AB Trading Advisors

+44 (0)20 3405 0201

contact@abderivs.com

EU Central Securities Depositories Regulation: Settlement Discipline Regime

05 - Jan - 2022

The Short Read

It was announced in November 2021[1] that the implementation of controversial mandatory buy-in provisions under the Regulation on Central Securities Depositories[2] ("CSDR") has been postponed.

However, other aspects of the settlement discipline measures of CSDR[3] (the "Settlement Discipline Regime") will take effect as planned from 1 February 2022 – specifically, implementing new arrangements for confirming transactions and communicating allocations of securities, as well as the imposition of cash penalties in respect of settlement fails.

The Settlement Discipline Regime applies to transactions in certain financial instruments settling through a central securities depository based in the European Union ("EU"). The rules apply to all transacting parties – in other words, wherever located in the world.

In line with CSDR's broader aims to increase the safety of settlement in the EU, the Settlement Discipline Regime aims to incentivise market participants to settle cross-border transactions by their intended settlement date and hence improve efficiency and reliability of the settlement process – in particular, to reduce settlement fails.

The Settlement Discipline Regime has not been 'on-shored' into United Kingdom ("UK") law following Brexit, in which case securities transactions settled through CREST (the UK central securities depository) will not be subject to the Settlement Discipline Regime.

This *Briefs for the Buy side* considers the key measures of the Settlement Discipline Regime coming into force from 1 February 2022, as well as practical effects on buy-side firms.

The Full Read

Background

The central aim of the Regulation on Central Securities Depositories[4] ("CSDR") is to harmonise certain aspects of the transaction settlement process and to provide a set of common requirements for European Union ("EU") based central securities depositories ("EU CSDs"). Many of the substantive terms of CSDR's settlement discipline measures ("Settlement Discipline Regime") are set out in a delegated regulation[5] (the "Settlement Discipline Delegated Regulation") and form a key component of CSDR. The Settlement Discipline Regime is intended to incentivise settlement of relevant in-scope transactions by the intended settlement date[6] ("Intended Settlement Date") by applying measures to prevent settlement fails and that deal with the consequences of settlement fails. For the purposes of this *Briefs for the Buy side*, we focus on the following two aspects of the Settlement Discipline Regime:

- Written allocations and confirmations (intended to prevent settlement fails); and
- Cash penalties (intended to disincentivise settlement fails).

Postponement of mandatory buy-in rules

The announcement in November 2021 that the implementation of the proposed mandatory buy-in rules (intended to disincentivise and resolve settlement fails) has been postponed was met with a collective sigh of relief across the industry. It had been unclear exactly how the controversial rules would take effect in practice, as buy-in obligations would apply all the way up a settlement chain (the Settlement Discipline Delegated Regulation expressly envisaging that "parties in the settlement chain" would be required to establish contractual arrangements incorporating mandatory buy-in processes and procedures as well as "each party in the settlement chain" being required to ensure that such "contractual arrangements established with its relevant counterparties are enforceable in all relevant jurisdictions"). Concerns also arose around adverse effects on market liquidity and pricing.

An initiative had been started by a group of trade associations to develop a documentation solution for mandatory buy-in requirements; however, this was subsequently paused due to an increasing market expectation that the mandatory buy-in rules would be delayed.

Impact on the buy side

Although CSDR has been in force since 17 September 2014, certain of its provisions are subject to phase-in periods. Provisions of CSDR already in effect (for example covering settlement cycles and authorisation for EU CSDs) have primarily affected EU CSDs and the sell-side, but now buy-side firms will be affected too.

Who does the Settlement Discipline Regime apply to?

The Settlement Discipline Regime applies to parties located anywhere in the world engaging in in-scope transactions under which certain types of financial instruments settle through an EU CSD.

Which transactions are in-scope of the rules?

The written allocations and confirmations requirements of the Settlement Discipline Regime apply to transactions in transferable securities, money market instruments, units in collective investment undertakings and emissions allowances that are intended to settle through an EU CSD. The cash penalties regime: (i) applies to such aforementioned financial instruments that are admitted to trading or traded on an EU trading venue or cleared (or eligible for clearing) by an EU CCP but (ii) does not apply to shares where the principal trading venue is located outside of the EU.

Written Allocations and Confirmations

The Settlement Discipline Regime includes new requirements for EU investment firms executing orders to ensure that their clients/counterparties promptly communicate the allocation of securities under a transaction, confirm that allocation and confirm the acceptance or rejection of terms in good time before the Intended Settlement Date[7].

Consequently, clients of EU investment firms will be required to send detailed information (as set out in the Settlement Discipline Regime[8]) in writing relating to the allocations of securities or cash under in-scope transactions, as well as information as required by the EU investment firm in order to facilitate settlement of the transaction ("Allocations"). Once the EU investment firm has received

confirmation of the execution of a transaction, the client must confirm its acceptance of the terms of the transaction in writing ("Confirmation"). Both Allocations and Confirmation must be received by the EU investment firm within specified timeframes, being before close of business on the date of execution or by 12:00 Central European Time (CET) on the following business day in certain circumstances[9]. The EU investment firm must also confirm receipt of the Allocations and Confirmation within two hours. Professional clients are exempted from the requirement to comply with the Allocations and Confirmation rules where the cash and securities necessary for the settlement of the transaction are held at the same EU investment firm.

Impact on the buy-side

The new Allocations and Confirmation requirements must be enshrined in contractual arrangements between an EU investment firm and its client – as a result, buy-side clients can expect their EU brokers to amend their terms of business or otherwise seek to amend existing contracts to include such requirements. Buy-side firms will also need to update their operational procedures to: (i) ensure that the required information in respect of the Allocations can be provided; and (ii) meet the delivery timeframes set out in the Settlement Discipline Regime. The Settlement Discipline Regime permits the Allocations and Confirmations to be sent by professional clients electronically through the international open communications procedures and standards, rather than in writing. Appropriate connectivity with the EU investment firm would need to be in place if this approach is to be relied upon.

Cash Penalties

What are cash penalties and who is responsible for paying them under CSDR?

EU CSDs will be required to impose cash penalties on EU CSD participants responsible for late matching and/or settlement failures. In which case, an EU CSD participant acting on behalf of an underlying client to an in-scope transaction (i.e., settling the transaction on behalf of an underlying client) will be responsible for payment of cash penalties. That EU CSD participant may then pass on the cash penalties to its underling clients.

When are cash penalties calculated and reported?

EU CSDs will report any cash penalties applied to a failed settlement instruction to each relevant EU CSD participant on a daily basis. The net amount of cash penalties to be paid by the failing participant will be charged and collected directly by the EU CSD on at least a monthly basis. The EU CSD will then, on at least a monthly basis, distribute the net amount of such cash penalties to the receiving participants affected by settlement fails.

Types of cash penalties

Cash penalties will be applied by an EU CSD where a settlement instruction:

- is matched after the Intended Settlement Date ("Late Matching Fail Penalty"); and
- is matched but fails to settle on the Intended Settlement Date due to either a lack of securities or cash ("Settlement Fail Penalty").

A Late Matching Fail Penalty is charged to the EU CSD participant which last entered or modified the relevant settlement instructions in the securities settlement system between the Intended Settlement Date and the matching date (so, if both participants send settlement instructions after the Intended Settlement Date, only one of those participants will be subject to the Late Matching Fail Penalty).

A Settlement Fail Penalty applies from the Intended Settlement Date or the matching date (where matching takes place after the Intended Settlement Date and no settlement occurred on the matching date), to the actual settlement date or the date upon which the instruction is agreed to be cancelled, and is charged to the party causing the settlement fail. However, both counterparties to the transaction could be subject to a Settlement Fail Penalty if both legs of a transaction are "on hold".

The explicit purpose of this penalty measure is to serve as a deterrent for participants which cause settlement fails.

The penalties are calculated for each business day that the in-scope transaction fails to settle by applying the relevant penalty rate to the market value of the security/financial instrument, as follows:

- between 0.5 basis points and 1 basis point depending on the type of security/financial instrument involved and whether, in the case of shares, such shares are liquid or illiquid; and
- for settlement fails due to a lack of cash, by reference to an official interest rate for overnight credit (floored at zero)[10].

The cash penalty mechanism will not apply: (i) where insolvency proceedings are opened against the failing party; and (ii) in certain other limited situations where settlement cannot be performed for reasons that are independent from the involved participants[11] (such as where the security's ISIN is suspended from trading or the occurrence of a cyber-attack at the EU CSD). Certain types of instructions, such as redemptions and corporate actions, are not expected to be subject to the cash penalty measures.

Impact on the buy-side

Cash penalties are applied at the level of the EU CSD participant, meaning that buy-side firms are not directly subject to such penalties. However, it is expected that EU CSD participants will pass on or at least retain the contractual discretion to pass on these penalties to their clients. As such, amendments may be required to relevant contractual arrangements with clients to reflect that approach. Any documentation changes will need to be carefully considered to ensure that the penalties are being passed up the settlement chain to the buy-side firm only where such firm causes the settlement fail and that the buy-side firm may also 'collect' (or get the benefit of) any cash penalties where it is the non-failing party.

In respect of cash products (usually governed by a dealer's terms of business), some dealers are circulating amendments whereby any penalty debits and penalty credits will initially be for the dealer's account although they retain the right to recover such penalties from or make a payment in respect of a penalty credit to the client. Applicable prime brokerage/custody/depositary agreements may already contain indemnity (or similar) provisions to allow the EU CSD participant to recover such costs from the client, in which case one may expect less engagement with clients under these arrangements. We are aware that several prime brokers have taken an approach not to pass penalty debits or credits on to their clients (although no changes to contractual terms will be made to reflect this), however they may choose to do so if their increased costs warrant such an approach. Other trading agreements such as repurchase or securities lending agreements (and possibly ISDA Master Agreements, to cater for physical settlement and/or delivery of non-cash collateral) may also need to be amended. Finally, buy-side firms should consider the level of reporting and transparency they wish to receive from their counterparties in respect of cash penalties, and will also want to ensure that their counterparties will assist them in any appeals process in respect of penalties passed on to them. Buy-side firms may wish to consider the "CSDR Settlement Discipline Penalties Market Practice for Bilateral Claims" guidelines issued by the Association for Financial Markets in Europe[12] which set out recommendations applying to bilateral claims between trading counterparties where it may be necessary to reimburse a cash penalty.

Investment managers should also consider both:

- necessary documentation amendments for allocation of responsibility as between the investment manager and its underlying funds/managed accounts; and
- a policy for the proper allocation of cash penalties between its underlying funds.

[1] See the Press Statement of 25 November 2021 headed "*Digital Finance: Commission welcomes political agreement on the Distributed Ledger Technology pilot regime*" (available at: https://ec.europa.eu/commission/presscorner/detail/en/mex_21_6293) and the ESMA Public Statement of 17 December 2021 (available at: https://www.esma.europa.eu/sites/default/files/library/esma70-156-5153_public_statement_on_buy-in.pdf).

[2] Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 (available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0909&from=EN).

[3] The substantive terms of which are contained in Articles 6, 7 and 8 of CSDR and in Commission Delegated Regulation (EU) 2018/1229 of 25 May 2018 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on settlement discipline, as amended (available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018R1229&from=EN).

[4] Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 (available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0909&from=EN).

[5] Commission Delegated Regulation (EU) 2018/1229 of 25 May 2018 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on settlement discipline, as amended (available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018R1229&from=EN).

[6] This is the date that is entered into the securities settlement system as the settlement date and on which the parties to a securities transaction agree that settlement is to take place: for transferable securities executed on trading venues this must be no later than the second business day after trading takes place, subject to certain exceptions (such as where the transaction is privately negotiated but executed on a trading venue).

[7] The written allocations and confirmations rules differ depending on whether it is a professional client or retail client executing the transaction. This *Briefs for the Buy-side* only considers the regime applicable to professional clients.

[8] See Article 2(1) of the Settlement Discipline Delegated Regulation.

[9] See Article 2(2) of the Settlement Discipline Delegated Regulation.

[10] The penalty rates applicable to settlement fails are contained in the Annex to Commission Delegated Regulation (EU) 2017/389 of 11 November 2016 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council as regards the parameters for the calculation of cash penalties for settlement fails and the operations of CSDs in host Member States (available at: https://eur-

lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0389).

[11] See “Settlement Discipline Answers 4” of the *ESMA Questions and Answers Implementation of the Regulation (EU) No 909/2014 in improving securities settlement in the EU and on central securities depositories* (dated 17 December 2021); available at: https://www.esma.europa.eu/sites/default/files/library/esma70-708036281-2_csdr_qas_1.pdf).

[12] Available at https://www.afme.eu/Portals/0/CSDR%20Settlement%20Discipline%20-%20Bilateral%20Penalty%20Claims%20August%202021.pdf?ver=2021-09-02-091345-440