDs to their NCAs, which is extensive to the fact that the existing data does not provide sufficient visibility on the ageing of settlement fails.

We agree that there is scope for a recalibration of current penalty rates, which should be done on a periodic basis by ESMA, per asset class. When recalibrating penalty rates, some of the factors which should be considered include:

- Interest rates: higher interest rates create an additional cost/disincentive to fails to deliver.

- Ability to remediate the fail using securities lending markets: taking into account the average cost, minimum duration and availability of borrowing the security.

- Broader market conditions: times of volatility/market stress typically result in higher settlement fail rates, as evidenced in March 2020 and February 2022. Higher penalty rates may exacerbate rather than remediate issues.

- Impact of a shorter settlement cycle: at least in the short-term, a move to T+1 may result in more settlement fails due to market participants having less time available to resolve operational issues and place cash/securities ready for settlement.

The ESMA consultation introduces the concept of 'actionably avoidable' settlement fails. AFME agrees that such fails should be targeted by regulators and the industry as an obvious area for improvement. We refer to the AFME report on 'improving the Settlement Efficiency Landscape

in Europe' which further explores the causes of settlement fails with a strong focus on those which are 'actionably avoidable'.

AFME members welcome further consideration of measures to create additional behavioural incentives for market participants to address 'actionably avoidable' fails. However, it is important to ensure that the penalty regime protects the immunisation principle previously outlined. Therefore, such incentives may need to exist outside of the core penalty regime.

<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>

AFME members broadly believe that the current asset class categorisation is appropriate.

We do support the proposal in Option 1 to introduce a new category for ETFs, which takes into account the market specificities of the product and the role of market-makers in providing liquidity. However, we do not support the proposed rates outlined in Option 1 for ETFs (i.e., 2.5 bps on 1st Business Day Fail, 3.5 bps on 2nd Business Day Fail, etc.).

We strongly believe that increasing penalty rates for ETFs will not have a positive impact on improving settlement efficiency. Instead, the primary effect would be an increase in costs to EU investors in ETFs, making the region less competitive. As outlined in our response to Q17, we believe that greater focus on addressing existing structural barriers to timely settlement is critical to improving settlement efficiency in ETFs.

<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>

Progressive penalty rates (by asset type) - ESMA's proposal Option 1	**Please see ESMA's proposed Option 1 in Section 5.3 of this CP.**	
	Qualitative description	**Quantitative description/ Data**
Benefits	- Proposed creation of new penalty type for ETFs allows for this asset class to have an appropriately calibrated penalty rate.	TYPE YOUR TEXT HERE
Compliance costs: **- One-off** **- On-going**	- Multi-year implementation project for T2S and CSDs to redesign penalty calculation engines. - Same impact for all market participants (custodians, trading parties) who will need to also amend internal systems to match. - Build costs for FMIs would be passed through to end users.	TYPE YOUR TEXT HERE
Costs to other stakeholders	- Wider bid-offer spreads by liquidity providers to account for the increased cost of a potential failed settlement.	TYPE YOUR TEXT HERE
Indirect costs		TYPE YOUR TEXT HERE

	.	
Progressive penalty rates (by asset type) - ESMA's proposal Option 2	**Please see ESMA's proposed Option 2 in Section 5.3 of this CP.**	
	Qualitative description	**Quantitative description/ Data**
Benefits	None	TYPE YOUR TEXT HERE
Compliance costs: **- One-off** **- On-going**	- Multi-year implementation project for T2S and CSDs to redesign penalty calculation engines. - Same impact for all market participants (custodians, trading parties) who will need to also amend internal systems to match. - Build costs for FMIs would be passed through to end users.	TYPE YOUR TEXT HERE
Costs to other stakeholders	- Wider bid-offer spreads by liquidity providers to account for the increased cost of a potential failed settlement.	TYPE YOUR TEXT HERE
Indirect costs	- Knock-on impact on primary markets, increased cost for issuers seeking to raise new capital.	TYPE YOUR TEXT HERE

	- Negative impact on competitiveness of EU markets	

<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>

We do not support any form of progressive penalty regime, therefore do not have alternative proposals.

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

Compliance costs: **- One-off** **- On-going**	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	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 refer again to the “immunisation principle”, which ESMA has previously highlighted as a critical component of a functioning penalty mechanism.

The proposal to differentiate penalty rates based on the value of the instruction is fundamentally contradictory to this principle and would create obvious arbitrage opportunities.

Transactions in a settlement chain are not on a “one-for-one” basis. For example Party A may fail to deliver 100 shares to Party B, which in turn causes Party B to fail on its deliveries of 40 shares to Party C, 30 shares to Party D, and 30 shares to Party E. Under the current regime, Party B would receive equal and offsetting penalty credits and debits. Under these proposals, Party B would receive a net penalty debit or credit.

Parties could be motivated to try and minimise penalty debits and/or maximise penalty credits simply by changing how they input their settlement instructions (e.g. splitting into smaller shapes) rather than making any positive changes to improve their settlement efficiency.

Further to this, we reiterate our previous support for maintaining the current simplicity and transparency for calculating cash penalties. We do not support any proposals to increase complexity.

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

Please refer to our response to Question 26. Note that we propose these criteria are considered holistically by ESMA to determine appropriate per-asset class levels of penalty rate on a periodic basis. We do not support any changes to the basic methodology for calculating the penalty amount on any individual failing settlement instruction.

<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>

No. AFME members believe that the current calculation methodology, based on the daily marking to market of the financial instruments, remains appropriate, and most accurately reflects the risk associated with the settlement fail.

As outlined in our response to previous questions, we do not believe that material changes to the basic methodology for calculating penalties are necessary and would divert resources and effort away from fixing underlying causes of settlement fails along with creating additional costs and adding strains to the systems.

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

We believe that the current methodology for valuing FoP instructions, as outlined in Section 7 of the ECSDA CSDR Penalties Framework, is appropriate. There is no need for any changes to this methodology.

<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 believe that the level of penalty rate will have any impact on whether transactions are instructed DvP or FoP. The penalty calculation for DvP and FoP transactions is identical, therefore there would be no difference in the penalty amount.

FoP instructions are only used in specific circumstances, for example:

- Realignment of securities between accounts
- Pledging of collateral
- Cross-border settlements where DvP in the relevant currency is not supported by the CSD

<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>

Applying lower penalty rates for illiquid bonds		
	Qualitative description	**Quantitative description/ Data**

Benefits	Differentiation of bonds according to the liquidity of the asset could enable penalty rates to be more precisely calibrated, and could increase the granularity of the data ESMA collect.	TYPE YOUR TEXT HERE
Compliance costs: **- One-off** **- On-going**	Significant build cost for Financial Market Infrastructures and all market participants. We believe that it would be helpful to create a golden source database maintained by ESMA (as suggested in our response to CSDR Refit proposals) which records in a central, publicly accessible place all data relevant to the calculation of penalties. This would bring in a number of benefits to market participants in terms of transparency and predictability of the penalty calculation mechanism.	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

TYPE YOUR TEXT HERE

<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>

AFME members consider this as a credible risk. The higher the penalty rate, the more that parties will be incentivised to maximise penalty credits rather than focusing on minimising debits.

As previously stated, the level of penalty rates should take this into consideration, and should be supplemented by broader market changes that help to ensure that parties are not incentivised to delay settlement.

<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>

In a low or negative interest rate environment, the opportunity cost of holding cash increases. On the other side, higher interest rates will likely increase settlement rates since parties have greater economic incentives to deliver the securities in order to get the cash.

However, we note that cash penalties are not directly related to the interest rate or the cash that one of the parties would have received; the penalty is calculated solely on the value of the security. To this extent, we consider that the idea that penalty rates should be above the rate for securities borrowing would be counter-productive, in the sense that the incentive to borrow securities is made up of two costs: the cost of the penalty, but also the cost of not having the cash.

<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. We consider that this proposal would be fundamentally contradictory to harmonisation principles, and would have a significant negative impact on market participants' ability to transact seamlessly cross-border. Furthermore, this would again be contradictory to the 'immunisation principle'.

It is clear that there is significant deviation in settlement efficiency levels across CSDs. We consider that it is far more likely that this is caused by differences in market structure and CSD functionality, rather than behaviour of market participants. On that basis, we believe that increasing penalties for instructions in those CSDs with higher fail rates would be ineffective.

We strongly encourage public authorities to instead focus attention in ensuring greater harmonisation in the functioning of CSDs, with respect to their facilitation of automated partial settlement, partial release, the number of batches per day, and their cut-off times. We refer to our response to Question 15 where we present an AFME analysis of settlement efficiency based on the available data from the annual CSDs public disclosure of settlement fails. We observe that out of the analysed CSDs, none of the CSDs where settlement efficiency rates have gone down offer partial settlement functionality.

<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>

Application of the penalty mechanism only at the level of CSDs with lower settlement fail rates		
	Qualitative description	**Quantitative description/ Data**
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: **- One-off** **- On-going**	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	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. AFME members generally consider that any changes to the current scope should be minimised. Generally, the application of different penalty rates to different transaction types will represent a breach of the 'immunisation principle'.

AFME believes that certain transaction types should be exempt from the penalty regime, or subject to a 0 penalty rate, where the application of a penalty does not create any behavioural incentive for timely settlement.

In particular, we welcomed the proposal in the CSDR Refit to amend Article 7.2 of CSDR to exempt "settlement fails … caused by factors not attributable to the participants to the transaction" from the scope of the penalties regime.

A practical example of this would be the exclusion of CSD-generated instructions from 'late matching' penalties. Where the instruction is created by the CSD itself with a back-dated intended settlement date, it is clearly outside the control of the participants. Neither participant can be fairly penalised for the failure to settle on intended settlement date
.

Applying penalty rates by transaction types		
	Qualitative description	**Quantitative description/ Data**
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: **- One-off** **- On-going**	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	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>

We note that there are a number of additional factors that need to be considered when looking at the actual cost of borrowing. Besides the borrowing fees, some of the direct costs may include: transaction fees, collateral costs, tax and borrower creditworthiness..

As previously stated, the cost of failing is composed of different factors; the main component is the cost of funding, which is linked to interest rates in addition to cash penalties. Stock borrowing charges are also highly correlated to interest rates as is the cost of the collateral required to secure the stock loan.

Given the existing correlation between the cost of funding fails, and the cost of stock borrowing, both of which are highly driven by interest rates, there is no need to 'double up' and link cash penalty rates to the cost of borrowing securities.

It is also important to note that there is not always lending supply for certain asset classes, most notably the less liquid securities, and if there is, the rates are 'special' and therefore would not be appropriate to base cash penalties on.

It also has to be noted that securities lending arrangements are usually for minimum amounts and periods, which will likely not coincide with the settlement fail. Therefore, it may be more appropriate to leave the decision on how best to structurally address settlement fails to the delivering parties.

Furthermore, as a result of Basel III, market participants will need to be more aware of the capital costs associated with their transactions. Whether you conduct your securities lending transactions via OTC or through a CCP or via a pledge versus a title transfer structure, can impact the cost of capital associated with the transaction.

Due to the considerations required to determine the cost of borrowing it would cause significant complexity for the market and would reduce the predictability of cash penalties which could result in a significant increase in bilateral claims between parties.

We refer to our comments in response to Question 26, where we agree that there is scope for a recalibration of current penalty rates, which should be done on a periodic basis by ESMA, per asset class, and taking into account a number of factors.

<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>

We reiterate the message that the cash penalty mechanism should be as simple as possible, being easily operable for all market participants. Adding unnecessary complexities to the calculation method of cash penalties will divert significant industry resource away from other initiatives. Notably, we note that the greater the complexity of the changes, the longer the industry (including the ECB as operator of the T2S penalty calculation engine) will require to implement the changes. Regulators and policymakers must carefully consider how this interacts with other policy objectives, such as the potential adoption of T+1.

It should be noted that settlement fails may be classified based on the ageing of the fail, and the root causes driving these fails will differ. Most settlement fails that are resolved within 1-2 business days are typically caused by factors such as lack of STP, behavioural issues, data mismatches, etc. In these cases, the application of cash penalties may therefore act as an incentive for improving those elements within the control of market participants. On the other hand, longer settlement fails may be caused due to fundamental systemic issues or limited market liquidity. An application of penalties that increase over time on these securities will not address the underlying root causes, and may severely impact market makers' ability to inject liquidity into the market, thus making it more difficult for market participants to access capital markets.

Furthermore, AFME members are supportive of further efforts aiming at alignment of rules in the area of penalty reporting (MT537). Despite a unified regulatory framework, there are still

inconsistencies in reporting penalty information depending on market. Further guidance and standardisation in this area would benefit all market participants and lower overall costs of penalties processing.

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

We note that there is no publicly available data regarding settlement fails in the US market, so there is no way of having a meaningful data comparison. However, feedback from AFME members indicates that, in general terms, settlement levels in the European Union are comparable to other jurisdictions such as the US and UK.

We reiterate the fact that EU capital markets present significant complexity, compared to global peers. In the US for example, trading, clearing and settlement is concentrated in significantly fewer financial market infrastructures as compared to the European Union. The higher

proportion of cross-border transactions creates additional complexity in Europe – for example, in trade matching and position management processes. Whereas US market participants can assume with a high degree of certainty that their transaction will be settling in DTC; in Europe, it is important that counterparties proactively communicate and agree the place of settlement, to reduce the likelihood of a mismatch. European CSDs also operate with bilateral matching and irrevocable settlement finality whereas, for example, the US can operate with 'delivery without matching' and certain types of transaction can be 'kicked back' post settlement. We understand that these 'kick backs' represent a not immaterial proportion of overall transactions and should be accounted for in any comparison of settlement efficiency rates. Generally, a higher proportion of transactions are centrally cleared in US markets under a 'continuous net settlement' model which nets new and outstanding instructions (not only those facing the CCP) to settle for a specific day. Markets in the Asia-Pacific region are not homogenous, with local market practices varying across jurisdictions. However, many markets require the pre-placement of securities and cash prior to the execution of a transaction, which may contribute to lower levels of settlement fails – but possibly at the expense of increased costs and barriers to participation in these markets.

We note that there are higher levels of central clearing in the US, with a higher proportion of transactions that benefit from netting. For non-centrally cleared activity, general feedback from AFME members states that there is no real difference in settlement efficiency rates between the US and the EU. Similarly, we understand that settlement efficiency data for the UK shows that there are no significant differences with the EU.

AFME will look to undertake a further exercise following submission of this response to further compare settlement fail rates in different jurisdictions.

<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 intermediary, 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.

<ESMA_QUESTION_CSDR_45>

Q46 Do you consider that introducing a minimum penalty across all types of fails would improve settlement efficiency? Is 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>

We do not support the introduction of a minimum penalty across all types of fails and we understand that its implementation will present a number of challenges:

- Penalties may be updated; therefore, a penalty could move above/below the minimum threshold. It is unclear how this would be reported.

- If the minimum threshold was determined at transaction level, penalties would need to be calculated and reported only after settlement has (fully) taken place, which would imply a major change in the system functionality for the CSDs.

- Design and the efficiency of the cash penalty mechanism as a whole: the mechanism implies a high-volume system (large numbers of individual penalties) in which most penalties are very small. It works by affecting patterns of behaviour (incentivising good behaviour, and penalising bad behaviour) rather than through its effects on any individual transaction (as a penalty on any individual transaction may be very small). Not imposing penalties below a minimum threshold may result in eliminating a large number individual penalties and thus may have the effect of changing the overall incentives and perceived efficacy of the system, whilst going in contradiction to the 'immunisation principle'.

- The aim should be to achieve a simple and highly-automated process with minimal manual interventions. For CSDs and intermediaries in the custody chain that have achieved a high level of automation, the minimum penalty threshold will increase the operational burden of investigation and resolution (potentially bilateral claims) of any 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>

There may be factors that would impact the development required for CSDs and market participants to change their systems and processes in order to implement any changes to the penalty mechanism.

There will be a need for comprehensive end-to-end testing and a review of the lessons learned from the cash penalty regime go-live in February 2022. We note that preparation for compliance with cash penalties provisions took significant amounts of time, and the resolution of issues derived from its implementation took circa 6 months. Considerations around the timing, in particular with regards to any changes on T2S, through any change to the cash penalty methodology should be taken into account, given the length of its change requests processes.

We note that a review of cash penalties should not be conducted in isolation, regardless of any considerations on T+1 settlement. Notably, implementing a high-penalty regime ahead of T+1 would produce negative effects – particularly in terms of costs and liquidity – thus the arising issues could outweigh the benefits the regime aims to achieve. A potential adoption of T+1 settlement in the EU will require market participants to carry out the corresponding works in preparation for the reduction of the settlement window, thus adding complexity to the task of implementing changes to the CSDR cash penalty mechanism. We recommend that should there be any changes to the cash penalty regime, these should take into account a potential EU move to T+1 and the changes required to get there, including removing the structural barriers and accordingly plan each implementation date, providing sufficient lead time in order for market participants to prepare.

A timeline estimation should not only consider the technical aspects of system developments to incorporate the changes to the cash penalties; front-to-back processes should also be taken into account, as a more complex penalty mechanism will increase the associated operational burden in addition to added processing challenges.

<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 support the idea of special penalties being applied to participants with high settlement fail rates as this would create a differentiation factor in the market and would add complexity in terms of how the CSDs would calculate the penalty to be applied.

There are a number of elements outside of the control of the direct CSD participants that could be behind settlement fails (e.g., instrument type and its liquidity, CSD batch times / functionality, willingness of the buyer to accept partials, etc.). Furthermore, custodians will typically be the larger CSD participants and are dependent on the timeliness and accuracy of the information and the instructions being passed from their clients down the custody chain. Custodians will also be dependent on their clients having sufficient resources (securities and cash) to settle their instructions on time.

A custodian has multiple clients for whom it provides settlement services. Should a custodian be subject to an additional 'special penalty', they would likely have to mutualise this additional cost across all clients. Trading parties who have a higher rate of settlement fails will already, by default, be receiving the higher proportion of cash penalties. The focus should be around addressing operational behaviours and resource management deficiencies through the chain of custody that lead to settlement fails, looking at incentivising higher efficiency, rather than the application of more severe penalties.

<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>

In the context of the CSDs implementation of working arrangements with the top 10 participants with the higher settlement fails, we reiterate that the participant is an intermediary in the settlement chain and cannot influence the trading patterns of its clients and necessarily prevent settlement fails. Therefore, the CSD participant cannot be held fully responsible for settlement failures due to its clients' trading or settlement practices.<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>

We strongly recommend that the topic of settlement efficiency should be a standing item of the CDSs' User Committees. We reiterate that it is crucial that high-quality, granular information about current settlement efficiency rates is made publicly available by the CSDs. We note that the methodology deployed and the current fail reporting parameters differ across the CSD community, which creates inconsistency and leads to ambiguity and a distorted view of settlement fails.

There should be a natural focus on monitoring and improving settlement efficiency and explaining any challenges / spikes on settlement fails. More broadly, settlement efficiency is a performance indicator, and there needs to be tighter correlation between the systems' technical performance (up / down time) and how this impacts settlement efficiency.

Regular discussions on levels of settlement efficiency and the reason for settlement fails will help to identify any changes required to CSDs functionalities and daily timetables (please refer to our user-case on Euroclear Sweden outlined in response to Question 18).

We would suggest that for topics as broad and impactful as settlement efficiency or the speed of fail resolution, each CSD should have a separate Committee with a broader and more

diverse membership, perhaps based on volume / scale distinguishing between brokers / custodians / buy side, to ensure that there is a balanced representation between ‘trading parties’ and custodians.

<ESMA_QUESTION_CSDR_51>