Central Securities Depositories Regulation (CSDR) Articles 6 and 7: The Settlement Discipline Regime (SDR)

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Contents

1 Introduction

The Central Securities Depositories Regulation (CSDR) is a European Union Regulation (EU) No 909/2014, focused on improving securities settlement in the European Union. It was designed to introduce harmonised rules across all CSDs within the European Economic Area (EEA) and complement the Target2Securities (T2S) project. CSDR entered into force in 2014 and the various requirements have been staggered, with implementations to date including the shortening of settlement cycles and internalised settlement reporting.

The current regulatory focus is on the new settlement discipline rules under the CSDR Regulatory Technical Standards on settlement discipline (CSDR RTS), which came into force on 1 February 2022.

The aim of this FAQs document is to provide useful information about these upcoming changes. Please note, that in view of anticipated changes to the settlement discipline rules under CSDR and the CSDR RTS, the European Commission, European Parliament and European Council agreed the postponement of the mandatory buy-in rules' effective date. Accordingly, the European Securities and Markets Authority (ESMA) issued a public statement on the supervisory approach on the implementation of the CSDR buy-in provisions, in which it recommends National Competent Authorities (NCAs) not to prioritise supervisory actions in relation to the application of the CSDR buy-in regime until the legislative provision postponing the application of the buy-in regime is formally in place. Therefore, mandatory buy-ins are not covered in this FAQs document.

2 Regulation Summary

2.1 What is the Settlement Discipline Regime (SDR) under the CSDR RTS?

The SDR is a new set of rules set out in the CSDR RTS on settlement discipline which seeks to prevent and address settlement fails.

Specifically, it provides:

- measures to prevent settlement fails, including measures such as timely allocations, partial settlements, continuous real time matching and Real Time Gross Settlement (RTGS); and
- measures to address settlement fails, including measures such as cash penalties for late settlement, calculated and applied by CSDs for each settlement instruction that fails to settle by the intended settlement date (ISD) (i.e. the original value date of the trade). While mandatory buy-ins are also provided as a measure to address settlement fails, they will not be covered in these FAQs (see section 1).

The legislative text of CSDR and accompanying regulatory technical standards can be accessed via the below link:
ec.europa.eu/info/law/central-securities-depositories-regulation-eu-no-909-2014_en

ESMA releases guidelines and questions and answers periodically, which may be accessed via the below link:
www.esma.europa.eu/regulation/post-trading/settlement

The UK Government has not adopted the SDR.

2.2 What is the Scope of the SDR?

CSDR SDR applies to transactions in transferable **securities (including shares and bonds), money-market instruments, units in collective investment undertakings and emission allowances that settle in an EEA CSD**. We understand that CSDs are applying the SDR to those instruments that trade on an EEA venue, are admitted to trade on an EEA venue or are cleared by a CCP. Shares with a principal trading venue in a third country are out of scope.

CSDR SDR applies to non-EEA clients and firms where financial instruments are settled in an EEA CSD and are also admitted to trading/traded on an EEA trading venue and/or are cleared at an EEA CCP, even where those entities only have an indirect relationship with the CSD. Therefore, all parties to the settlement chain involved in transactions in EEA markets are potentially impacted, including where the trading parties are outside the EEA (i.e. CSDR has an extra-territorial impact). ESMA's Final Report[1] specifies that the "settlement chain" involves: "CSD participants, the trading venue members, clearing members, trading parties, their clients and any intermediary in between […]".

CSDR provisions generally apply to CSDs and international CSDs (iCSDs) operating within the EEA. The European Supervisory Markets Authority (ESMA) will maintain a register of authorised CSDs.

[1] Final Report_on_CSDR RTS_on Settlement_Discipline:
www.esma.europa.eu/sites/default/files/library/2016-174_-_final_report_on_csdr_rts_on_settlement_discipline_0.pdf

3 What are the measures to prevent Settlement fails?

3.1 Timely confirmation and allocation of settlement details from professional clients

Investment firms, including in-scope Bank of America entities such as BofA Securities Europe SA and Bank of America Europe DAC, shall require their professional clients to send them written allocations of securities to in-scope transactions, identifying the accounts to be credited or debited. Those written allocations must include the following:

(a) one of the following types of transaction:
   (i). purchase or sale of securities;
   (ii). collateral management operations;
   (iii). securities lending/borrowing operations;
   (iv). repurchase transactions;
   (v). other transactions, which can be identified by more granular ISO codes;
(b) the International Securities Identification Number (ISIN) of the financial instrument or where the ISIN is not available, some other identifier of the financial instrument;
(c) the delivery or the receipt of financial instruments or cash;
(d) the nominal value for debt instruments, and the quantity for other financial instruments;
(e) the trade date;
(f) the trade price of the financial instrument;
(g) the currency in which the transaction is expressed;
(h) the ISD of the transaction;
(i) the total amount of cash that is to be delivered or received;
(j) the identifier of the entity where the securities are held;
(k) the identifier of the entity where the cash is held; and
(l) the names and numbers of the securities or cash accounts to be credited or debited.

Written allocations shall include all other information required by the investment firm for facilitating the settlement of the transaction.

With respect to timing requirements for written allocations and confirmations, Section "CHAPTER II Measures to prevent settlement fails, Article 2 Measures concerning professional clients" of the SDR RTS[2] outlines that;

"2. Professional clients shall ensure that written allocations and written confirmations are received by the investment firm by one of the following deadlines;

(a) by close of business on the business day on which the transaction has taken place where the investment firm and the relevant professional client are within the same time zone;
(b) by 12.00 CET on the business day following that on which the transaction has taken place where one of the following occurs;
   (i). is a difference of more than two hours between the time zone of the investment firm and the time zone of the relevant professional client;
   (ii). the orders have been executed after 16.00 CET of the business day within the time zone of the investment firm.

Investment firms shall confirm receipt of the written allocation and of the written confirmation within two hours of that receipt. Where the written allocation and the written confirmation is received by an investment firm within less than one hour before its close of

[2] eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018R1229&from=EN

business, that investment firm shall confirm receipt of the written allocation and of the written confirmation within one hour after the start of business on the next business day."

Written allocations do not need to be sent by professional clients when the investment firm has received the relevant information in advance.

We would encourage clients to consider the electronic offerings available to send their allocation instructions to Bank of America, to prevent settlement fails. If clients would like to use an electronic offering, please discuss further with your usual Sales or Operations representative.

3.2 Additional mandatory matching and non-matching fields

CSDs are required to provide functionality to participants with fully automated, continuous real-time matching of settlement instructions.

CSDs require their participants to populate additional fields in their settlement instructions, which include Trade Date, Place of Trade (where required by the CSD) and Transaction Type code (outlined in the Annex of AFME's "Response Guidelines on Internalised Reporting" document3.

Transaction types include the purchase or sale of securities, collateral management, securities financing, repurchase transactions and buy-in transactions.

Parties will need to ensure that they instruct all relevant details necessary as this could affect whether their transactions settle on time and so whether they are subject to a settlement discipline penalty.

Bank of America is making changes to its SWIFT MT54x settlement instruction message processing to enable clients to instruct these fields.

3.3 Tolerance matching

CSDs will introduce functionality to allow matching even if the cash amounts on the two settlement instructions differ.

In this scenario, matching will occur provided that the difference in cash amounts is not greater than a standard tolerance level. There will be two uniform tolerance levels; EUR2.00 for settlements up to EUR100K and EUR25.00 for settlements over EUR100K will be introduced.

3.4 Bilateral cancellation facilities

Under CSDR, CSDs are obliged to make bilateral cancellation facilities available to participants to bilaterally cancel matched settlement instructions.

3.5 Partial Settlement

CSDR requires that CSDs provide participants with functionality to partially settle transactions.

Bank of America would encourage counterparties and clients to enable auto partial settlement capabilities and leverage at the earliest appropriate point. This should maximise the settlement opportunity and, in so doing, reduce the risk and scale of CSDR cash penalties payable by the delivering party in the event of a settlement fail.

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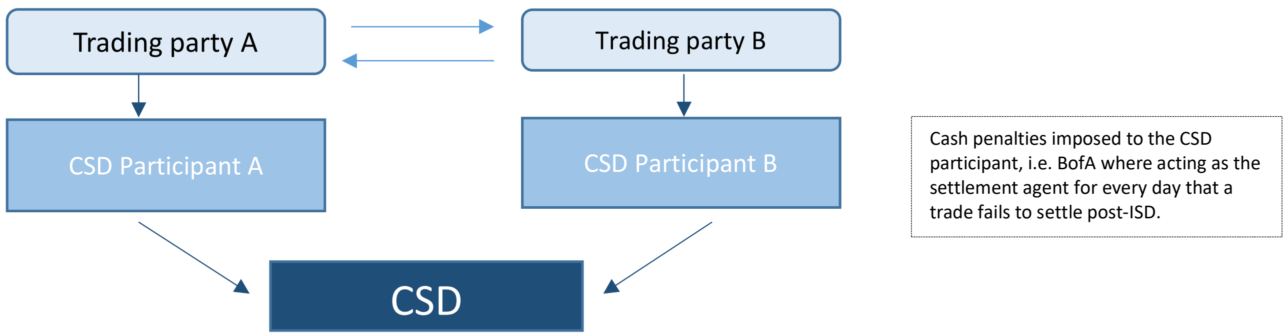
[3] www.esma.europa.eu/file/23104/download?token=gJ7fmQF2

4 What are the measures to address Settlement fails?[4]

Measures to address settlement fails include cash penalties for late settlement, calculated and applied by CSDs for each settlement instruction that fails to settle by the ISD. Parties that consistently fail risk being reported to the relevant competent authority and risk losing their CSD membership.

4.1 Cash Penalties

Cash penalties on failing participants are calculated and applied by CSDs for each settlement instruction that fails to settle by the ISD. Cash penalties are calculated and applied at the end of each business day where the settlement instruction fails to settle.



4.1.1 How will Cash Penalties be applied?

Cash penalties will be applied to matched transactions that fail to settle from the end of the ISD, up until the date the instruction is settled or cancelled.

There are two types of penalties:

- Late Matching Fail Penalty (LMFP) - where the settlement instruction has been entered into the securities settlement system or has been matched after the ISD. Cash penalties for the period between the ISD and the business day before the day on which matching has taken place must be paid by the last participant who has entered or modified the relevant settlement instruction in the securities settlement system.

- Settlement Fail Penalty (SEFP) - where a matched instruction fails to settle on the ISD due to lack of securities or cash (including when being on hold). The failing participant is required to pay the cash penalty.

Cash penalties are calculated based on the value of the trade and attributed to the party at fault. The penalty rate varies by financial instrument and fail reason.

4.1.2 What are the penalty rates charged by the CSDs for LMFP and SEFP?

Penalty rates are defined in an EU delegated regulation (the Penalty Delegated Regulation[5]) and are common across the EEA CSDs.

[4] While mandatory buy-ins are also provided as a measure to address settlement fails, the European Commission, European Parliament and European Council have agreed the postponement of their effective date post 1 February 2022. Therefore, they will not be covered in this FAQs document.
[5] COMMISSION DELEGATED REGULATION (EU) 2017/389 of 11 November 2016: eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0389

The cash penalty rate (i.e. fail due to lack of cash) is the official interest rate for overnight credit charged by the central bank issuing the settlement currency with a floor of 0.

The security penalty rate is determined based on a number of criteria:

- Financial instrument type;
- Liquidity (only relevant for shares); and
- If the trade is executed on a trading venue considered an SME Growth Market.

Below is the daily securities penalty rates applicable to settlement fails:

Type of Security	Rate
1. Liquid shares, excluding shares referred to in point 3	1.0 basis point
2. Illiquid shares (e.g. Exchange Traded Funds, Depository Receipts), excluding shares referred to in point 3	0.5 basis point
3. SME growth markets, excluding debt instruments referred to in point 6	0.25 basis point
4. Government debt, including sovereign issuer, third country sovereign issuer, local government authority, central bank, multilateral development bank and the European Financial Stability Facility or the European Stability Mechanism	0.1 basis point
5. Other debt, other than those referred to in points 4 and 6	0.20 basis point
6. SME growth markets debt instruments	0.15 basis point
7. Other financial instruments not covered in points 1 to 6	0.5 basis point

4.1.3 How are cash penalties collected?

For non-central counterparty (non-CCP) penalties, CSDs will be required to calculate, collect and distribute, on at least a monthly basis, the net amount of cash penalties. CSDs are also required to report on all penalties (including CCP penalties). Settlement penalty currencies are calculated by CSDs and follow the rules of the CSD for the currency used.

For CCP cleared trades, CCPs will collect and distribute penalties.[6]

4.1.4 Can penalties distributed by the CSD be appealed?

According to the industry guidance noted in ESMAs Q&A and the European Central Securities Depositories Association's (ECSDA) draft framework, when a CSD participant disagrees with the penalty amount calculated or party at fault reported by a CSD, the CSD participant may log an appeal within 10 business days of the following month.

The appeal must consist of a minimum level of information such as transaction reference, reason for appeal and expected calculations and penalties.

The amendment or removal of previously calculated penalties are expected to happen only under exceptional circumstances, including:

- ISIN suspension from trading or settlement;

[6] CCPs continue to lobby ESMA to be excluded from the collection / distribution of CCP penalties (i.e. CCPs want the CSDs to complete this process).

- settlement instructions involving cash settlement outside the securities settlement system operated by the CSD, if on the respective day, the relevant payment system is closed for settlement; or

- as referenced in the ECSDA's CSDR Penalties framework document,[7] *"iv. Technical impossibilities at the CSD level that prevent settlement, such as failure of the infrastructure components, a cyber-attack or network problems".*

4.1.5 What is Bank of America's bilateral claims process?

Bank of America is actively engaged in the Association for Financial Markets in Europe (AFME) working group discussions and provides feedback on proposed bilateral claims guidelines. Bank of America's bilateral claims process is expected to be in line with the bilateral claims guidelines published by AFME[8].

[7] Link to ECSDA's CSDR Penalties Framework Document: ecsda.eu/wp-content/uploads/2021/03/2021_03_09_CSDR_Penalties_Framework_updated.pdf
[8] Link to AFME Bilateral Claims Document: www.afme.eu/Portals/0/DispatchFeaturedImages/CSDR%20Settlement%20Discipline%20-%20Bilateral%20Penalty%20Claims%20FINAL.pdf

Definitions and Abbreviations

Abbreviation	Definition
CCP	Central Counterparty
CSD	Central Securities Depository
CSDR	Central Securities Depositories Regulation
EEA	European Economic Area, covering the European Union and the three additional countries of Norway, Liechtenstein, and Iceland
ESMA	European Securities and Markets Authority
FTP	Failing Trading Party
ISD	Intended Settlement Date
LMFP	Late Matching Fail Penalty
SDR	Settlement Discipline Regime
SEFP	Settlement Fail Penalty
RTS	Regulatory Technical Standards

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