

The Settlement Discipline Regime of CSDR

LCH The Markets' Partner

EquityClear



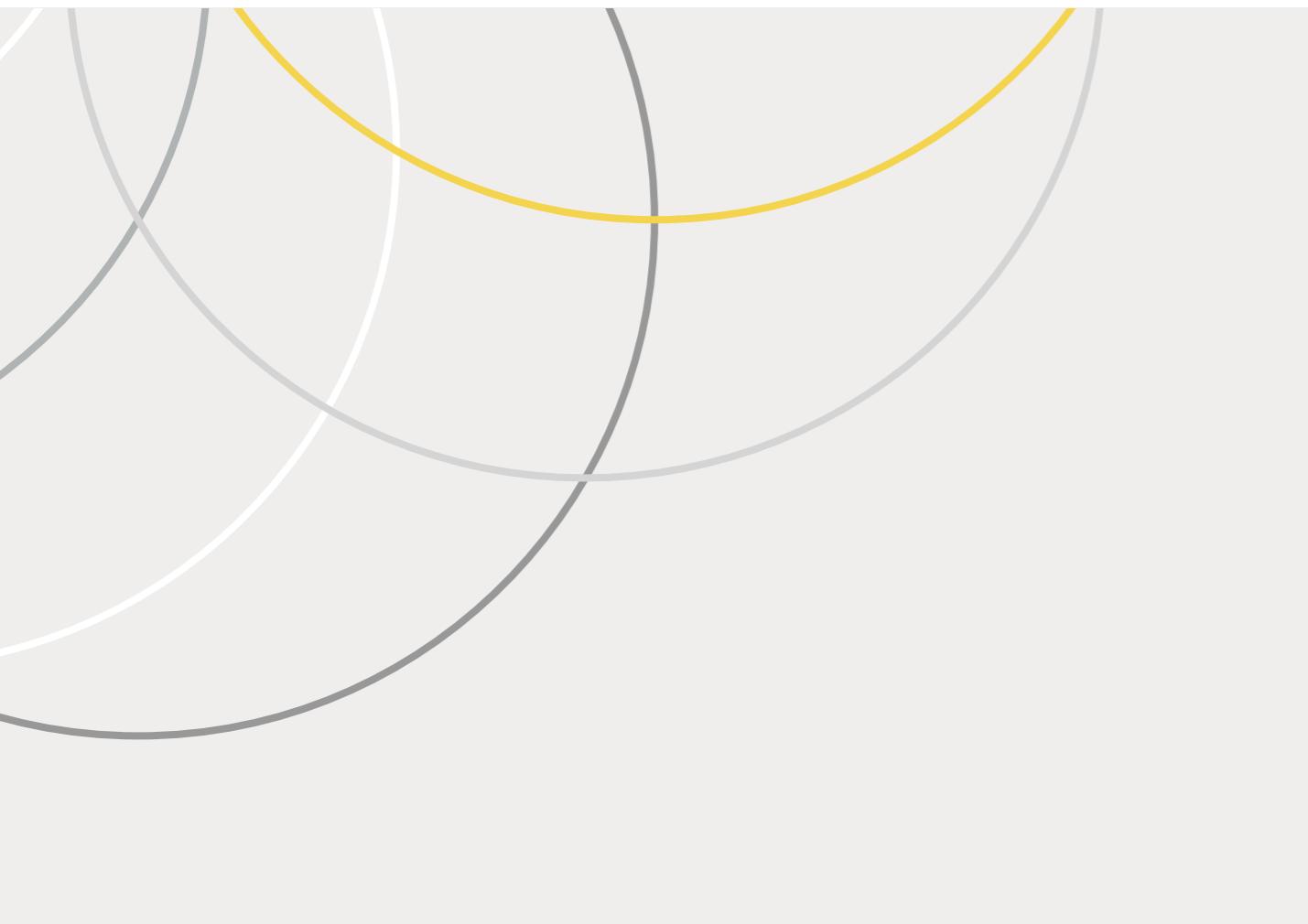


TABLE OF CONTENTS

- Foreword 4
- 01. Introduction 5
- 02. The Financial Penalty Regime 7
- 03. The Mandatory Buy-in Regime 9
- 04. Unintended Consequences 11
- 05. Knowledge and Preparedness 12
- 06. Conclusion 14

Implementing the mandatory changes will require significant investment in people; operational change and IT systems, and the regulators foresee they will lead to behavioural change.

Foreword

The settlement discipline regime under the Central Securities Depositories Regulation (CSDR) will introduce far-reaching changes to the way in which European securities transactions settle.

The Regulation recognises that the **safety of settlement** is ensured through settlement of obligations on their intended settlement date. It seeks to achieve the benefit of improved safety by **addressing fails** through compulsory enforcement of the original agreement. Settlement efficiency should improve through market participants making the effort to improve **timely matching** of settlement instructions and avoid the mandatory enforcement measures of **penalties and buy-ins** on fails. Implementing the mandatory changes will require significant investment in people; operational change and IT systems, and the regulators foresee they will lead to behavioural change. The costs will be borne broadly without an obvious net value benefit from increased trading. In the longer term, as processes become established and settlement efficiency improves, costs should reduce.

The regulation recognises that the new measures should be "scaled in such a way that maintains and protects liquidity", particularly for market-making in less liquid securities. However, strong indications from the market are that the balance may not be correct, and market-makers and dealers may be compelled to reduce coverage and widen spreads.

When researching this paper, we have learned that knowledge of CSDR, and preparedness for its challenges, varies widely.

At the time of commissioning this paper in early Q3 2019, the CSDR settlement discipline regime was due to come into effect on 13 September 2020.

Asset managers, banks and securities firms based outside Europe, but active in European securities markets, are particularly at risk of being taken by surprise by the settlement discipline regime. At the time of commissioning this paper in early Q3 2019, the CSDR settlement discipline regime was due to come into effect on 13 September 2020. So it was with a sense of urgency, as well as concern, that we invited Dominic Hobson and Piers Cardew of Hobson Cardew Consultancy to discuss the settlement discipline regime with all parts of the European securities industry. As the research progressed it became clear that a short delay to early 2021 was likely and this has now been formalised as 1 February 2021. However, due to Covid-19, a proposal has been made by the European Securities and Markets Authority (ESMA) to further delay the date to 1 February 2022. This paper provides a description of the settlement discipline regime, including certain unresolved issues, which will help even the least prepared get ready. While lobbying by industry bodies has sought to resolve the difficult issues raised in this paper, progress still needs to be made in most of these areas. ESMA has recently requested input from industry bodies as to CSDR, which may result in legislative changes to make the objectives of the CSDR settlement discipline regime more achievable in practice.

The settlement discipline regime will leave no part of the European securities markets untouched. This affects us all, and we must work together to solve the challenges it sets. This paper is our initial contribution to that process of constructive collaboration. It highlights the main topics, issues and challenges of the CSDR settlement discipline regime. But behind the highlights published here lies a lot of detail. Therefore, we are publishing simultaneously on our website further discussion and analysis.

We hope this paper will be of interest. We continue to follow the development of the settlement discipline regime closely and will be sure to continue to collaborate with our market partners.

Alex Krunic
Head of Equities, LCH Limited

01. Introduction

The settlement discipline regime of the Central Securities Depositories Regulation (CSDR) aims to reduce the number of securities transactions that fail to settle on the intended settlement date, and reduce the duration of such settlement failures. It marks an intensification of an approach first introduced by the Short Selling Regulation of 2012¹ that obliges central counterparties (CCPs) that clear share trades in Europe to apply financial penalties on fails and initiate buy-ins in cases of extended fails.

It was officially scheduled to come into effect on 13 September 2020, but this has now been formally moved to 1 February 2021² and ESMA has proposed a further delay to 1 February 2022³.

The settlement discipline regime intends to incentivise more timely settlement by the imposition of daily financial penalties for failed settlements, to be paid by failing participants to receiving participants, via the relevant CSD.

If a transaction has still failed to settle at the end of a prescribed extension period, a mandatory buy-in process is initiated by the receiving trading party. The failing counterparty is required to meet all the costs of the buy-in.

The sums involved are difficult to estimate with confidence at this stage. But the transfers of value occasioned by cumulative financial penalties and especially buy-ins may be substantial, even if CSDR improves settlement behaviour overall. It follows that all securities market participants are encouraged to invest in the people and systems necessary to minimise the costs and risks and improve the post-trade efficiency of markets.

¹See Recital 23 and Article 15 of the Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps, Official Journal of the European Union, L86/4.

²See Commission Delegated Regulation (EU) 2020/1212 of 8 May 2020 amending Delegated Regulation (EU) 2018/1229 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on settlement discipline.

³See the ESMA Final Report called "CSDR RTS on Settlement Discipline – Postponement until 1 February 2022", which is located here – www.esma.europa.eu/sites/default/files/library/esma70-156-3490_final_report_-csdr_rts_on_settlement_discipline_-postponement_until_1_february_2022.pdf.

02. The Financial Penalty Regime

WHAT YOU NEED TO KNOW

01. ESMA has proposed a delay to the settlement discipline regime from 1 February 2021 to 1 February 2022.
02. Participants responsible for settlement fails will pay penalties to receiving participants, via the relevant CSD.
03. Trading parties that fail to deliver securities will pay the costs of buying in securities.
04. CSDs will report to regulators on the settlement performance of their participants.
05. Persistently poor settlement performance may lead to suspension of a participant by the CSD.
06. Internalised settlements must be reported to regulators once a quarter.
07. Many detailed issues remain to be resolved.
08. Investment in new people and systems to comply should remain a priority.

WHAT CENTRAL SECURITIES DEPOSITORYES (CSDs) ESTABLISHED IN THE EUROPEAN ECONOMIC AREA ARE DOING

01. Developing, through European Central Securities Depositories Association (ECSDA), a solid framework to fulfil their role in the financial penalties regime.
02. Working out how to monitor settlement instructions and calculate, collect, pay and report financial penalties.
03. Clarifying the reference prices necessary to calculate the ad valorem charges on the value of undelivered securities.
04. Establishing systems and processes to adhere to the ECSDA CSDR penalties framework.
05. Modelling how to charge for the cost of operating the financial penalties mechanism.
06. Considering how to standardise inter-CSD interactions.

If a transaction has still failed to settle at the end of a prescribed extension period, a mandatory buy-in process is initiated by the receiving trading party.

The value of the financial penalties that may be levied is hard to predict, but on the basis of unchanged behaviour, these penalties could be substantial.

The settlement discipline regime imposes financial penalties on participants that fail. This is accomplished by applying an ad valorem charge to the value of the undelivered securities that varies with the liquidity and type of instrument from one basis point to a tenth of a basis point. Daily penalties will be applied each day that the transaction fails to settle, up to the point at which a mandatory buy-in process is completed. Cash compensation is paid if the securities needed for the buy-in prove to be unobtainable.

The administration of the financial penalties, in terms of their calculation, collection and payment, is the responsibility of the affected CSDs. The European Central Securities Depositories Association (ECSDA) has devised a common administration methodology that all CSDs are expected to adopt, which is described in their "ECSDA CSDR Penalties Framework". This includes a process for contesting penalties.

The value of the financial penalties that may be levied is hard to predict, but on the basis of unchanged behaviour, these penalties could be substantial. The volume of settlement fails liable to penalties will also test existing operational processes and systems, necessitating investment in people and automating processes. Securities market participants are trying to identify which counterparts and instrument types and locations are likely to cause the most settlement fails.

Redesigning workflows and investing in automation are difficult tasks while uncertainties persist over which ad valorem charge particular securities will attract; whether CSDs are always responsible for the calculation, collection and payment of penalties, or whether CCPs will sometimes be involved; the consequences of the exemption of internalised settlements; and the operational difficulty and limited appetite for accommodating partial deliveries of securities.

WHAT YOU NEED TO KNOW

01. Participants that cause settlement fails will pay daily financial penalties in cash until settlement or a mandatory buy-in process is complete.
02. Participants failing to deliver securities will pay an ad valorem penalty on the value of the undelivered securities.
03. The ad valorem charge varies by the type and liquidity of the securities from 0.1 to 1 basis point daily.
04. Participants failing to deliver cash will pay a rate of interest on the undelivered cash.
05. The financial penalties will be calculated, collected, paid and reported by CSDs once a month.
06. CSDs are agreeing through ECSDA a single methodology for calculating, collecting and paying financial penalties, but CSD procedures may still vary.
07. Participants have time to appeal penalty calculations to their CSD before collection.
08. SWIFT is adapting standard message types to the needs of the financial penalties regime
09. The value of settlement fails could be substantial.

WHAT GLOBAL CUSTODIAN BANKS ARE DOING

01. Reviewing the settlement fail rates of brokers, asset managers and custodian banks used by their clients.
02. Investing in people and systems to anticipate fails earlier, increase operational efficiency, manage the different workflows and increased number of client queries, and implement the regulatory reporting required under CSDR.
03. Investing in systems and processes to improve the matching of settlement instructions and move inventory faster.
04. Where operations of asset managers are insourced, working with them to develop processes to pay and receive the proceeds of financial penalties calculated by CSDs.
05. Discussing with sub-custodians operating accounts at CSDs how to reconcile financial penalties with their own records.
06. Working out how to reconcile financial penalties debits and credits with asset management clients.
07. Considering whether to absorb the costs of penalties on behalf of asset owners and pay the proceeds of penalties to asset owners.
08. Investigating whether they need to play a role in notifying asset managers that are being bought in or need to appoint a buy-in agent.

03. The Mandatory Buy-in Regime

The settlement discipline regime mandates that a buy-in process be initiated on the business day following a defined extension period of a fail beyond its intended settlement date. The extension period is four business days for liquid shares, 15 days for securities trading SME growth markets, and seven business days in the case of all other securities.

There is an exception for transactions of illiquid shares cleared by CCPs, which remain at four business days.

- A. The receiving trading party, or CCP, will appoint a buy-in agent to buy the undelivered securities. Buy-in costs are reimbursed by the failing trading party.
- B. If the securities cannot be bought in, the failing party is obliged to pay cash compensation.
- C. The buy-in regime permits an additional deferral period to allow more time for the securities to be sourced.

Buy-ins were first made mandatory by the Short Selling Regulation of 2012, but the measure applied to CCP-cleared share transactions only. Until the passage of that legislation, buy-ins have tended to be voluntary in Europe and are at present rarely invoked outside of the mandatory regime.

An analysis by ECSDA using 2014 data from 11 European CSDs estimates 1.8 million buy-ins a year, worth more than €2.5 trillion.²

As a result, the number of mandatory buy-ins is expected to increase significantly after the implementation of the CSDR settlement discipline regime. An analysis by ECSDA using 2014 data from 11 European CSDs estimates 1.8 million buy-ins a year, worth more than €2.5 trillion.² While the actual outcome is unlikely to be as high as this, since market participants will adjust their behaviour, as is the intent of the settlement discipline regime, a significant increase from present levels of buy-ins is almost certain.

This will test the ability of largely manual processes to cope with the increased volume. By discouraging short selling, mandatory buy-ins might also reduce the appetite of market-makers to make two-way prices in illiquid securities, such as corporate and high-yield bonds. Importantly, short-dated (less than 30 days) securities financing transactions, such as repos, are excluded from buy-ins.

Details of the buy-in regime still to be settled include whether failing parties are permitted to receive the benefit if the price of buying in the shares is lower than the price of the shares in the original transaction; the need to avoid multiple buy-ins in "chains" of settlement fails through "pass-ons" and cash payments that penalise the failing party at the start of the chain only; and a potential lack of buy-in agents.

²ECSDA Comments on the upcoming CSDR technical standards and technical advice on settlement discipline, 19 February 2015.

04. Unintended Consequences

WHAT YOU NEED TO KNOW

01. The receiving party appoints the buy-in agent, which must achieve "best execution" for the failing party in buying in the undelivered securities.
02. The buy-in agent has four to seven business days in which to complete the buy-in and deliver the securities to the receiving party, with the deadline varying by the type and liquidity of the security.
03. Receiving parties can defer the buy-in for a prescribed period so as to allow more time to source the undelivered securities.
04. If the buy-in agent ultimately fails to buy some or all of the securities, the failing party pays cash compensation based on market values to the receiving party instead.
05. The deadline for triggering a buy-in ranges from four business days to 15 days depending on the liquidity and type of the security, the place of trade, and whether the transaction is cleared by a CCP.
06. Definitions of liquid and illiquid shares are yet to be finalised.
07. The mandatory buy-in regime limits the time period in which parties may utilize existing contractual remedies for handling settlement failures ahead of the mandatory buy-in being imposed.
08. Because they are mandatory, the number of buy-ins is likely to increase significantly.
09. Once a buy-in process starts, the original failed settlement instruction is put on hold and the original seller becomes just another potential source of the securities to complete the buy-in.
10. Failing parties are not permitted to receive the benefit if the price of buying in the shares is lower than the price of the shares in the original transaction.
11. A chain of settlement fails with a single root cause could trigger an unnecessary chain of multiple buy-ins; an agreed "pass on" mechanism is required to avoid these chains and the disruptive impacts they would cause.
12. Transactions (such as repos) for which the intended settlement date (ISD) of the return leg is within 30 days after the ISD of the first leg (exempt transactions) are exempt from the buy-in regime.
13. CCPs which fail to deliver securities to clearing members are exempt from the buy-in regime.
14. There is a potential shortage of buy-in agents.

WHAT CCPs ARE DOING

01. Clarifying whether CCPs will play any part in collecting and paying financial penalties where the CCP is a failing or receiving participant.
02. Ensuring their clearing members know that a CCP cannot be bought in.

The settlement discipline regime, like any regulation, is likely to have unintended consequences. These include a possible imbalance between the costs of compliance and the benefits of reduced settlement fails. The costs include investment in technology, staff and legal advice; potential adverse effects on liquidity and transaction costs in less liquid instruments, such as small- to mid-cap equities, exchange traded funds (ETFs), and corporate, high-yield and emerging market bonds, as market-makers and dealers reduce coverage and widen spreads; the risk of shrinkage in the willingness to lend securities; and hypothetical incentives for some trading and settlement activities to move outside the EU.

WHAT YOU NEED TO KNOW

01. The systems, staffing, legal and operational costs of compliance with the settlement discipline regime may outweigh the benefits of reduced settlement fails.
02. The additional costs may ultimately be borne by asset owners.
03. Liquidity in small- and mid-cap equity markets might fall as market-makers reduce the number of shares they cover and widen bid-offer spreads on those they do cover.
04. Liquidity in corporate and high-yield bonds might fall as bond dealers reduce the number of bonds they cover and widen bid-offer spreads on those they do cover.
05. Securities lending and financing transactions without a fixed maturity date may not be exempt from the settlement discipline regime in the same way as repo transactions of less than 30 days in duration are.
06. Asset owners and their agent lenders may be less willing to lend securities, raising the cost of borrowing stock to cover short sales and settlements.
07. The risks of short-selling are increased by lack of supply of securities available to borrow, greater recall risk and an increased possibility of being bought in.
08. On the other hand, the risk of being bought in might increase demand to borrow securities to avoid settlement fails.
09. Some trading and settlement activities might move outside the EU.

WHAT ASSET MANAGERS ARE DOING

01. Reviewing the settlement fail rates of their brokers and custodian banks.
02. Where operations are outsourced to a global custodian bank, discussing with them how to pay and receive the proceeds of financial penalties calculated by CSDs.
03. Working out how to allocate financial penalties debits and credits fairly across different funds and asset owner clients.
04. Considering whether to absorb the costs of penalties on behalf of asset owners and pay the proceeds of penalties to asset owners.
05. Considering whether mandatory buy-ins will increase the risk of short-selling.
06. Investigating which brokers and other entities are willing to act as buy-in agents.
07. Investing in systems and people to adapt operational processes and workflow to the demands of the settlement discipline regime.
08. Reviewing and determining buy-in policy.
09. Working with investment teams on overall impact around liquidity and costs to clients.

05. Knowledge and Preparedness

The absorption of regulated firms in achieving compliance with other measures, such as the second version of the Markets in Financial Instruments Directive (MiFiD II), means preparations for the settlement discipline regime are running close to the required compliance dates. However, research undertaken on behalf of LCH indicates firms in Europe are better prepared than firms in North America, which are in turn better prepared than their counterparts in Asia; and CSDs, CCPs, broker-dealers and custodian banks are better prepared than asset managers.

Though CCPs will have to manage more buy-ins of fails-to-receive, they are well versed in undertaking buy-ins. CCPs are also discussing harmonisation of their operating procedures and timetables so that clearing members are not disadvantaged by different settlement cut-off times.

CCPs are also seeking further clarity from regulators on whether they must take responsibility for collecting and paying financial penalties to clearing members.

Trading desks at some major broker-dealers may be underestimating the impact of the settlement discipline regime. However, many are identifying counterparts, markets and instruments that are likely to be problematic under the regime, and this may narrow the range of counterparts and instruments they cover or lead to a change in their terms of business.

Dealers and market-makers in corporate bonds, high-yield bonds, emerging market bonds, small- and mid-cap equities, and ETFs, with whom we have spoken, consider that the settlement discipline regime is likely to lead them to cut the numbers of securities they cover and widen the bid-offer spreads in certain securities for which they continue to provide bid-offer prices.

Custodian banks (like broker-dealers), with whom we have spoken, are reviewing counterparts and instruments to identify major sources of settlement fails.

Custodian banks (like broker-dealers), with whom we have spoken, are reviewing counterparts and instruments to identify major sources of settlement fails. They are also expecting to help asset managers comply with the regime, chiefly by acting as information conduits, though the roles and the design of the information flows have yet to be finalised. One complication is that the asset managers are rarely the client of the custodian banks, whose customers are asset owners. Asset owners are expected to be net beneficiaries of the financial penalties regime.

WHAT YOU NEED TO KNOW

01. The settlement discipline regime affects all parties in the European securities markets, including those based outside the European Economic Area (EEA) to which CSDR applies.
02. To protect revenues and minimise costs, all such parties need to understand the impact of the settlement discipline on their existing business.
03. Research indicates (a) European market participants are better prepared than North American participants, which are in turn better prepared than Asian market participants, and (b) the buy-side is less prepared for the settlement discipline regime than the sell-side.

WHAT BROKERS AND MARKET-MAKERS ARE DOING

01. Investing in systems and people to adapt operational processes to the demands of the settlement discipline regime.
02. Reviewing the settlement fail rates of broker and custodian bank counterparties, with a view to potentially reducing the counterparties they work with.
03. Reviewing exposures to less liquid securities, such as corporate bonds, small- to mid-cap equities, and ETFs.
04. Considering whether to reduce the range of securities in which they offer two-way prices.
05. Investigating whether to widen the bid-offer spreads on the securities for which they will continue to offer prices.
06. Pressing regulators to alleviate the adverse effects they believe the settlement discipline regime will exert on less liquid securities markets.

06. Conclusion

The settlement discipline regime of CSDR remains imminent, even allowing for the proposed delay to 1 February 2022. The scale of its impact on the European securities industry, in terms of the infrastructural costs of achieving compliance and buy-ins, is unclear but is potentially significant for some firms. Therefore, it behoves all firms to understand how the financial penalties and buy-ins will work; collaborate with counterparts, CCPs and CSDs to clarify and refine the settlement discipline regime where necessary; and then invest in the systems and people to comply with its requirements. Acting now will not only help firms avoid unnecessary costs in the future. It will also position firms to capture the cost-saving and risk-reducing benefits of more efficient settlement.

For a more in-depth version of this report, please contact Alex Krunic.



Alex Krunic
Head of Equities, LCH Limited
Alex.Krunic@lch.com
T: + 44 (0) 20 7392 8345

DISCLAIMER

This document has been provided to you for informational purposes only and is intended as an overview of certain aspects of Regulation (EU) No. 909/2014 of the European Parliament and of the Council of 23 July 2014 (CSDR) and certain of the regulatory technical standards adopted under CSDR.

Dreamflo Limited (Hobson Cardew Consultancy) and LCH Limited (LCH) have prepared this document using (inter alia) information received from various financial institutions, market participants, industry bodies and market infrastructure institutions. LCH is regulated as a "recognised central counterparty", authorised under Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 and supervised by the Bank of England within the UK regulatory framework, and is a "derivatives clearing organization" registered with the U.S. Commodity Futures Trading Commission. Hobson Cardew Consultancy is an independent research, consulting and copywriting agency registered in England and Wales (registered number 06652343).

This document does not, and does not seek to, constitute advice of any nature, and it has not been prepared for any specific person. You may not rely upon the contents of this document under any circumstance and should seek your own independent legal, investment, tax and other advice. The information and any opinion contained in this document does not constitute a recommendation or offer with respect to any course of action, service, financial instrument or derivative. Neither Hobson Cardew Consultancy nor LCH make any representation, warranty, condition or guarantee (whether express or implied) that the content of this document is accurate, complete or up-to-date, and neither entity makes any commitment to offer a particular product or service. Hobson Cardew Consultancy and LCH shall have no liability for any losses, claims, demands, actions, proceedings, damages, costs or expenses arising out of, or in any way connected with, the information contained in this document, except that each of Hobson Cardew Consultancy and LCH accept liability that cannot be excluded by applicable law.

Copyright © LCH Limited 2020. All rights reserved.

Ich.com