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Proposals to harmonise and standardise pre-settlement date matching processes throughout Europe

1. Introduction

In summer 2004 ESF set up a working group tasked with working out proposals to harmonise and standardise pre-settlement date processes, this initiative being part of the ESF Action Plans 2004 and 2005.

A first discussion with the Board of the European Central Securities Depositories Association (ECSDA), ESF's chosen prime partner in this matter, in Vienna in September 2004 showed a high degree of high level consensus on the basis of which a close cooperation between the two associations was agreed.

This document has been agreed by both organisations reflecting the cooperation, which included several meetings between the respective working groups of ECSDA and ESF. It also takes into account results of a consultation carried out in the first half of 2006.

2. Deficiencies of current situation

Current pre-settlement date matching processes in Europe are diverse and increased costs and risks are caused by and linked to

- diversities of (i) scope of matching, (ii) matching times and (iii) matching procedures and matching fields
- the lack of automation / electronic matching in a number of markets
- language issues and misunderstandings associated with verbal pre-matching
- dependencies on intermediaries
- diversities of handling matching systems, e.g. custodians / agents banks requiring availability of securities as a condition for matching in order to comply with regulatory requirements in certain markets
- diversities in one and the same market / product according to the type of transaction (DvP, FoP, transfer)

3. Objectives

The objectives of harmonising and standardising pre-settlement date matching are

- to reduce the risk of fails and contract differences
- to increase settlement efficiency and reduce settlement cost accordingly
- to improve matching rates and increase certainty over open trade populations
- to build on ISO 15022 / SMPG standards where possible

4. Uniform terminology

- *Matching* is the process of comparing the instruction details for settlement provided by the counterparties to ensure that they agree with respect to the terms of the transaction.
  The result of successful matching is pairs of *matched instructions.*

- *New Message (NEWM)* is an instruction that requires no further input for settlement. NEWM instructions are *released instructions.*

- *Pre-Advice (PREA)* is an instruction that must be followed by NEWM before it goes to the settlement process. PREA instructions are instructions in *hold status.*

- *Hold / release mechanism* is the facility that allows changing the instruction status from hold to release and vice versa.

- *Locked-in instructions* are instructions that can neither be put in hold status nor cancelled. These will automatically go to the settlement process.

5. Scope of proposed standards

- The scope of the proposed standards *includes a*ll cash equities and fixed income DvP and FoP transactions, which require bilateral input with the CSD to match. [1]

- Out of scope are transactions in which a Central Counterparty (CCP) interposes itself, directly or indirectly, between the counterparties even if input is bilateral.

- *In scope* are portfolio transfers, stock lending and repo transactions in so far as they are not recognised as the respective specific types of transactions by the systems of the respective CSDs.

- *Out of scope* are portfolio transfers and financing transactions (stock lending, repo) that are recognised as such by the systems of the respective CSDs.

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[1] For electronic exchange transactions this matching process would normally be provided by the exchanges.

6. Concept

In order to
- induce early matching *and*
- allow a process with one matching instruction only by each party *and*
- avoid the requirement of availability of cash and securities as a condition for matching,

in a first phase of the life cycle, starting from the conclusion of the transaction and ending with the beginning of the settlement process, matched instructions shall not be locked-in instructions. However, as from the start of the settlement process they shall become automatically locked-in unless they are previously cancelled or be made subject to hold and release mechanisms. Fail transactions (transactions not settling due to lack of cash or securities) will not be locked-in anymore after the settlement run until the next run starts.

However, as this concept and, as a consequence in particular Standards 6 and 7, may not be compliant with legal and regulatory requirements (or the interpretation thereof) in certain European markets, interim solutions may be necessary before full implementation of the standards will be possible. In this context the cooperation of the Legal Certainty Group set up by the European Commission is sought to provide the legal and regulatory basis for removing such interim solutions as early as practically possible.

The implementation of this concept shall be based on a modified version of the ISO 15022 message functions PREA (Pre-Advice) and NEWM (New Message). According to current SMPG ISO15022 market practice rules, the PREA is used for matching, while the NEWM is a settlement instruction. The PREA will not automatically be converted into a NEWM. Rather "a settlement instruction will follow the pre-advice to release - unblock, unfreeze - the transaction for settlement". In order to fulfil the standards put forth in this paper, the rules shall be modified as follows:
- PREA and NEWM are not matching fields (i.e. PREA matches with PREA or NEWM)
- NEWM instructions can be put in hold status (whether by submitting a related PREA or by other means is for ISO / SMPG to decide).

7. Proposed standards

- **Matching fields**

Standard 1: The encompassing list of mandatory matching fields should include
- *Intended Settlement date*
- *Trade date where applicable (in transactions like for example portfolio transfers, trade date is usually not applicable)*
- *Cash amount including currency (should be left blank / 0 amount for FoP transactions)*
- *Share quantity (for equities) or nominal amount (for fixed income instruments)*
- *Buy/sell*
- *ISIN*
- *Counterparty (CSD participant)*
- *Second layer market participant (sub-account / customer of counterparty). The field shall be optional and thus allowed to match to blank.*

(It should be noted that some systems offer trade enrichment facilities, which means that participants need not fill in all mandatory matching fields. Above matching fields apply regardless of whether the data are input by participants or generated by trade enrichment facilities.)

- **Principle of one matching instruction only**

*Standard 2: One matching instruction only by each party to a trade should be required with no additional instruction for settlement needed.
That is, in the case where a hold / release mechanism is not utilised, matching and subsequent settlement could be achieved (without further messaging) via the use of NEWM instruction.*

- **Lifetime and timing of instructions**

Standard 3: Matching should occur real-time and continuous throughout each business day from Trade Date up to and including the Intended Settlement Date deadline and possibly beyond.

Standard 4: Matching should take place as early as possible.

Standard 5: Unmatched settlement instructions should remain in the CSD at least for 20 business days from the latter of the Intended Settlement Date or the last status change, after which date, if the trade is still valid, the trade should be re-instructed with original Trade and Settlement Dates.

Standard 6: *Matched trades should remain matched until actual settlement occurs, except otherwise required by (i) a cancellation of one or both of the parties, depending on the rules of the CSD, or (ii) a corporate actions event requiring cancellation or (iii) action taken by the CSD due to an event related to the respective security or one of the counterparties.*

Standard 7: *Matching instructions should only become locked-in at the time of the start of the settlement process.*

- **Separation of matching from availability of cash or securities, hold / release mechanisms**

  Standard 8: *Matching should be separated from the availability of cash or securities.*

  Standard 9: *All types of transactions should be covered by respective hold / release mechanisms, based on enhanced ISO 15022 SMPG standard formats as outlined in the Concept above.*
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- **Electronic / automated matching including reporting / monitoring matching**

Standard 10: *The instruction process to the CSD should be available to be performed by electronic data transfer between the user and the CSD. The matching process should be fully automated and free of manual intervention at the CSD.*

Standard 11: *The instruction process to the CSD should enable the 'amendment' of transactions in non matching relevant areas (e.g. hold / release mechanisms) rather than the cancellation and re-submission of the trade.*

Standard 12: *Matching fields applicable in the CSD matching criteria should be readily identifiable; they should be displayed in a standardised format and layout on GUI applications.*

Standard 13: *Trade attributes that assist the 'delivery management' process (e.g. hold / release mechanisms) should be readily available and displayed in a standardised format and layout on GUI applications, but they should be distinguishable from matching field information.*

Standard 14: Matching status information, including the previous matching status, should be accessible (i) real time and continuous throughout the business day and (ii) via means of electronic and / or automated issuance from the CSD.

Standard 15: The frequency and format of electronic matching status information should be user selectable, e.g. updates of all information, specific inquiries or changes since the last data extract.

Standard 16: Matching standards, attributes and availability of data should also be available for counterparty trade allegements.

- **Tolerance amount for settlement**

Standard 17: The tolerance amount for all types of securities and transactions should be consistent across all markets, e.g. EUR 25 or approximate counter value in any other currency, i.e. USD 30, GBP 20, SKR/NKR/DKR 200, CHF 40.
CSDs may introduce a second tier for retail markets whereby the above tolerance amount is only applicable for transactions with values exceeding EUR 100,000 or counter value in any other currency. For retail transactions with values up to and including EUR 100,000 or counter value in any other currency, the applicable tolerance amount should be EUR 2 or approximate counter value in other currencies, i.e. USD 2.40, GBP 1.60, SKR/NKR/DKR 16, CHF 3.20.

8. Benefits of the proposed standards

When implemented, the proposed standards will

- provide for uniform scope of matching, matching times and matching procedures and fields
- eliminate existing lack of automation / electronic matching
- significantly increase the overall efficiency of matching processes
- simplify internal processes of all types of market users (investment banks, custodians, prime brokers etc.) which will reduce required resources
- decrease the complexity of IT solutions through harmonisation of matching processes across markets
- allow early remedy of contract differences reducing thus the number of fails
- warrant risk reduction resulting from incentives for market users to instruct early
- increase the transparency of the post-trade value chain
  facilitate a shortening of the settlement cycle.

9. Implementation

It is planned to finalise the implementation of these standards by end 2009.