ECSDA
European Central Securities Depositories Association

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ECSDA Comments on the upcoming CSDR technical standards and technical advice on settlement discipline

This paper constitutes the first part of ECSDA's response to the ESMA consultations of 18 December 2014 on technical standards (covering questions 1 to 14, as well as question 32) and technical advice (questions 1 to 4) under the CSD Regulation. The full consultation response was submitted to ESMA on 19 February 2015 using the mandatory reply form. This version of the document includes an executive summary and is intended for public circulation.

Amendment proposals included in this paper are presented in italics, with suggestions for additional wording in ***bold italics,*** and suggestions for deletions marked by ~~***a strikethrough***~~*.*

Executive Summary

The draft Level 2 measures issued by ESMA for consultation in December 2014 in the context of the CSD Regulation (CSDR) would create a settlement discipline framework which has the potential to substantially affect the way securities transactions are cleared and settled today.

Despite generally high settlement efficiency rates across EU CSDs, the volume and value of instructions at stake means that the impact of ESMA's draft standards is likely to be substantial. Using November 2014 data obtained from 11 EU CSDs, ECSDA estimates that over 150,000 buy-ins would have been initiated that month had the standards been in place, for a total value of around EUR 214 billion. In other words, each business day, more than 7,500 buy-ins would have been triggered for a value of EUR 10.7 billion on average. Assuming that November 2014 figures are broadly representative of a typical month, the total number of buy-ins initiated each year could thus reach over 1.8 million, representing a total value of more than EUR 2.5 trillion.

As for late settlement penalties, a similar exercise based on data from 17 CSDs showed that the accumulated gross late settlement penalties to be collected over the month of November 2014 would have totalled around EUR 183 million or EUR 9 million per business day. Assuming again that the month of November is representative, this translates into yearly gross late settlement penalties of close to EUR 2.2 billion.

Looking more specifically at the implementation costs for CSDs, and based on estimates collected from 19 ECSDA members, we anticipate that CSDs' development costs to comply with the proposed settlement discipline rules will amount to over EUR 67 million, or EUR 3.5 million per CSD on average. The costs incurred by CSD participants and other impacted infrastructures such as CCPs would have to be added to this number to assess total implementation costs for the industry.

All these figures are rough estimates and must be used with caution. However, they have the merit of showing that the settlement discipline standards being elaborated by ESMA will require considerable adaptations from CSDs and market participants, and that their impact on the efficiency and stability of post trade processes should not be underestimated.

Although ECSDA welcomes many helpful proposals in the ESMA Consultation Paper, CSDs are concerned that the following issues have not yet been properly addressed:

- **First, the absence of an impact assessment as part of the ESMA Consultation poses serious questions as to whether the market impact of the proposed measures has been properly assessed.** ECSDA members have spent considerable time and resources in the second half of 2014 to provide ESMA (and the consultancy firm mandated by it to work on a cost-benefit analysis) with details on existing procedures and processes across the EU. We would have highly appreciated being given the opportunity to cross-check and comment on ESMA's draft impact assessment as part of the consultation, and we understand that this will not be possible, since the impact assessment accompanying the Level 2 standards will not be shared with the market prior to being submitted to the European Commission in June 2015. ECSDA thinks that the impact assessment is especially important for assessing the market-wide impact of the proposed settlement discipline framework, which is likely to be substantial, as suggested by the figures collected by ECSDA and other associations. In addition to the market wide impact, implementation costs of CSDs, their participants and other market infrastructures are likely to be significant and warrant a proper assessment before finalising the standards.

- **Second, ECSDA is particularly concerned about ESMA's proposal to give CSDs an unprecedented central role in relation to buy-ins.** Although CSDs, unlike CCPs, are not required to execute buy-ins, ESMA expects them to perform new tasks which are not entrusted to them today, such as collecting detailed information on buy-ins, appointing a buy-in agent, or performing "consistency tests" on the instructions they receive in order to prevent multiple buy-ins. CSDs fear that some of these tasks might not be practically possible for them to perform, and they are also worried that these new responsibilities will unavoidably have an impact on their liability, increasing their risk profile. ECSDA thus strongly believes that an alternative approach is required, whereby buy-ins will be handled at trading level, in line with today's accepted market practice, rather than at the settlement level.

- **Third, ECSDA remains convinced that Level 2 legislation should not mandate specific technical functionalities of CSD systems.** The draft ESMA technical standards are in some instances too prescriptive, without that this be necessary to achieve the objectives of the CSDR. This is for instance the case for standards mandating the type of matching fields that should be compulsory in settlement instruments, the technical functionalities that CSDs should have in place to prevent settlement fails (e.g. partial settlement, hold/release mechanism), the number and duration of settlement batches CSDs should have at a minimum, or the technical solutions used to inform CSD participants of pending settlement instructions. In many such instances, ECSDA believes that a high level of settlement efficiency can better be achieved by allowing each CSD to decide on the most appropriate tools and technical solutions, based on the specific characteristics of the market in which it operates.

  As regards certain matching fields and in particular the identification of transaction types, ECSDA fears that ESMA underestimates the importance of harmonising market practices prior to imposing the use of certain codes. Imposing mandatory matching fields by law might not only create obstacles to future adaptations, it is also unlikely to bring substantial benefits in terms of improving settlement efficiency. On the contrary, imposing mandatory matching fields without having ensured that all market participants have first agreed and implemented a harmonised market practice as to how these fields should be populated could increase the number of settlement fails and create systemic risk.

- **Fourth, ESMA should not mandate the use of codes which are not compatible with global standards.** Some of the codes currently being proposed by ESMA in relation to CSD records and the identification of certain transactions and instruments for the purpose of the settlement discipline regime are not aligned with internationally recognised ISO standards. Given that CSDs and their participants operate in global markets, and given the CSDR requirement for CSDs to use open and international communication standards, ECSDA strongly believes that, when harmonised standards are required in Level 2 legislation, these should be compatible with international standards.

- **Fifth, as regards penalties for late settlement, ECSDA generally supports the ESMA approach of designing a simple and proportionate system for calculating penalty rates and determining the instructions in scope. Nonetheless, many issues still require a practical solution for the system to be workable:**
  - A central database of financial instruments allowing CSDs to determine which instruments are "in scope" and which are "out of scope" of penalties and buy-ins needs to be developed by ESMA;
  - Clear rules are needed as regards reference prices to be used by CSDs to calculate penalties. In particular, ESMA needs to clarify whether a single harmonised source for reference prices is indispensable to ensure a consistent application of penalties across the EU;

- The categories of instruments used for the purpose of settlement discipline (e.g. categories subject to different penalty rates) must be consistent with those categories used by CSDs for the reporting of settlement fails to regulators, which is not currently the case.

- **Finally, ECSDA strongly supports ESMA's proposal to phase in the implementation of the settlement discipline rules under the CSDR, but calls upon ESMA to delay implementation of the rules by 24 months at a minimum.** Given the huge scope of the project to implement the required changes, a shorter transition could still pose a major risk, in particular as regards the parallel implementation of TARGET2-Securities by several EU CSDs.

1. Responses to the ESMA consultation questions (technical standards)

Q1: Do you think the proposed timeframes for allocations and confirmations under Article 2 of the RTS on Settlement Discipline are adequate?
If not, what would be feasible timeframes in your opinion?
Please provide details and arguments in case you envisage any technical difficulties in complying with the proposed timeframes.

This question refers to:
Section 2.1 of the Consultation paper (p.9-10)
Annex 1, Chap.2, art.2 (p.113-115): draft RTS

CSDs are not in the scope of art.2 of the draft RTS, which concerns measures to be taken by investment firms. However, we would like to point out that the fields required for the purpose of trade confirmations need to be consistent with the fields used in the further processing of the transaction (e.g. for the matching of instructions).

Q2: Do you agree with the cases when matching would not be necessary, as specified under Article 3(2) of the draft RTS?
Should other cases be included? Please provide details and evidence for any proposed case.

This question refers to:
Section 2.1 of the Consultation paper (p.11-12)
Annex 1, Chap. 2, art.3(2) (p.115-116): draft RTS

ECSDA supports ESMA's proposal that CSDs should offer mandatory matching on a continuous and automated basis, and we agree with ESMA's proposals in relation to matching tolerance levels which is in line with the ESSF-ECSDA matching standards.

We welcome the exemptions proposed by ESMA in art.3(2) of the draft RTS in relation to compulsory matching, but we believe that these exemptions should not be considered as "mandatory exemptions". In other words, ECSDA would like ESMA to confirm that matching can be allowed by the CSD on an optional basis in the cases mentioned under points (a) and (b), even if it is not mandatory.

Regarding exception (b), ECSDA believes that the wording proposed by ESMA does not cover all relevant scenarios, especially in direct holding markets and thus needs to be adjusted. As mentioned in our response of 22 May 2014 to the ESMA Discussion Paper, FoP instructions between accounts managed by the same participant should be excluded from the compulsory matching requirement since these are typically collateral movements, portfolio transfers or account allocation movements, especially in direct holding markets. We believe that the phrase *"accounts opened in the name of the same participant"* contained in art.3(2)(b) of the draft RTS is too narrow and should be replaced by *"accounts* *managed by the same participant"* in order to take into account the different ways in which beneficial owner accounts can be managed in CSDs.

In some CSDs, securities can be held in accounts belonging to end investors (clients of the CSD participant). The CSD participant responsible for managing these accounts can act as account operator (as mentioned under CSDR article 31) and/or it can act based on a Power of Attorney granted by the end investor. In the latter case, the securities accounts are not necessarily opened in the name of the CSD participant, but might be opened solely in the name of the end investor. This is currently not reflected in the draft RTS and must be addressed to avoid creating distortions in markets where this practice is established, well-recognised and even encouraged.

Concretely, when securities are transferred directly from the account of a client of Participant A (or from Participant A's account) to the account of a client of Participant B, mandatory matching can be enforced. However, the very same transfer of securities is sometimes executed in two steps: first, the securities are transferred from the account of Participant A to the account of Participant B in one transaction, and second, Participant B instructs a delivery between its account and the account of its customer, the end investor. In this latter scenario, the second transaction allocating securities from Participant B's account to the account of the customer of Participant B is only effected by one participant and between accounts opened in the name of different entities (one account is in the name of Participant B, the other account is in the name of the end investor, a client of Participant B). ECSDA is concerned that the wording proposed by ESMA in art.3(2)(b) of the draft RTS would not cover this scenario. Not exempting such account allocations from mandatory matching would create major practical problems since compulsory matching is practically not feasible (Participant B would have to match "with itself"). As a result, we strongly recommend that the exemption from compulsory matching for FoP instructions contained in art.3(2)(b) be extended to all FoP transfers between *accounts managed by the same participant,* irrespective of the name in which the securities accounts were opened..

Furthermore, the two exemptions set out in art.3(2) should not be considered exhaustive. Given the diversity of current market practices, more exemptions from mandatory matching will be necessary in a number of cases, including:

- in the context of corporate actions processing;
- for certain transfers effected as a result of complaints or corrections in the CSD's registry;
- when instructions are processed as a result of a Court order (e.g. insolvency proceedings).

In order to allow for the necessary flexibility in relation to mandatory matching and to avoid any market distortions, ECSDA suggests giving CSDs the possibility to define further exemptions in addition to the cases mentioned in (a) and (b), subject to the approval of the competent authority.

Moreover, ESMA's proposal that *"CSDs shall require that CCPs send already matched settlement instructions into the securities settlement system operated by a CSD"* is not always practically possible when multiple CCPs are involved. Indeed, two CSD participants might use a different CCP and, in such cases, matching can often not occur at the CCP level, but must occur at CSD level.

More generally, ECSDA is concerned that the current drafting of art.3(2)(a) might create some ambiguity as regards the matching location relevant for settlement purposes and might need to be rephrased. Indeed, point (a) introduces the notion of "*already matched*" instructions and, from a legal perspective, ECSDA wants to ensure that this does not in any way conflict with the fundamental principle that only matching performed at the CSD can be binding for settlement purposes. This is without prejudice to the possibility of CSDs to consider for their own purposes settlement instructions as "*already matched*" when all the required matching information for both legs of the transaction have been received from the relevant market infrastructures (CCPs or trading venues) which de facto have all the required information in their own systems and which send instructions to the CSD on behalf of their users. This operating model, favouring STP and settlement efficiency, should be supported. Finally, the use of the term "*already matched*" could also create confusion with the notion of "already matched" in T2S, which refers to settlement instructions that are pre-matched at CSD level, not at the level of the trading venue or the CCP.

ECSDA recommends the following amendments to art.3(2) of the draft RTS:

Article 3 - Details of the CSD procedures facilitating settlement and details of the measures to be established by CSDs to encourage and incentivise the timely settlement of transactions

[…] 2. A CSD shall match settlement instructions prior to settlement, based on the instructions sent by participants, except in the following circumstances:

(a) the settlement instructions received by the CSD are already matched by trading venues or other entities such as CCPs;

*(b) FoP instructions which consist of transfers of financial instruments between different accounts ~~**opened in the name of**~~ **managed by** the same participant~~.~~**;***

(c) any other circumstances deemed necessary by the CSD, provided these are approved by the competent authority.

~~CSDs shall require that CCPs send already matched settlement instructions into the securities settlement system operated by a CSD, unless letter b) of subparagraph 1 applies.~~

Q3: What are your views on the proposed approach under Article 3(11) of the draft RTS included in Chapter II of Annex I?
Do you think that the 0.5% settlement fails threshold (i.e. 99.5% settlement efficiency rate) is adequate? If not, what would be an adequate threshold? Please provide de-tails and arguments.
Do you think that the 2.5 billion EUR/year in terms of the value of settlement fails for a securities settlement system operated by a CSD is adequate? If not, what would be an adequate threshold? Please provide details and arguments.

This question refers to:
Section 2.1 of Consultation paper (p.15-16)
Annex 1, Chap.2, art.3(5)-(7) and (11) (p.117-118): draft RTS

ECSDA remains convinced that Level 2 legislation should not mandate specific technical functionalities of CSD systems and thus believes that the draft RTS proposed by ESMA are unnecessarily prescriptive. CSDs believe it should be up to each market to decide on the most effective and appropriate tools to prevent settlement fails, and that the objectives of the CSDR can be achieved without imposing a single technical design on all EU CSDs.

In this respect, ECSDA would like to remind ESMA of the conclusion of the European Commission Impact assessment[1] of 2012 on the proposal of a CSD Regulation, which recommended the adoption of common principles for settlement discipline while arguing against prescribing the use of certain standard processes for improving settlement efficiency, acknowledging in particular that *"prescribing a common way of organising settlement processes across the 30+ CSDs in Europe would be a very lengthy and likely impossible task"* and that *"any measures that were too prescriptive could become obsolete very quickly in the rapidly changing market environment"*.

ECSDA thus welcomes the additional flexibility introduced by ESMA through the thresholds in art.3(11) of the draft RTS. That said, in line with the T2S AG response to ESMA, ECSDA confirms that the recycling functionality could be removed from the exemption under art.3(11) since all CSDs can be expected to offer such a functionality.

More generally, we believe that a proportionate approach is indispensable given the substantial implementation costs that CSDs, including small and medium CSDs, would have to face in order to develop these functionalities (see our answer to question 4 for further details). These costs will ultimately have to be borne by CSD participants and will not always be justified by the potential market benefits.

Q4: What are your views on the proposed draft RTS included in Chapter II of Annex I?

This question refers to:
Section 2.1 of the Consultation paper (p.10-16)
Annex 1, Chap. 2 (p.115-118): draft RTS

Before commenting in detail on Chapter II of Annex I in the draft RTS, ECSDA would like to share the findings of an analysis carried out among its members in relation to CSD implementation costs. In order to substantiate our arguments with quantitative figures on individual ESMA proposals, we collected cost estimates from 19 CSDs (including the 2 ICSDs) during the consultation period. We refer to the outcome of this exercise throughout our response and, wherever relevant, we hope that ESMA can take these cost estimates into account for its impact assessment.

[1] See http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52012SC0022 (p.24-25)

As regards Chapter II requirements, i.e. measures to prevent settlement fails and fails reporting requirements, our analysis shows that, alongside the proposals on buy-ins, the proposed requirements on preventing and monitoring fails are expected to be the most substantial cost factor in relation to CSDR settlement discipline. CSDs estimate total implementation costs in relation to the proposals on preventing and reporting fails alone to amount to nearly EUR 24 million, or EUR 1.25 million per CSD on average. The high costs are partly due to the need for the ICSDs to implement the functionalities and reporting not just in relation to EU "domestic" transactions, but also to their international business. Once implemented, the system for preventing and monitoring fails will have to be operated. This is expected to cause further yearly operating costs of nearly EUR 5 million or over EUR 250,000 per CSD.

- **Manual interventions: art.3(1) of the draft RTS (p.115)**

As stressed in the ECSDA response of 22 May 2014 to the ESMA Discussion Paper, occasional manual interventions in CSD procedures are necessary and essential for the smooth processing and timely settlement of instructions, in particular where corrective actions are required, or in times of crisis.

In the absence of a definition of "manual intervention" in art.3 of the draft RTS and in order to avoid legal uncertainty we would like ESMA to clarify the following points in relation to the reporting of manual interventions by CSDs:

- The notion of "manual intervention" is limited to the processing of settlement instructions and thus to the settlement service only, as stated in the first sentence of art.3(1);
- "Manual intervention" refers to direct interventions by the CSD only and excludes, for instance, manual interventions by CSD participants e.g. via a user interface;
- CSDs will only be expected to report manual interventions which are not foreseen in the CSD's operating procedures. As a one-off exercise, we expect CSDs to initially provide their competent authority with a description of all the manual interventions listed in their operating manual, with the possibility for the competent authority to assess them based on their impact on the smooth functioning of the SSS;
- In addition, if deemed necessary, CSDs could report periodically (e.g. semi-annually or annually) aggregate figures on the manual interventions having taken place in line with the CSD's operating procedures.
- Finally, reporting *"without any delay"* seems excessive given the lack of urgency in such cases. It would be more appropriate to require CSDs to report manual interventions *"within a reasonable timeframe"* to their competent authority.

In order to reflect these points better in the text, ECSDA recommends the following amendments to art.3(1) of the draft RTS:

Article 3 - Details of the CSD procedures facilitating settlement and details of the measures to be established by CSDs to encourage and incentivise the timely settlement of transactions

1. A CSD shall process settlement instructions on an automated basis.
A CSD shall report any types of manual intervention ***by the CSD in relation to the settlement process*** *to the competent authority****, ~~without any delay~~ within a reasonable timeframe where such manual interventions are not foreseen in the CSD operating procedures****, covering at least: […]*

- **Standardised matching fields: art.3(3) of the draft RTS (p.116)**

ECSDA would like to reiterate its view that prescribing the use of standardised mandatory matching fields is not appropriate for binding Level 2 legislation and is not necessary to fulfil the Level 1 mandate granted to ESMA by the CSDR. Imposing mandatory matching fields by law will prevent flexible adaptations in the future and is unlikely to bring substantial benefits in terms of improving settlement efficiency. On the contrary, we believe that imposing mandatory matching fields by law could increase the number of settlement fails and create systemic risk. This is because the higher the number of mandatory matching fields, the more likely it becomes that two instructions do not match. Market practices take time to harmonise, and CSDs cannot guarantee that their participants will always "populate" mandatory matching fields in the correct way.

In order to avoid an adverse impact on settlement efficiency, which would clearly go against the very objective of the CSDR, ECSDA recommends an alternative approach whereby ESMA would define a list of harmonised matching fields, but would leave it up to each CSD to define which of these fields should be made mandatory for matching, and which fields remain optional matching fields.

Most importantly, field (d) on "transaction type" can only be made a mandatory matching field once there is an agreed harmonised market practice on how to populate such a field (i.e. what value to assign for the different types of transactions). Without such harmonised market practice, there is a high risk of an increase in the number of matching fails, and thus a negative impact on settlement efficiency.
Besides, field (d) as proposed by ESMA must be amended to comply with ISO standards (see our answer to question 23 of the Consultation Paper).

Furthermore, ESMA should be aware that field (c) on trade date is not currently used in most CSDs, especially for OTC transactions. ECSDA is not convinced that such a field is always necessary, and believes that imposing it as a mandatory matching field would significantly increase the cost and complexity of CSDR implementation. We thus recommend removing field (c) from art.3(3) of the draft RTS, knowing that CSDs can still make use of the field where this is appropriate.

In case ESMA decides to follow our suggestion and to turn the "transaction type" field into an optional field in order to avoid a negative impact on settlement efficiency, they should be aware that:

- The CSD will still have to compare the way the field is populated in two matching instructions in order to determine whether an exemption should be applied (e.g. in the context of buy-in rules) and, in case the two values do not match, the exemption will not apply;

- CSD records and regulatory reporting may unavoidably include inconsistencies as a result, with the possibility that a single transaction is occasionally reported with two different transaction codes.

Irrespective of whether matching fields are made mandatory or optional, the main obstacle to the implementation of a "transaction type" field is the lack of harmonised market practice. As pointed out in the T2S AG response to the ESMA Consultation Paper, EU CSDs and market participants are currently using certain values to populate this field in a way that triggers differences in the processing of settlement instructions. Achieving a harmonised standard which is agreed, endorsed, monitored and implemented within the ISO global framework will take a considerable amount of time and require important coordination efforts by standard setters, infrastructures and their participants. The consequences on the overall implementation timeline must therefore be duly considered, in line with our response to question 14 and the arguments put forward in the T2S AG response.

ECSDA recommends the following amendments to art.3(3) of the draft RTS:

Article 3 - Details of the CSD procedures facilitating settlement and details of the measures to be established by CSDs to encourage and incentivise the timely settlement of transactions
[…] 3. A CSD shall require its participants to use at least the following ~~***mandatory***~~ *matching fields for the matching of settlement instructions:*
(a) instruction type (covering at least the types of instructions specified in point h) of Article 4(2));
(b) intended settlement date;
~~***(c) trade date;***~~
(d) transaction type (covering at least the types of transactions specified in point f) of Article 4(2));
[…]

- **Mandatory bilateral cancellation facility: art.3(4) of the draft RTS (p.117)**

ECSDA recognises that bilateral cancellation facilities are a best practice and that CSDs should be encouraged to offer such functionality based on market demand, although we do not believe it is necessary to mandate its use in Level 2 legislation.

If ESMA however maintains art.3(4), we believe that it should be clarified that this article only applies to instructions that are already matched and that it does not impact the ability of the CSD to cancel instructions as necessary, for instance in the context of corporate actions on flows.

- **Hold and release mechanism, recycling, partial settlement: art.3(5) to (7) of the draft RTS (p.117)**

ECSDA remains convinced that Level 2 legislation should not mandate specific technical functionalities of CSD systems and that the draft RTS proposed by ESMA are thus unnecessarily prescriptive. CSDs believe it should be up to each market to decide on the most effective and appropriate tools to prevent settlement fails. The objectives of the CSDR can be achieved without imposing a single technical design to all EU CSDs.

ESMA should be aware of the substantial implementation costs that would be incurred by some CSDs, especially CSDs not participating in T2S, for developing the proposed functionalities. With regard to the mandatory functionalities in art.3(5)-(7), the cost estimates collected from ECSDA members have shown important differences among CSDs. Most CSDs participating in T2S have not separately counted the mandatory functionalities as costs, given that they will be available in T2S and are thus perceived as part of the general T2S costs. For CSDs outside T2S however, implementing the compulsory functionalities, in particular partial settlement, will cause substantial costs. For a relatively small CSD, this could require an estimated one-off investment of up to EUR 200,000 and yearly running costs of further EUR 35,000. The related costs for the ICSDs would be multiple times higher given that they will have to implement the functionalities not just in relation to EU "domestic" transactions, but also for their international business. It is important to carefully consider such costs, which will ultimately be borne by market participants with the potential benefits, which are not always obvious in markets with an already high settlement efficiency rate.

If ESMA nevertheless decides to maintain art.3(5), (6) and (7) as proposed, we recommend amending art.3(6) to clarify that the obligation to recycle failed settlement instructions should only apply to instructions that have been matched and that a CSD should be allowed to foresee the cancellation of instructions after a certain time to avoid "indefinite" recycling for those instructions in financial instruments which are not subject to penalties for late settlement and buy-ins:

Article 3 - Details of the CSD procedures facilitating settlement and details of the measures to be established by CSDs to encourage and incentivise the timely settlement of transactions
[…] 6. Without prejudice to the application of Directive 98/26/EC, the penalty mechanism referred to in Article 7(2) of Regulation (EU) No 909/2014, the right to bilaterally cancel the transaction, as well as to the buy-in requirements referred to in Article 7 of Regulation (EU) No 909/2014, a CSD shall recycle ***~~failed~~ matched*** *settlement instructions until they are either settled or* ***~~bilaterally~~*** *cancelled.*

- **Information to participants: art.3(8) of the draft RTS (p.117)**

ECSDA agrees with ESMA that CSDs should be required to provide up-to-date information on pending settlement instructions to their participants. It should however be up to each CSD participant to decide whether they wish to receive such information in push or in pull mode. As pointed out in the T2S AG response to ESMA's Consultation Paper, not all participants require allegement messages in order to support their processing of instructions. In the context of T2S, for instance, it has been agreed that the

CSDs' allegement message service should be optional and not mandatory, given that many participants have pointed out that they do not want to be flooded with messages that are not needed to identify pending instructions.
In the same spirit, we do not think that Level 2 technical standards should go as far as specifying the exact timing of this process, as proposed by ESMA in art.3(8) of the draft RTS. The practical modalities typically depend on the technical design of each CSD's system and on participants' preference based on the costs involved. The most important thing is to ensure that participants should have easy and timely access to such information.

As a result we think that art.3(8) of the draft RTS should be amended as follows:

Article 3 - Details of the CSD procedures facilitating settlement and details of the measures to be established by CSDs to encourage and incentivise the timely settlement of transactions
[…] 8. A CSD shall ***offer its participants the possibility to be informed*** ***~~inform its participants~~*** *about pending settlement instructions of counterparties* ***in a timely manner*** ***~~at least within 1 hour after the first unsuccessful attempt to match the instructions and 1 hour from the beginning of the intended settlement date.~~***

- **Real-time access: art.3(9) of the draft RTS (p.117-118)**

ECSDA generally agrees with the need for CSD participants to be able to access real-time information regarding ISD and settlement instructions but, for some of the fields listed in art.3(9), we note that there are currently no existing ISO standards allowing for harmonised implementation. This is in particular true for the buy-in information under point (e), but also for fields (a) to (d). As explained in our answer to question 5, the required information on buy-ins is in most cases not available to the CSD.

ECSDA thus suggests the following amendments to art.3(9) of the draft RTS, which are aligned with the proposed amendments for art.4(1) of the draft RTS:

9. A CSD shall enable its participants to have real-time access to the information regarding the intended settlement date and the status of their settlement instructions […] covering at least the following:
(a) ***~~matched settlement instructions that are not settled~~*** ***pending instructions, which can still settle on the intended settlement date;***
~~(b) settlement instructions that are not matched;~~
~~(e)~~ ***(b)*** *failed settlement instructions* ***~~that are not matched~~*** ***which cannot settle anymore on the intended settlement date,*** *including,* ***where available,*** *information on: […]*
~~(c) settlement instructions on hold;~~
~~(g)~~ ***(c) fully*** *settled settlement instructions~~.~~**;***

(d) partially settled settlement instructions, ~~***with respect to both the settled part and the unsettled part***~~ ***including the settled part and the missing part of either securities or cash;***

~~**(f)**~~ **(e)** cancelled settlement instructions***, including information whether it is cancelled by the system or by the participant*~~;~~*.***

For each of the categories of settlement instructions above, the following information should be provided:

- whether an instruction is matched or not matched;

- whether an instruction can settle partially;

- whether an instruction is on hold;

- where relevant, what are the reasons for instruction being pending or failing.

Q5: What are your views on the proposed draft RTS on the monitoring of settlement fails as included in Section 1 of Chapter III of Annex I?

This question refers to:
Section 2.2 of the Consultation Paper (p.17-20)
Annex 1, Chap.3, Section 1 (p.119-122): draft RTS, including annexes 1 and 2 (p.133-153)

- **Monitoring system: art. 4 of the draft RTS (p.119-121)**

The reporting requirements specified by ESMA need to properly reflect the fact that CSDs can only identify and report information that they actually have access to. This in turn depends heavily on the functionalities and communication flows that CSDs will be expected to develop and the role they play under the other settlement discipline provisions. Given the already very heavy implementation burden on CSDs and for the sake of efficiency, additional costly developments for the sole purpose of reporting should be avoided. The cost estimates provided in our answer to question 4 suggest that a re-calibration of the type of information CSDs will have to monitor and report could contribute to significantly lower implementation costs by reducing complexity and focusing on the information items which are truly necessary for CSDR compliance and which can reasonably be provided by CSDs.

Consistency across the different parts of the technical standards is especially crucial. The monitoring and reporting requirements under art.4 of the draft RTS need to reflect the solutions found on other issues, including matching fields, penalty mechanism and buy-in rules.

In relation to the required information on buy-ins, we would like to point out that this information is in most cases currently not available to CSDs. Most CSDs are not aware of the buy-in process and its outcome, and if an instruction is settled or cancelled, the CSD typically cannot know if this is the result of a successful buy-in, or because securities were finally delivered, or because a cash compensation was agreed. As explained in our answer to question 7, we strongly believe that CSDs should not be required to be involved in the buy-in process. CSD do not - and should not - have access to all the information listed under art.4(1)(b). In line with the T2S AG response, we therefore suggest to require CSDs to report the information on buy-ins only "*where available*".

Furthermore, as explained in our answer to question 23 of the Consultation Paper on draft RTS for recordkeeping, many of the proposed items that CSDs would need to identify and record for the purpose of monitoring and reporting settlement fails are not consistent with existing ISO standards. Although we do not think Level 2 legislation should refer to any specific standards at all, if ESMA nevertheless decides to require specific codes to be defined, it is essential that these codes are fully aligned with internationally recognised standards. CSDs and their participants operate in global financial markets and compatibility with open and internationally-recognised standards must be ensured, in line with CSDR article 35, if ESMA imposes the use of specific transaction and status codes.

ECSDA would also like to ask for some clarification regarding the term *"per Intended Settlement Date"* used in art.4 of the draft RTS. Both the first sentence of art.4(1) and art.4(2)(a) require CSDs to identify (and report) settlement related information and settlement fails per intended settlement date (ISD). Our understanding is that CSDs are expected to monitor the related items on a daily basis, rather than having to group all items according to their ISD.

As regards art.4(1)(f) on "*recycled settlement instructions*", we believe it should be deleted as it is redundant. Indeed, recycled settlement instructions are either pending settlement on ISD, in which case they are covered under art.4(1)(a), or they have failed and are thus covered under art.4(1)(e), until they are settled or cancelled. In addition, no ISO code currently exists to identify recycled transactions (either in T2S or outside T2S). In any case, competent authorities can deduct which instructions have been recycled from the use of the other codes and will be aware in case a given CSD is exempt from the recycling requirement as per art.3(11).

In line with the T2S AG response to the ESMA consultation, ECSDA thus supports the following amendments to art.4(1):

Article 4 - Details of the system monitoring settlement fails

1. A system monitoring settlement fails shall enable a CSD to identify and to keep a record of information about the intended settlement date and the status of settlement instructions entered into the securities settlement system that it operates, covering at least the following including per intended settlement date:

(a) ***~~matched settlement instructions that are not settled~~ pending instructions, which can still settle on the intended settlement date;***

~~(b) settlement instructions that are not matched;~~

~~(e)~~(b) *failed settlement instructions,* ***which cannot settle anymore on the intended settlement date,*** *including,* ***where available,*** *information on: […]*

~~(c) settlement instructions on hold;~~

*~~**(h)**~~ **(c) fully** settled settlement instructions~~.~~**;***

(d) partially settled settlement instructions, including the settled part and the missing part of either securities or cash;

*~~**(g)**~~ **(e)** cancelled settlement instructions~~;~~**, including information whether it is cancelled by the system or by the participant.***

~~(f) recycled settlement instructions;~~

For each of the categories of settlement instructions above, the following information should be provided:

- whether an instruction is matched or not matched;

- whether an instruction can settle partially;

- whether an instruction is on hold;

- where relevant, what are the reasons for instruction being pending or failing.

Art.4(2)(b) of the draft RTS requires a CSD to identify the reasons for failed instructions. In addition to a lack of securities or a lack of cash, ESMA should be aware that there are other reasons for settlement fails, such as the linking of an instruction with the settlement of another instruction which is not yet settled, the sending of late instructions, or temporary restrictions for settlement with a certain ISIN code. These reasons are captured by ISO codes and should be available in the reports. As explained in our answer to question 1 of the ESMA Consultation on the draft technical advice, we believe that, in line with the definition of *"settlement fail"* in the CSDR Level 1 text, penalties should in principle only be applied in case of fails due to a lack of securities or cash or instructions on hold.

Furthermore, the current drafting of art.4(2)(b) would cause problems for CSDs in case of fails due to a lack of cash, since CSDs often do not have access to information regarding the *"missing amount"* of cash in the cash accounts maintained by their participants, typically at the central bank. Similarly, CSDs in omnibus markets often do not have access to information on the missing part of securities on such account. Art.4(2)(b) must be redrafted to take these limitations into account.

ECSDA thus suggests the following amendments to art.4(2)(b):

Article 4 - Details of the system monitoring settlement fails

[…] 2. A system monitoring settlement fails shall allow a CSD to identify:

*[…] (b) the reason for ~~**whether**~~ the settlement fail ~~**is due to a partial or total lack of securities or due to a lack of cash, and the missing amount of securities or cash,**~~ **based on information available to the CSD**.*

As regards the "*types of asset classes*" defined in art.4(2)(d), ECSDA is concerned that these are not consistent with the categories used by ESMA to determine the applicable penalty rate in the draft technical advice (see our answer to question 2 of the ESMA Consultation on the draft technical advice) and with the categories proposed in the context of the buy-in rules. In the case of penalties for instance, ESMA suggests in its draft technical advice that a different penalty rate should apply to government bonds and corporate bonds. Such a distinction is however not foreseen in fails reporting under art.4(2)(d)(ii), which covers all bonds under a single category, although different penalty rates would apply. ECSDA is concerned about these inconsistencies and believes that, to be meaningful, fails reporting should reflect the categories of financial instruments subject to different penalty rates and subject to different buy-in rules.

We suggest to amend art.4(2)(d) as follows:

Article 4 - Details of the system monitoring settlement fails

[…] 2. A system monitoring settlement fails shall allow a CSD to identify:

[…] ***~~(d) at least the following types of asset classes:~~***

(d) the relevant ISO type of asset classes required for the purpose of compliance with requirements under article [penalty rates] and article [buy-in rules] of this Regulation.

~~(i) transferable securities referred to in point (a) of Article 4(1)(44) of Directive 2014/65/EU;~~

~~(ii) transferable securities referred to in point (b) of Article 4(1)(44) of Directive 2014/65/EU issued by public authorities;~~

~~(iib) all other transferable securities referred to in point (b) of Article 4(1)(44) of Directive 2014/65/EU;~~

~~(iii) exchange-traded funds (ETFs);~~

~~(iv) units in collective investment undertakings, other than ETFs;~~

~~(v) money-market instruments;~~

~~(vi) emission allowances.~~

As regards the "*types of transactions*" listed in art.4(2)(e), we believe that a redrafting of the ESMA proposal is necessary to ensure a more meaningful categorisation. In particular, we would like to point out the following problems with the current categories proposed by ESMA:

- The codes being proposed by ESMA for recording and reporting transaction types are not consistent with ISO standards and need to be adjusted to ensure full compatibility with internationally recognised standards;
- The ISO field currently in use for “transaction type” does not provide all the information required by ESMA under art.4(2)(e). In fact, the purpose of the current “transaction type” field is not to identify the location of trading or clearing but rather to provide information on the underlying business transaction or the type of business operation per financial instrument. If ESMA wishes to collect information on the place of trading or clearing for fails monitoring purposes, it should require CSDs and their participants to use the ISO fields “place of trading” and “place of clearing” instead. For the "place of trading", the Market Identification Code ISO 10383 could be used if the instruction is resulting from a trade concluded on a trading venue. When the field is left blank, the settlement instruction would be considered as an OTC instruction. For the "place of clearing", the

BIC of the CCP could be included in the settlement instruction. In case of a blank field, the instruction would be considered as non-CCP-cleared;

- A financial transaction is either concluded on a trading venue or OTC: the category currently described in art.4(2)(e)(v) is thus in all likelihood unnecessary and void, since all transactions will either fall under art.4(2)(e)(i) or art.4(2)(e)(ii). If ESMA deems necessary to identify CCP-cleared trades, it should consider introducing a separate field to provide this information;
- Similarly, a repo transaction falling under art.4(2)(e)(iii) might also qualify as an OTC purchase or sale under art.4(2)(e)(ii). The categories should thus be revised to clarify which ones are mutually exclusive, and which ones are cumulative;
- In Table 2 of Annex 1 of the draft RTS (p.140-151), there is an additional transaction type called "Others (please specify)", which is not included in art.4(2)(e). ESMA must ensure that, if this category of "others" is necessary, it is included in art.4(2)(e) to ensure full consistency between the article of the draft RTS and the annex.

In line with the T2S AG response, ECSDA recommends amending art.4(2)(e) and (f) of the draft RTS as follows:

Article 4 - Details of the system monitoring settlement fails

[…] 2. A system monitoring settlement fails shall allow a CSD to identify:

[…] (e) ~~***at least the following types of transactions:***~~ ***the relevant ISO transaction type of the settlement instruction;***

~~***(i) trades (purchase or sale of securities) executed on a trading venue;***~~

~~***(ii) over-the-counter (OTC) trades (purchase or sale securities);***~~

~~***(iii) transactions related to collateral management, securities lending/borrowing, repurchase transactions;***~~

~~***(iv) corporate actions and custody related operations;***~~

~~***(v) CCP cleared transactions, other than those mentioned under points (i)-(iv).***~~

(f) the place of trading and of clearing, where applicable;

As regards art.4(3) on the "*working flow*" with the top ten participants, ECSDA supports the spirit of ESMA's proposal, but disagrees that such working flow should be specified in Level 2 legislation. CSDs fully recognise the need to establish a dialogue with their most important participants in terms of settlement fails as part of their broader efforts to improve settlement efficiency. In our view, it is however not appropriate to determine by law that this work stream should be composed in all cases of the "*top ten participants with the highest rates of settlement fails*". The absolute number of 10 participants is arbitrary and does not take into account other factors that are important to determine participants which should be involved in the "*working flow*". An absolute number ignores the diversity of CSDs in terms of size and total number of participants, which for EU CSDs currently ranges between less than 15 to nearly 1500. The proposal also does not take into account the existing level of settlement efficiency and the urgency to involve a wide range of participants, if need be. Finally, a high fail rate as such is not necessarily an indicator that a participant should be represented in a work flow to improve settlement efficiency. If the fail rate is calculated just based on a few trades, there might be other more active participants that would be better placed to provide valuable input to the work of such group. Overall, ECSDA believes that CSDs could be required to establish a work flow with participants to improve settlement efficiency, but that CSDs should have the right to decide themselves on the most appropriate composition of this group.

We thus suggest the following redrafting of art.4(3):

Article 4 - Details of the system monitoring settlement fails

*[…] 3. A CSD shall set up a working flow with the **most relevant** **~~top ten~~** participants **~~with the highest rates of settlement fails~~**, as well as, if applicable, with relevant CCPs and trading venues, in order to identify the main reasons for settlement fails and to establish measures to improve settlement efficiency.*

- **Reports to public authorities: art.5 of the draft RTS (p.121) and templates in Annex I, (p.133-151)**

ECSDA supports the reporting requirements to public authorities set out in art.5 of the draft RTS. We also agree with the general structure of the two templates provided in Annex I, provided that our comments on art.4 of the draft RTS are taken into account and properly reflected in the reporting templates.

We also remark that item 27 in Table IA (p.138) on *"measures to improve settlement efficiency"*, unlike the other free text fields in the table, cannot be provided in an automated way. CSDs should thus be allowed to provide this information separately, e.g. as an annex to the template (in which case item 27 might simply refer to the free text in annex).

- **Public disclosure: art.6 of the draft RTS (p.122), and template in Annex II (p.152-153)**

ECSDA supports art.6 of the draft RTS on the disclosure of settlement fail data to the public. However, regarding the template in Annex II, in order to be consistent with reporting templates sent to competent authorities, we believe that CSDs should report values in "EUR or equivalent", i.e. in local currency rather than having to convert value amounts in EUR. As above, item 18 in the public disclosure report (Annex II, p. 153) cannot be completed in an automated way and will have to be provided separately.

Q6: What are your views on the proposed draft RTS related to the penalty mechanism? Do you agree that when CSDs use a common settlement infrastructure, the procedures for cash penalties should be jointly managed?

This question refers to:

Section 2.3 of the Consultation paper (p.21-24)
Annex 1, Chap.3, Section 2 (p.122-124): draft RTS

- **Remarks on the scope of settlement discipline measures (penalties and buy-ins)**

As defined in art.7(10) of the Level 1 CSDR, settlement discipline measures will apply to all transactions in financial instruments that are admitted to trading (or traded) on a trading venue, or cleared by a CCP. Importantly, ECSDA would like to point out that CSDs currently do not have access to the information required to assess if a particular financial instrument is admitted to trading to a MiFID trading venue (Regulated Market, MTF or OTF) and that giving CSDs access to a central and reliable source of information on which securities are "*admitted to trading on a MiFID venue*" (and not only a regulated market) will be indispensable for a proper implementation of the Level 2 standards on settlement discipline.

ECSDA thus calls on ESMA to confirm whether it is in a position to develop and maintain a publicly available database of all financial instruments admitted to trading on a trading venue, so that CSDs can assess whether a given financial instrument falls under the scope of the CSDR penalty and/or buy-in provisions.

In line with the T2S AG response to the ESMA Consultation, we also note that the scope of the proposed measures on penalties and buy-ins is independent of the type of transaction underlying the settlement process, except for those explicitly exempt. As the proposed scope extends to all "*transfer orders*", as defined by the Settlement Finality Directive, some types of transfer, such as movements related to corporate actions on stocks, portfolio transfers, and collateral movements (including collateral movements to and from central banks) could fall within the scope of penalties and buy-ins. In addition to financial instruments in the scope, ECSDA would therefore also like to ask ESMA to clarify the scope of penalties and buy-ins in relation to the underlying transaction types.

- **Collection of penalties: art.7 RTS (p.122-123)**

As regards art.7(1) of the draft RTS, ECSDA understands that both parties will be subject to a penalty in case both instructions are on hold at the end of ISD. Likewise, we expect both participants to be subject to a penalty in case they both fail to deliver cash and securities respectively by the end of the intended settlement date. In all those cases, each participant will be charged a different penalty rate, as specified in the ESMA draft technical advice.

ECSDA does not believe that it is necessary for art.7(2) to distinguish between DvP and FoP instructions in order to achieve the objective of the article. In fact, determining the cut-off time as the relevant moment to calculate penalties for DvP instructions could be inappropriate in a number of circumstances. This would for instance be the case where, at the moment of the cut-off time, the reference price is not yet available as the trading venue is still open. In order to avoid any ambiguities and to keep the system as simple as possible, we therefore suggest referring to the end of the settlement day for both FoP and DvP instructions:

> *Article 7 - The collection of cash penalties*
>
> *[…] 2. The penalty shall be calculated or applied on the failed settlement instructions* ***~~at the moment of the cut of time for DVP settlement instructions and~~*** *at the end of the settlement day* ***~~for FoP settlement instructions.~~***

As regards art.7(3), ECSDA understands that both parties will be subject to a penalty in case both instructions are input after the intended settlement date. In case the delivering participant has instructed prior to ISD but the receiving participant had instructed late, i.e. after ISD, it is ECSDA's current understanding that the CSD will only charge a penalty to the receiving participant. The delivering participant will not be charged a penalty for each day between the ISD and the actual settlement date since it has instructed on time and is not responsible for late settlement. ECSDA would welcome a confirmation by ESMA that this understanding is correct. Finally, in case both participants instruct after ISD, it is not clear whether both participants are automatically liable for the full period as of ISD or whether the participant instructing first benefits from an exemption for part of the period. In this context, we would like to refer to the request for clarifications raised in the T2S AG response to question 6 of the ESMA Consultation, including in relation to the scope of settlement discipline measures.

As regards the notion of "dedicated cash account" in art.7(5), ECSDA believes that some clarifications would be helpful. We currently understand that such "dedicated" account would be one technical account that CSDs are required to establish for the sole purpose of collecting and redistributing penalties from and to all their participants.

For the sake of clarity, we recommend amending art.7(5) of the draft RTS as follows:

> *Article 7 - The collection of cash penalties*
>
> *[…] 5. The CSD shall collect the payment of penalties in a* ***separate*** ***~~dedicated~~*** *cash account,* ***exclusively used for the purpose of collecting and paying penalty amounts.***

- **Redistribution of penalties: art.8 RTS (p.123)**

ECSDA supports art.8 of the draft RTS on the redistribution of cash penalties, but we would like ESMA to confirm our understanding as regards cases of non-payment or late payment of settlement penalties by CSD participants. Indeed, art.8(2) foresees that *"The CSD shall redistribute the net amount to be received by each participant at least on a monthly basis, shortly after receiving payment of the penalty charged."* ECSDA fully agrees that CSDs should only redistribute monies they have actually collected, in order not to bear any financial risks. In cases where a participant does not pay late settlement penalties owed to the CSD at the end of the month (e.g. if a participant goes into default), ECSDA would like to clarify that, as per art.8 of the draft RTS, the CSD is entitled to delay the payment of the "redistributed" penalties to the suffering parties until such moment as the payment is received. Furthermore, in order not to unnecessarily delay the redistribution of penalty monies to all participants, we understand that CSDs may establish in their rules and procedures a mechanism to allocate the shortfall resulting from any outstanding penalty payment in a way that ensures that the CSD is not exposed to any credit risk from the penalty mechanism. The same is of course true for penalty monies that have been collected but cannot be redistributed by the CSD, e.g. as a result of the default of a participant.

- **CCP exemption: art.9 RTS (p.123-124)**

ECSDA understands that the ESMA proposals in relation to the CCP exemption from penalties may present important difficulties for CCPs in certain markets. In order to allow CSDs and CCPs to address potential problems in relation to the imposition of penalties by CCPs to their clearing members, we believe that art.9 of the draft RTS should provide sufficient flexibility for CSDs and CCPs to establish the appropriate communication flow and procedures to properly implement the penalty mechanism.

Moreover, we understand that some CCP operating models, such as those based on trade-date-netting, would allow the CSD to calculate and collect penalties correctly, including where a CCP is involved in the chain. In such cases, it may be more efficient for the CCP to outsource the whole operation of the penalty mechanism to the CSD in order to ensure automatic processing and to avoid unnecessary complexities. The draft RTS should consequently allow CSDs and CCPs to implement such arrangements, where feasible.

ECSDA therefore suggests the following amendment to art.9(2) of the draft RTS:

Article 9 - Application of the penalty mechanism when a CCP is involved as a participant
[…] 2. The CSD where the CCP is involved as a delivering participant shall provide to the CCP the calculation of the penalty to be charged for the receipt settlement instruction submitted by the CCP to the CSD that failed to settle. The CSD where the CCP is involved as a receiving participant shall provide to the CCP, the calculation of the penalty that it would have redistributed if the CCP would have been submitted to the penalty mechanism. ***CSD and CCP shall coordinate closely to establish appropriate communication flows and procedures that allow the CSD to calculate and provide to the CCP the applicable penalty in each case where the CCP is involved as delivering or receiving participant. Where feasible, a CCP shall be allowed to outsource all processes related to the operation of the penalty mechanism to the CSD to ensure efficiency of processing.***

- **Cost of the penalty mechanism: art.10 RTS (p.124)**

ECSDA understands that art.10 of the draft RTS would leave it up to each CSD to decide how the costs of the penalty mechanism should be charged to participants, and in particular whether the cost of the mechanism should be borne by all participants or only by those participants having been subject to penalties.

The cost estimates collected by ECSDA show that this question is far from insignificant. Developing a penalty mechanism based on the ESMA draft standards and draft technical advice could cost on average around EUR 1 million per CSD. This amount does not include annual running costs, which are expected to reach over EUR 200,000 per CSD. Furthermore, these figures only cover direct costs for CSDs having to implement the necessary IT system and do not take into account the wider market impact of late settlement penalties.

Q7: What are your views on the proposed draft RTS related to the buy-in process?
In particular, what are your views on applying partial settlement at the end of the extension period? Do you consider that the partialling of the settlement instruction would impact the rights and obligations of the participants?
What do you think about the proposed approach for limiting multiple buy-in and the timing for the participant to provide the information to the CSD?

This question refers to:
Section 2.4 of the Consultation paper (p.24-28)
Annex 1, Chap.3, Section 3, art.11 (p.125-127): draft RTS

First of all, ECSDA would like to stress that the draft RTS would give CSDs a new and unprecedented central role in relation to buy-ins. As ESMA is well aware, CSDs are, with a couple of exceptions, not involved in the buy-in process today. The only CSDs which perform buy-ins do so in markets where there is no CCP and have to manage a special guarantee fund to cover the resulting risks. Giving CSDs a role in relation to buy-ins will inevitably result in new liabilities and will thus increase a CSD's risk profile, contrary to the overall objective of the CSDR, which is for CSDs to maintain the lowest possible risk profile. ECSDA is of the view that the role being proposed by ESMA in the draft RTS could be inconsistent with the Level 1 CSDR, which clearly states that a CSD's only responsibility in relation to buy-ins is to include a buy-in obligation in its internal rules.

Although the ESMA draft RTS do not require CSDs to execute buy-ins (and thus do not expose CSDs to principal risk in relation to buy-ins), they would impose totally new obligations on CSD, for instance:
(1) CSDs are expected to have access to detailed information on buy-ins, and to be able to identify buy-ins from other securities deliveries, which in most cases cannot be done today;
(2) CSDs are expected in some cases to appoint a buy-in agent, which is not a responsibility currently entrusted to CSDs;

(3) CSDs are also expected to perform "consistency tests" on the instructions they receive in order to prevent multiple buy-ins. Such tests are not currently performed today and we have serious doubts that they are even possible.

Such obligations result in handling information on buy-ins at the settlement level when, in fact, a buy-in is essentially the enforcement of a legal obligation at trading level. There are several important problems with this. First of all, in practice, there is no one-to-one correspondence between trades and settlement instructions. For instance, it is common for a settlement instruction to aggregate multiple trades from various clients of a CSD participant which, in addition, may have been concluded on several trading venues. Second, in most cases, CSDs do not have any contractual relationship with the trade counterparties (which, unlike CSD participants, are responsible for executing buy-ins). Collecting information on buy-ins at CSD level, rather than at trading level, is going to generate a whole set of problems given that CSDs currently do not have access to the required information on buy-ins and, even if they receive such information in the future, they will have absolutely no way to control that this information is complete or accurate. One possible negative consequence of the proposed buy-in requirements would be to reduce the efficiencies linked to the aggregation of multiple trades into single settlement instructions, forcing market participants to "atomise" instructions for the purpose of buy-in processing.

The draft RTS would require CSDs and participants to develop entirely new communication flows. In addition to being suboptimal (collecting trading information at settlement level rather than allowing trading counterparties to report to regulators directly), such communication flows will require substantial development costs and time for the necessary market practices to be developed.

Based on individual cost estimates collected from 19 CSDs, ECSDA tried to quantify the expected implementation costs in relation to the buy-in proposals. The analysis shows that the costs would be very significant and could ultimately increase settlement costs for market participants, affecting the competitiveness of European financial markets. In particular:

- The proposed buy-in rules are likely to be the most significant cost factor compared to penalties for late settlement and measures to prevent settlement fails, with total implementation costs of around EUR 24.5 million, or on average close to 1.3 million per CSD.
- In addition, yearly running costs for CSDs to fulfil their responsibilities under the buy-in proposals are expected to add up to nearly EUR 5 million per year, or on average more than EUR 250,000 per CSD.

That said there are several important additional considerations that have to be taken into account in relation to the buy-in proposals and implementation costs:

- First of all, there are substantial remaining uncertainties around the buy-in process. CSDs believe that some of the measures described by ESMA in the draft RTS are simply impossible to implement in practice, and their costs can thus not be estimated. This is for instance the case for art.11(10).

- Similarly, the fact that CSDs are typically not involved in buy-ins today makes it difficult for them to accurately estimate implementation costs of the proposed measures. For instance, it is difficult to see at this stage the level of automation in the process that can be achieved. In case the process would require significant manual intervention on the side of the CSD (which many CSDs currently expect), the real cost would be substantially higher than the costs reported above.
- Moreover, the costs only include direct implementation costs for the CSD. They do not account for the impact of the measures on the CSD's risk profile. Although hard to quantify, the negative impact in terms of increased systemic risk could be significant, for the CSD but more importantly for the market as a whole.
- This is also true for the wider market impact of the buy-in rules. Handling buy-ins at settlement and not at trading level would lead to various other problems, as explained in our response. The resulting sub-optimal outcome would need to be factored in when assessing the costs and benefits of the proposed measures.

In addition to collecting CSDs' cost estimates, ECSDA attempted to assess the wider market impact of the proposed rules based on settlement fails data provided by 11 CSDs. This exercise has some limitations and for example it was impossible to take into account any exemptions or differences in the extension period as proposed by ESMA. Based on the default buy-in process (buy-in initiated after ISD+4), the figures indicate that:

- Had the rules been in place in November 2014 for the 11 CSDs included in the sample, more than 150,000 buy-ins would have been initiated that month, for a total value of around EUR 214 billion. In other words, each business day, more than 7,500 buy-ins would have been triggered for a value of EUR 10.7 billion on average. Assuming that November 2014 figures are broadly representative of a typical month, the total number of buy-ins per year could thus reach over 1.8 million, representing a total value of more than EUR 2.5 trillion.
- Not surprisingly, the two ICSDs account for the biggest share of the fails still pending after ISD+4 (around 85%), as a result of their overall size, but also due to their significant global cross-border business. However, the figures also show that buy-ins would be far from insignificant for the remaining 9 CSDs. In these markets, still around 20,000 buy-ins would have been initiated during that month, with 4 markets counting more than 1,000 buy-ins (and up to 7,500).
- The numbers above are irrespective of the potentially negative impact of mandatory buy-ins on liquidity and spreads in certain instruments and markets, as described in the ICMA response to the ESMA Consultation.

For all these reasons, ECSDA is strongly opposed to any involvement of CSDs in the buy-in process and believes that article 11 of the draft RTS should be redrafted in a way that reduces the CSD's role in the buy-in process to a strict minimum and leaves responsibility for initiating and reporting buy-ins to the trading counterparties, in line with current practice.

Trading counterparties will need to amend existing agreements and industry rules in order to include the mandatory buy-in requirement imposed by the CSDR, and to ensure that the settlement agents they use and which act as CSD participants comply with CSDs' internal rules. We expect that CSD participants will have to include provisions on mandatory buy-ins in their agreements with clients.

Where no CCP is involved, the prejudiced receiver/buyer will initiate the buy-in and issue notices (with information on the extension period, quantity and timing, etc.) through the chain of settlement intermediaries up until the CSD for reporting purposes. It will also be important that, as soon as the buy-in or cash compensation is executed, parties should instruct the cancellation of the outstanding failing settlement instructions through their agents. This also provides the CSD with a final confirmation that the buy-in process is completed.

For more detailed explanations on how such an alternative model work, ECSDA would like to refer to the ICMA response to question 7 of the ESMA Consultation Paper.

At a minimum, we suggest the following amendments to art.11 of the draft RTS:

Article 11 - Details of operation of the appropriate buy-in process

*[…] 3. The ~~**CSD,**~~ CCP~~**, trading venue**~~ or the ~~**receiving**~~ **buying trading counterparty** ~~**participant**~~ **in case of transactions not cleared by a CCP** shall appoint a buy-in agent or execute the buy-in by auction. The buy-in agent shall not have any conflict of interest in the execution of the buy-in. **Once the buy-in has been executed, s**ecurities shall be delivered to the receiving participant and the related settlement instruction shall be deemed executed.*

*4a. **In the case of transactions cleared by a CCP,** ~~**The CSD,**~~ the CCP~~**, or trading venue, as applicable in accordance with Article 7(10) of Regulation(EU) No 909/2014,**~~ shall send a notice to both the failing and the receiving participants:*

(a) at the end of the business day when the extension period elapse informing them that the buy-in will be initiated the following business day;

(b) on the last business day of the buy-in period at the latest, informing them of the results of the buy-in or that the buy-in is not possible.

4b. In the case of transactions not cleared by a CCP, the CSD shall send a notice to both the failing and the receiving participants:

a) at the end of the business day when the extension period elapse informing them that the buy-in can be initiated the following business day;

b) on the last business day of the buy-in period at the latest, the CSD will send a notice of settlement or, in case no settlement has taken place, a notice of cancellation of the instruction as in that case a cash compensation has taken place.

ECSDA disagrees with the proposed wording of art.11(5) and believes that the obligation for CSDs to reserve relevant securities before partial settlement should be deleted. Not only is such "reservation" unnecessary, but it would also potentially create various problems for CSDs and their participants. Given that financial instruments on the participant's account are by definition not available if they are reserved by the CSD, partial settlement cannot take place. Importantly, in the case of omnibus accounts, it is impossible for the CSD to know whether available securities are truly "available" from the perspective of the participant's client. The "reservation" process described by ESMA would thus create a risksthat investors holding securities in an omnibus account at a CSD would have their holdings reserved and used for the purpose of settling the failed instructions of other investors, creating a liability issue for the CSD and CSD participants managing such accounts.

ECSDA thus recommends amending art.11(5) of the draft RTS as follows:

Article 11 - Details of operation of the appropriate buy-in process
[…] 5. Except when the settlement instruction is on hold in which case the buy-in shall be performed for the full instruction, the buy-in shall only relate to the financial instruments that are not available in the failing participant's account with the CSD. ~~***The CSD shall reserve the relevant financial instruments available in the failing participant's account for the settlement of that instruction.***~~

As regards art.11(6) of the draft RTS, ECSDA supports the proposal of the T2S AG response to the ESMA consultation that mandatory partial settlement should be required as of ISD + *x* days (at least one settlement cycle before the end of the extension period) instead of the currently proposed end of the extension period. The AG proposal would provide some opportunity for the trade to settle (partially) before the end of the extension period. This, in turn, would allow more opportunities for other pending transactions to settle before the end of the extension period, since more liquidity (securities and cash) would be available in the settlement system. In this context, ESMA also needs to consider the case when CSDs decide to make use of the exemption provided in art.3(11) and choose not to provide the partial settlement functionality. We assume that in such case, art.11(6) would not apply.

As regards art.11(10), requiring CSDs to test the consistency of the information provided by failing participants or a trading venue with settlement instructions is unpractical and will not allow CSDs to prevent multiple buy-ins. We understand that, in line with article 7(10) of the Level 1 CSDR, ESMA wishes to avoid unnecessary buy-ins in the context of chains of failed transactions, but we are convinced that the proposed wording of art.11(10) is unworkable and will not achieve this aim. The proposed art.11(10) is even dangerous as it assumes CSDs can take responsibility for deciding on the number of buy-ins to be executed, which is clearly not an appropriate decision for a CSD to make.

CSDs are not aware of the originating trading parties behind the settlement instructions on their books, and CSD participants themselves often do not have knowledge of the whole transaction chain, so participants "in the middle" can only pass on the information down the transaction chain. As stated in the T2S AG response to the ESMA consultation, there should be an inverse flow process whereby the CSD first informs its participants of the failed settlement transactions. As a next step, CSD participants inform their own clients responsible for the failed instruction. On their part, trading parties shall inform the CSD of the status of the buy-in process, through the CSD participant (i.e. settlement agent).

ECSDA therefore recommends deleting art.11(10). As an alternative, ESMA may want to consider replacing art.11(10) by a paragraph that describes the inverse information flow outlined above. Based on the information provided by the CSD, receiving participants themselves, in coordination with their clients, should be able, where possible, to take action in order to limit the number of buy-ins to be executed.

Article 11 - Details of operation of the appropriate buy-in process

[…] ***~~10. For transactions not cleared by a CCP, the failing participants or the trading venue shall provide to the CSD, by the day preceding the expiration of the extension period, the details of the settlement instructions on the same financial instruments and with the same date of expiry of the execution period that are causing the failure to deliver. The details shall contain the identification of the failing participants in the chain, the identification of the settlement instructions.~~***

~~The CSD shall test consistency of this information with pending receipt settlement instructions in the account of the participant and process that information in order to limit the number of buy-ins to be executed.~~

Q8: What are your views on the proposed draft RTS related to the buy-in timeframe and extension period?

This question refers to:
Section 2.4 of the Consultation paper (p.29-30)
Annex 1, Chap.3, Section 3, art.12-13 (p.127-128): draft RTS

As regards the extension period applicable to illiquid securities under art.13 of the draft RTS, ECSDA would like ESMA to confirm that a central list of those instruments falling under the definition of "liquid market" in accordance with point (a) of Article 2(1)(17) or point (b) of Article 2(1)(17), respectively, of Regulation (EU) No 600/2014, will be made available.
ECSDA also expects that such a list will be updated periodically, e.g. on an annual or semi-annual basis.

Q9: What are your views on the proposed draft RTS related to the type of operations and their timeframe that render buy-in ineffective?

This question refers to:
Section 2.4 of the Consultation paper (p.30-32)
Annex 1, Chap.3, Section 3, art.14 (p.128-129): draft RTS

In line with the response of the T2S AG to the ESMA Consultation Paper, ECSDA would like to highlight the considerable technical developments that CSDs would have to undertake in order to comply with the requirements in art.14 of the draft RTS. CSDs would have to identify, in their own systems, operations composed of several transactions, often requiring additional functionalities to be built. In case transactions are linked, this information needs to come from the counterparties of the underlying trade and be populated in the settlement instructions by the respective CSD participants for CSDs to be able to identify such links.

It is also important to note that even if the instruction contains a “repo flag”, it will often be impossible for CSDs to know whether the individual instruction is subject to a buy-in or exempt. From the individual instruction, a CSD does not know whether the instruction is the first or the second leg of a repo, and what the terms of the repo are. Although ISO messages could accommodate the inclusion of the necessary information on repos in the future, there is currently no harmonised practice on how to use these fields much more work is necessary before a comprehensive solution can be put in place allowing CSDs to identify the details of such transactions.

Finally, we would like to point out that the functionality to identify the length and the different legs of a repo will not be available in T2S. This means that CSDs participating in T2S will not be able to comply with the requirements proposed by ESMA in art.14 of the draft RTS. Indeed, it does not make sense for T2S participating CSDs to develop a mechanism to identify short-term repos outside of T2S, bearing in mind that transactions can be sent by directly into T2S (by directly connected participants) and that matching will take place in T2S. CSDs participating in T2S can therefore only be expected to apply the exemption in art.14 if T2S ensures that short term repos are identifiable, either by creating a new ISO instruction type or by linking both repo legs in the instruction.

Q10: What are your views on the proposed draft RTS related to the calculation of the cash compensation?

This question refers to:
Section 2.4 of the Consultation paper (p.33)
Annex 1, Chap.3, Section 3, art.15 (p.129): draft RTS

ECSDA supports the EACH response to question 10 of the Consultation paper as regards the importance of allowing participants to calculate the cash compensation based on a pre-agreed price or a pre-agreed method to determine such price.

Q11: What are your views on the proposed draft RTS related to the conditions for a participant to consistently and systematically fail?

This question refers to:
Section 2.4 of the Consultation paper (p.33-34)
Annex 1, Chap.3, Section 3, art.16 (p.130): draft RTS

ECSDA believes that the threshold proposed under art.16(1) of the draft RTS is too low and must be increased significantly to avoid unnecessary procedures against failing participants. In order to make sure that the notion of a *"consistently and systematically failing participant"* is meaningful, we suggest to raise the threshold to 25% below the average settlement efficiency rate for the SSS. Besides, we would like to insist that, when a participant falls under the threshold defined in art.16(1), this should never lead to the automatic suspension of that participant. The suspension of a participant is an extreme measure that can only be used as the ultimate solution to a serious problem and only be implemented after careful consideration of the circumstances in each case and in close consultation with the competent authority.

Article 16 - Conditions under which a participant is deemed to consistently and systematically fail to deliver the financial instruments
1. A participant shall be deemed to consistently and systematically fail to deliver the financial instruments when its settlement efficiency rate is ***25%~~10%~~*** *lower than the settlement efficiency rate determined for the securities settlement system over a number of days that exceeds 10% of the number of days when the participant is active in the securities settlement system, over a 12 months period.[…]*

Q12: What are your views on the proposed draft RTS related to the settlement information for CCPs and trading venues?

This question refers to:
Section 2.4 of the Consultation paper (p.35)
Annex 1, Chap.3, Section 3, art.17 (p.130): draft RTS

ECSDA believes that CCPs already have access to the settlement information they need today via their participation in the CSD.
As regards trading venues, ECSDA notes that CSDs are not always in a position today to identify the trading venue to which the settlement information should be communicated, e.g. if settlement instructions are input by CSD participants and not received via a trade feed.
Moreover, even where the trading venue is known to the CSD, the CSD might not have a contractual relationship and established communication channels with the trading venue. As a result of art.17 of the draft RTS, CSDs and trading venues might thus have to design new types of agreements allowing trading venues to obtain the necessary information in relation to buy-ins for non-CCP cleared transactions executed on trading venues.

Q13: What are your views on the proposed draft RTS related to anti-avoidance rules for cash penalties and buy-in?

This question refers to:
Section 2.5 of the Consultation paper (p.35-36)
Annex 1, Chap.5, art.19 (p.131): draft RTS

ECSDA supports the deletion of art.19 of the draft RTS, as suggested in the T2S AG response to the ESMA Consultation. Indeed, we are not convinced that the proposed article is necessary and we fear it might create legal uncertainty.

Q14: Do you agree that 18 months would be an appropriate timeframe for the implementation of the settlement discipline regime under CSDR? If not, what would be an appropriate timeframe in your opinion? Please provide concrete data and evidence justifying a phase-in for the settlement discipline measures and supporting your proposals.

This question refers to:
Section 2.6 of the Consultation paper (p.36-37)
Annex 1, Chap.5, art.20 (p.132): draft RTS

ECSDA strongly supports ESMA's proposal to phase in the implementation of the settlement discipline rules under the CSDR by delaying the entry into force of the relevant technical standards. The proposed 18 month period could however still pose a risk to the parallel implementation of TARGET2-Securities by many EU CSDs and ECSDA thus supports an extension of the transition period from 18 to a minimum of 24 months, in line with the response of the T2S AG to the ESMA Consultation.

At the same time as collecting data on CSD implementation costs, ECSDA asked CSDs to provide an estimate of the number of months they would require to make the necessary system changes and developments needed to comply with the draft ESMA requirements on settlement discipline. On average, the 19 CSDs which participated in the survey estimated that they would need more than 23 months to implement the proposed requirements. The estimates were very consistent across CSDs, ranging between 18 and up to 36 months. Regarding this range, it is however important to keep in mind that the maximum implementation time specified by the legal text will have to take as a reference the upper bound of these figures. This is particularly important for CSDs participating in T2S, who will only be able to start implementing the new settlement discipline regime once migration to T2S and the related testing have been completed.

Providing CSDs and their participants with sufficient time to implement the measures is also essential to avoid disproportionate implementation costs. Based on data provided by 19 EU CSDs, we anticipate that CSDs' development costs to comply with the proposed settlement discipline rules will already amount to over EUR 67 million, or EUR 3.55 million per CSD on average. The estimates provided mainly include the costs for developing the IT system required to implement the ESMA proposals. In most cases, non-IT costs, for instance in cases where no full automation is possible, were not included and would thus have to be added on top of these figures. In addition to the one-off costs for technical developments, CSDs were asked to estimate annual operating costs as a result of the settlement discipline technical standards. For the CSDs that participated in the survey, these would amount to EUR 13.5 million per year, or around EUR 750,000 on average per CSD.

In order to put these figures in perspective, it is important to keep in mind that CSDs are generally small or medium size companies. The CSDs in the sample have on average 325 employees, or 132 when excluding the 2 ICSDs. Implementation costs for settlement discipline measures alone would thus translate into additional costs per employee of well over EUR 10,000. It is moreover important to stress that implementation costs do not proportionally decrease with the size of the CSD. There are significant fixed costs in the development of the IT system, which means that smaller CSDs will have to bear a proportionately heavier burden relative to larger CSDs. Excluding the two ICSDs, for instance, leads to average costs per CSD still around EUR 2 million, or over EUR 15,000 per employee. For certain small CSDs, the costs could even reach up to EUR 30,000 per employee.

Considering that the sample of CSDs that participated in the survey seems broadly representative of the whole CSD industry in the EU and includes CSDs of various sizes, we can extrapolate from the figures above cost estimates for the entire CSD industry in the EU. Considering the average implementation costs per CSD (excluding the 2 ICSDs) mentioned above would give us total development costs for all 30 EU CSDs of around EUR 90 million and annual running costs of over EUR 18 million.

These figures are merely estimates and must naturally be considered with caution. Besides, they only cover direct CSD implementation costs, whereas an assessment of the total costs would also have to include the costs incurred by other impacted infrastructures (e.g. CCPs) and CSD participants (see the AFME response to question 14 of the ESMA Consultation for cost estimates provided by market participants). That said, these figures have the merit to show that the settlement discipline standards being elaborated by ESMA will require considerable adaptations from CSDs and market participants, and that their impact on the efficiency and stability of post trade processes should not be underestimated.

Irrespective of CSDs' costs and specific constraints, the widespread market impact of the draft measures on settlement discipline justify in themselves sufficient implementation time. Despite generally high settlement efficiency rates across EU CSDs, the volume and value of instructions at stake means that the impact of ESMA's draft standards is likely to be substantial, as illustrated by the figures provided in our answers to question 6 and 7.

Finally, it is very important to keep in mind that the timing of the implementation of settlement discipline measures is closely linked to the implementation of record keeping requirements, as set out in the separate technical standards on CSD authorisation. As explained in our answer to question 23 of the Consultation Paper, the implementation timeline of record keeping requirements must be aligned with the timeline for penalties and buy-ins. At the very least, the CSD records linked to the settlement discipline framework need to be decoupled from other records as they will not be practically "implementable" until the entry into force of the settlement discipline provisions, i.e. ideally at least 24 months after publication of the technical standards.

Q32: What are your views on the proposed draft RTS on internalised settlement (Annex V) and draft ITS on internalised settlement (Annex IX)?

This question refers to:
Section 6 of the Consultation paper (p.93-96)
Annex 5 (p.254-257): draft RTS
Annex 9 (p.338-348): draft ITS

CSDs are not in the scope of the standards on internalised settlement. ECSDA thus does not comment on question 32.

2. Responses to the ESMA consultation questions (technical advice)

Q1: What are your views on the proposed basis for the cash penalty calculation?

This question refers to Section 2.1.1 of the Consultation Paper (p.9-11)

ECSDA supports the mark-to-market approach proposed by ESMA, provided that:

- there are clear rules on which reference price should be used and;
- CSDs are able to access a reliable source for such prices.

It is very important that the ESMA technical advice clearly states whether all EU CSDs are expected to use the same references prices (and thus the same source of prices) or not.

Providers of market data compete with one another to provide the "best prices", which they source from various trading venues and market participants. As soon as two CSDs use a different provider for obtaining reference prices, it is impossible to guarantee that they will always have the same reference prices. This means that ESMA must choose between two options:

	Option 1: All EU CSDs use a single source for reference prices to ensure that penalty amounts are always the same across CSDs.	**Option 2: CSDs can choose any provider of market data. Penalty amounts might occasionally differ from one CSD to another.**
Pros	▪ No competitive distortions (level playing field) among CSDs as regards penalty levels	▪ Possibility for CSDs to appoint a provider of their choice, competition among providers
Cons	▪ Need for CSDs to agree on a single provider, involving potentially a complex tender procedure and the negotiation of contractual conditions with the selected provider	▪ Potential risk of competitive distortions, especially in relation to cross-CSD settlement

Irrespective of the option chosen by ESMA, ECSDA is concerned that reference prices might sometimes be difficult to obtain. In particular, we are not convinced that the "primary market" can always be identified for financial instruments included in the scope of the CSDR settlement discipline regime. ETFs, for instance, are often listed on multiple markets do not necessarily have a primary market. The "primary market" is also likely to be difficult if not impossible to identify for financial instruments admitted to trading on one or more OTFs.

Moreover, the ESMA technical advice should clarify whether the penalty fee imposed on a failed instruction that is pending for multiple days should be calculated based on a single reference price (determined at the end of ISD) or whether a different reference price should be used for each day when the instruction fails. The first option would have the advantage of being less complex and costly to implement.

Finally, ECSDA disagrees with the ESMA approach for partial deliveries and believes that it will be overly complex to implement, if not outright impossible. We recommend an alternative approach, whereby (a) the penalty would apply to the whole instruction, in case the delivering party rejects partial settlement, and (b) the whole instruction would be exempt from penalties, in case the receiving party rejects partial settlement. Such an approach will be easier to implement and would have the additional benefit of incentivising all parties to opt for partial settlement, as they would otherwise risk being penalised or not being compensated for the whole transaction.

Q2: What are your views on the proposed approach regarding the categories of financial instruments and the penalty rates? In particular, do you consider that these penalty rates could disincentivise trading in small caps? Please provide evidence to support your views.

The question refers to Section 2.1.2 of the Consultation Paper (p.11-15)

ECSDA welcomes the fact that ESMA takes into account the borrowing costs and liquidity when specifying the penalty rates for different categories of financial instruments. However, we are concerned that the proposed categories of instruments are not consistent with the categories used by ESMA to distinguish different asset types for the purpose of fails reporting in the draft RTS on settlement discipline (see our answer to question 5 of the Consultation Paper on the draft RTS). ECSDA believes that, to be meaningful, fails reporting should reflect the categories of financial instruments subject to different penalty rates.

In particular, the distinction between government bonds and corporate bonds in relation to penalty rates is not consistent with the use of a single category for debt instruments under art.4(2)(d)(ii) of the draft RTS on settlement discipline. ECSDA is not convinced that a different rate should apply for corporate bonds and government bonds, and we believe that an impact assessment is lacking to justify a different treatment.

Based on data collected from 17 CSDs, ECSDA attempted to assess the market impact of the proposed penalty framework. Some inconsistencies in the data were inevitable given the tight deadline and the lack of clarity as regards some of the measures proposed by ESMA in the draft standards and technical advice. The figures should thus be interpreted with caution. We are nevertheless confident that they can be used as rough indications of the actual impact of the proposed measures. The biggest difficulty faced by CSDs taking part in the exercise was to define the appropriate scope of instructions to be included in the fails data. Since CSDs are currently mostly not able to identify whether a financial instrument is "*admitted to trading on a trading venue*" (i.e. not only admitted to trading on a regulated markets, but also on MTFs or OTFs), the data provided often includes all instructions (in all financial instruments) processed by the CSD.

Keeping these limitations in mind, we estimated the value of late settlement penalties that would have to be collected and redistributed by CSDs on a monthly basis, if the categories and related rates put forward by ESMA were maintained. It should be noted that the figures were calculated on a gross basis, without taking into account the possibility for CSDs to net penalty payments per participant at the end of the month. The actual payments to be made at the end of the month based on the rules proposed by ESMA are therefore likely to be lower. On the other hand, we have assumed that no further penalties are due after ISD+4, once the buy-in is triggered, which may lead, to a certain extent, to an underestimation of the real amount of the penalties to be collected.

According to November 2014 data, the accumulated gross late settlement penalties to be collected by the 17 CSDs would have amounted to over EUR 183 million or around EUR 9 million a day. Assuming that the month of November is representative, this translates into yearly gross late settlement penalties of close to EUR 2.2 billion.

While the two ICSDs hold the largest share of late settlement fines to be collected (75%), the difference is less striking than for buy-ins. Excluding the two ICSDs, the remaining CSDs would on average still each account for more than EUR 3 million per month. Among these CSDs, figures range between very close to 0 and EUR 15 million per month, and only 5 CSDs would have collected less than EUR 100,000 worth of penalties.

In order to assess whether the different types of penalty rates suggested by ESMA were meaningful, ECSDA asked CSDs for fail rates per asset type, but not all CSDs were able to provide settlement fail rates based on the asset categories provided by ESMA. In particular, it was not possible to distinguish the fail rate of "*SME growth market shares*" from other equities.

Based on the sample and with only few exceptions, equities and ETFs combined seem to display the highest fail rate, compared to other asset categories - in most cases, at least 2-3 times the fail rate for debt instruments. Only 3 CSDs provided separate figures for ETFs, which suggest that the fail rate for ETFs is even higher than that of equities. Debt instruments seem to have the lowest fail rate relative to other instruments. In most cases, a distinction between government and corporate bonds was however not possible. Whenever the distinction was made, the rates were broadly aligned - with a few exceptions where fail rates on corporate bonds were significantly higher (however possibly due to a few significant outliers).

The fail rate for all other instruments including invesment funds was in general relatively high as compared to debt instruments and similar to the rate of equities and ETFs. This however differs quite substantially across CSDs and seems to depend very much on the specific instruments that each CSD settles.

Most CSDs did not provide numbers for fails due to a lack of cash. In the few cases where this data was available, their value accounted for 5-15 % of the total number of fails.

In general, it is also interesting to note that the relative weight of the instruments settled differs significantly across CSDs/markets. While some CSDs settle mainly equities, other CSDs primarily settle debt instruments (mainly government bonds). This obviously has an impact on the amount of the penalties collected, given that the penalty rate is significantly lower for government bonds in the ESMA proposal.

Based on the figures, the proposed rates would lead to an average effective penalty rate over all instruments and CSDs of 0.79 basis points. This rate differs however significantly across CSDs, ranging between close to 1 bp (if mainly equities and others) and only slightly above 0.3 bp (if mainly government bonds).

Q3: What are your views on the proposed approach regarding the increase and reduction of the basic penalty amount?

The question refers to Section 2.2 of the Consultation Paper (p.15-16)

ECSDA agrees with ESMA that no increases or decreases of the penalty rate should be foreseen at this stage. As explained in our response to the ESMA Discussion Paper on 22 May 2014, a system involving increases and/or decreases would make the implementation of the penalty mechanism very complex and would lead to various problems in relation to the "passing on" of penalties.

We also welcome ESMA's proposal to allow CSDs, in limited circumstances and on an ad hoc basis, to decrease the penalty rate to zero, e.g. if a fail is caused by circumstances outside the control of the failing participant. That said, in line with the T2S AG response to the ESMA Consultation, we think that it is appropriate to foresee a more general rule whereby penalties would be set to zero for all fails which are not due to a lack of cash or of securities, in line with the definition of "fails" in the Level 1 CSDR. Exceptions to this rule need to be explicitly mentioned in the Level 1 CSDR or the Level 2 technical standards, for example on hold instructions and instructions sent after the intended settlement date.

Q4: What are your views on the proposed approach regarding the cash penalties in the context of chains of interdependent transactions?

The question refers to Section 2.3 of the Consultation Paper (p.17)

ECSDA shares ESMA's view that the "passing on" of penalties should be sufficient to address issues related to chains of interdependent transactions, whether identifiable by the CSD or not. We thus agree that, for the sake of simplicity of the penalty mechanism, the parameters of penalty calculation should not be changed in cases of chains of interdependent transactions.

Annex I: CSD Cost estimates

This annex presents costs estimates collected by ECSDA in February 2015 in the context of the ESMA Consultation on CSDR settlement discipline. Data was collected from 19 EU CSDs (including the 2 ICSDs, Euroclear Bank and Clearstream Banking Luxembourg).

1. CSD implementation costs

- Total (one-off) development costs to implement the requirements proposed by ESMA in relation to settlement discipline for the 19 CSDs in the sample are expected to amount to over EUR 67 million, or EUR 3.55 million per CSD on average. The estimates provided mainly include the costs for developing the IT system required to implement the ESMA proposals. In most cases, non-IT costs, for instance in cases where no full automation is possible, were not included and would thus have to be added on top of these figures.

- In addition to the one-off costs for the technical developments, CSDs estimated annual operating costs that they will face as a result of the CSDR settlement discipline technical standards. For the CSDs that participated in the survey, these would amount to EUR 13.5 million per year, or around EUR 750,000 on average per CSD.

- In order to put these figures in perspective, it is important to keep in mind that CSDs are generally small or medium size companies. The CSDs in the sample have on average 325 employees, or 132 when excluding the 2 ICSDs. Implementation costs for settlement discipline measures alone would thus translate into additional costs per employee of well over EUR 10,000.

- It is moreover important to stress that implementation costs do not proportionally decrease with the size of the CSD. There are significant fixed costs in the development of the IT system, which means that smaller CSDs will have to bear a proportionately heavier burden relative to larger CSDs. Excluding the two ICSDs, for instance, leads to average costs per CSD still around EUR 2 million, or over EUR 15,000 per employee. For certain small CSDs, the costs could even reach up to EUR 30,000 per employee.

- Considering that the sample of CSDs that participated in the survey seems broadly representative of the whole CSD industry in the EU and includes CSDs of various sizes, we can extrapolate from the figures above cost estimates for the entire CSD industry in the EU. Considering the average implementation costs per CSD (excluding the 2 ICSDs) mentioned above would give us total development costs for all 30 EU CSDs of around EUR 90 million and annual running costs of over EUR 18 million.

- It is important to note that our estimates only cover direct CSD implementation costs. An assessment of the total costs will also have to include the costs incurred by CSD participants and other impacted infrastructures (e.g. CCPs).

2. Comparing costs of different types of requirements

In addition to total costs, ECSDA asked its members to provide a more detailed breakdown of the estimates, based on the three main types of measures proposed by ESMA in relation to settlement discipline:

A. Buy-in requirements (art.11 of the draft RTS)

- The numbers show that the proposed buy-in rules are likely to be the most costly ones for CSDs to implement, with total implementation costs of around EUR 24.5 million, or on average close to 1.3 million per CSD.

- In addition, yearly running costs for CSDs to fulfil their responsibilities under the buy-in proposals are expected to add up to nearly EUR 5 million per year, or on average more than EUR 250,000 per CSD.

- There are several important additional considerations that have to be taken into account in relation to the buy-in proposals and implementation costs:

    - First of all, there are substantial remaining uncertainties around the buy-in process. CSDs believe that some of the measures described by ESMA in the draft RTS are simply impossible to implement in practice, and their costs can thus not be estimated. This is for instance the case for art.11(10).

    - Similarly, the fact that CSDs are typically not involved in buy-ins today makes it difficult for them to accurately estimate implementation costs of the proposed measures. For instance, it is difficult to see at this stage the level of automation in the process that can be achieved. In case the process would require significant manual intervention on the side of the CSD (which many CSDs currently expect), the real cost would be substantially higher than the costs reported above.

    - Moreover, the costs only include direct implementation costs for the CSD. They do not account for the impact of the measures on the CSD's risk profile. Although hard to quantify, the negative impact in terms of increased systemic risk could be significant, for the CSD but more importantly for the market as a whole.

- This is also true for the wider market impact of the buy-in rules (see Annex II). Handling buy-ins at settlement level rather than at trading level would lead to various other problems, as explained in our response to the ESMA Consultation. The resulting sub-optimal outcome would need to be factored in when assessing the costs and benefits of the proposed measures.

B. <u>Preventing, monitoring and reporting fails (art.3-6 of the draft RTS)</u>

- Expected costs to implement the proposed requirements on preventing and monitoring fails are expected to be very close to the ones required for buy-ins. CSDs estimate total implementation costs to amount to nearly EUR 24 million, or EUR 1.25 million per CSD on average. The high costs are partly due to need for the ICSDs to implement the functionalities and reporting not just in relation to EU "domestic" transactions, but also to their international business.

- On the other hand, it is worth noting that there are significant cost differences across national CSDs, in particular between those participating in T2S and those outside T2S. The functionalities required by the draft technical standards will be available in T2S and were thus not separately counted by CSDs participating in T2S, since they are perceived as part of the general T2S costs. For CSDs outside T2S however, implementing the compulsory functionalities, in particular partial settlement, will cause substantial costs.

- Once implemented, the system for preventing and monitoring fails will have to be maintained. This is expected to cause further yearly operating costs similar to the ones for buy-ins, i.e. nearly EUR 5 million or over EUR 250,000 per CSD.

C. <u>Late settlement penalties (art.7-10 of the draft RTS)</u>

- Total reported costs for implementing the mechanism for cash penalties for late settlement amount to around EUR 19 million or around EUR 1 million per CSD.

- In addition, annual running costs are expected to be close to EUR 4 million or on average over EUR 200,000 per CSD.

- It is important to note that these figures only cover direct costs for CSDs having to implement the necessary IT system and do not take into account the wider market impact of cash penalties (see Annex II).

3. *Implementation timeline*

Finally, ECSDA asked its members to estimate the timeline necessary to implement the proposed settlement discipline measures:

- CSDs which participated in the survey estimated on average that they would need more than 23 months to implement the proposed requirements.

- Estimates were quite consistent across CSDs, ranging between 18 and up to 36 months. It is however important to keep in mind that the maximum implementation time specified by the legal text will have to take as a reference the upper bound of these figures. This is particularly key for CSDs participating in T2S, who will only be able to start implementing the new settlement discipline regime once migration to T2S and the related testing have been completed.

Annex II: Assessment of the market impact

This annex presents a simulation exercise undertaken by ECSDA in order to help assess the market impact of the settlement discipline measures proposed by ESMA in the draft CSDR Level 2 standards. The analysis is based on settlement fails data collected from 17 EU CSDs (including the 2 ICSDs) in February 2015. The figures are based on monthly data for November 2014.

1. *Basis for the market impact analysis*

- In 2013, the 30 ECSDA members that are established in the EU collectively processed around 350 million delivery instructions. In terms of value, these delivery instructions represented close to EUR 1.1 quadrillion. Despite generally high settlement efficiency rates across EU CSDs, the volume and value of instructions at stake means that the impact of the settlement discipline regime is likely to be substantial.

- CSDs which participated in the analysis were asked by ECSDA to provide as much granularity as possible in relation to fails data. Not all CSDs were able however to provide details based on the categories proposed by ESMA (e.g. fails per asset class or duration of fails).

- Some inconsistencies in the data were inevitable given the tight deadline and the lack of clarity as regards some of the measures proposed by ESMA in the draft standards and technical advice. The figures should thus be interpreted with caution. We are nevertheless confident that they can be used as rough indications of the actual impact of the proposed measures.

- The biggest difficulty faced by CSDs taking part in the exercise was to define the appropriate scope of instructions to be included in the fails data. Since CSDs are currently mostly not able to identify whether a financial instrument is "*admitted to trading on a trading venue*" (i.e. not only admitted to trading on a regulated markets, but also on MTFs or OTFs), the data provided often includes all instructions (in all financial instruments) processed by the CSD.

2. *Impact of mandatory buy-ins*

The figures collected from 11 CSDs were sufficiently granular to draw conclusions for the buy-in process. It was impossible however to take into account any exemptions or differences in the extension period as proposed by ESMA. Based on the default buy-in process (buy-in initiated after ISD+4), the figures indicate that:

- Had the rules been in place in November 2014 for the 11 CSDs included in the sample, more than 150,000 buy-ins would have been initiated that month, for a total value of around EUR 214 billion. In other words, each business day, more than 7,500 buy-ins would have been triggered for a value of EUR 10.7 billion on average. Assuming that November 2014 figures are broadly representative of a typical month, the total number of buy-ins per year could thus reach over 1.8 million, representing a total value of more than EUR 2.5 trillion.

- Not surprisingly, the two ICSDs account for the biggest share of the fails still pending after ISD+4 (around 85%), as a result of their overall size, but also due to their significant global cross-border business. However, the figures also show that buy-ins would be far from insignificant for the remaining 9 CSDs. In these markets, around 20,000 buy-ins would have been initiated during that month, with 4 markets counting more than 1,000 buy-ins (and up to 7,500).

3. Impact of late settlement penalties

Based on data collected from 17 CSDs, we attempted to draw some conclusions for the expected value of late settlement penalties to be collected and redistributed by CSDs on a monthly basis. It should be noted that the figures were calculated on a gross basis, without taking into account the possibility for CSDs to net penalty payments per participant at the end of the month. The actual payments to be made at the end of the month based on the rules proposed by ESMA are therefore likely to be lower.
On the other hand, we have assumed that no further penalties are due after ISD+4, once the buy-in is triggered, which may lead, to a certain extent, to an underestimation of the real amount of the penalties to be collected.

- According to November 2014 data, the accumulated gross late settlement penalties to be collected by the 17 CSDs would have amounted to over EUR 183 million or around EUR 9 million a day. Assuming that the month of November is representative, this translates into yearly gross late settlement penalties of close to EUR 2.2 billion.

- While the two ICSDs hold the largest share of late settlement fines to be collected (75%), the difference is less striking than for buy-ins. Excluding the two ICSDs, the remaining CSDs would on average still each account for more than EUR 3 million per month. Among these CSDs, figures range between very close to 0 and EUR 15 million per month, and only 5 CSDs would have collected less than EUR 100,000 worth of penalties.

4. Difference in the settlement fail rate per instrument

- Not all CSDs were able to provide settlement fail rates per asset type based on the categories provided by ESMA. In particular, it was not possible to distinguish the fail rate of "*SME growth market shares*" from other equities.

Based on the sample and with only few exceptions, equities and ETFs combined seem to display the highest fail rate, compared to other asset categories - in most cases, at least 2-3 times the fail rate for debt instruments. Only 3 CSDs provided separate figures for ETFs, which suggest that the fail rate for ETFs is even higher than that of equities. Debt instruments seem to have the lowest fail rate relative to other instruments. In most cases, a distinction between government and corporate bonds was however not possible. Whenever the distinction was made, the rates were broadly aligned - with a few exceptions where fail rates on corporate bonds were significantly higher (however possibly due to a few significant outliers).

The fail rate for all other instruments including investment funds was in general relatively high as compared to debt instruments and similar to the rate of equities and ETFs. This however differs quite substantially across CSDs and seems to depend very much on the specific instruments that each CSD settles.

- Most CSDs did not provide numbers for fails due to a lack of cash. In the few cases where this data was available, their value accounted for 5-15 % of the total number of fails.

- In general, it is also interesting to note that the relative weight of the instruments settled differs significantly across CSDs/markets. While some CSDs settle mainly equities, other CSDs primarily settle debt instruments (mainly government bonds). This obviously has an impact on the amount of the penalties collected, given that the penalty rate is significantly lower for government bonds in the ESMA proposal.

- Based on the figures, the proposed rates would lead to an average effective penalty rate over all instruments and CSDs of 0.79 bp. This rate differs however significantly across CSDs, ranging between close to 1 bp (if mainly equities and others) and only slightly above 0.3 bp (if mainly government bonds).