THE INVESTMENT ASSOCIATION

CSDR - Settlement Discipline

The impact of low value cash penalties and case for a de-minimis

1. Objective

The Investment Association (the IA) and our members very much share in the objectives of the CSDR settlement discipline regime in aiming to bring down settlement fail rates. Since before and from the go-live of the CSDR settlement discipline regime the buy-side have typically been responsible for a lower proportion of settlement rate fails. Often engagement is made with their trading counterparts to improve settlement rates across both sides, but are not always able to influence all debits or credits that hit the clients' account and therefore have to process the CSDR cash penalties.

These cash penalties are often relatively low value (member statistics suggest 81% are less than EUR 50) and often the operational burden of processing these cash penalties outweigh the value of the penalty itself.

This document aims to explore how the current cash penalty regime may end up negatively impacting the end investor, highlighting how different jurisdictional pressures can result in the end investor being treated differently and discussing how a market or CSD de-minimis value could aid in making the penalties regime more proportionate.

2. Contents

3. Background

Advocacy focus

Prior to CSDR go-live in February 2022, much of the focus of market participants and trade associations' advocacy was centred on mandatory buy-ins (MBIs), detailing how the current regime would have had unintended consequences and calling for their delay and/or removal. The Investment Association, along with many other market stakeholders, continue to advocate for the removal of mandatory buy-ins as a tool that will have unintended negative consequences on EU market liquidity and competitiveness.

This focus on MBIs meant that cash penalties did not get the emphasis they would had they been a standalone feature of the Settlement Discipline Regime, either in analysis or in market advocacy looking to refine the process.

ESMA data

As part of CSDR, ESMA are obliged to report various reports on the efficacy of CSDR to the European Commission. We would welcome public dissemination of this data assuming market participant anonymity, where appropriate, to provide further colour on how CSDR cash penalties are being applied. It would aim in root cause resolution to see the impact of cash penalties against each type of market participant and each type of securities concerned, and for transparency on the direction of settlement rates within the EU.

Of particular note would be whether the cash penalty regime is having an equal effect on all settlement rates or predominantly impacting the higher value trades and fails.

High-level impact on the buy-side

The buy-side and their underlying clients are generally responsible for a low proportion of settlement failures and are therefore commonly in net credit as it comes to CSDR cash penalties.

This is a facet worth highlighting in view of this document. The motivation is to discuss how a de-minimis may bring a more operationally proportionate approach to cash penalties and how the current system can produce scenarios that disadvantage the end investor or that sees them treated differently across jurisdictions, rather than seeking to avoid a net debit.

Although there are various approaches to negotiating the redistributions and penalties to a client account by an investment manager, as it comes to the debit penalties the investment manager will often incur the costs, despite not causing the debit. Scenarios will be explored later in the document exploring this and reflects the unintended consequences of CSDR settlement discipline.

Undue costs – supervisory briefing

Much discussion of CSDR in the buy-side community is centred around proportionality and the prevention of undue impact on the end-client and investor, despite most receiving a net credit. It is therefore worth highlighting ESMA's supervisory briefing on costs in UCITS and AIFs. Whilst the briefing is directed at NCAs, it centres around the "obligation to prevent undue costs being charged to investors", which is at the heart of what our membership are seeking to achieve.

CSDR makes this difficult given the ambiguous nature and ownership of the debit and credit cash penalties, how they should be applied and how they interact with local laws of national jurisdictions worldwide.

Turbulent go-live

A number of CSDs had not been able to test or had only done 1 month of testing prior to go-live. This meant intermediaries struggled providing their own testing for onward intermediaries and clients and this problem was exacerbated down the settlement chain with the buy-side commonly having little opportunity to test the CSDR cash penalty flow. As it came to go-live, the buy-side often receive reporting and payment of CSDR penalties weeks or months after the monthly calendar laid out by ECSDA, or in some cases not at all.

The IA and members are continuing to work with intermediaries to improve the process month on month, but the additional operational burden of processing cash penalties incurred by these CSD and intermediary delays have made it difficult to focus on root cause improvement and engagement.

4. Issues with low value cash penalties

Low value cash penalties have a disproportionately high operational footprint. Whilst this is mainly discussed below with regards to debits, it can also include credits, where an end account may receive cash penalties to which they are not due. Some of the causes and considerations are below:

Allocation of the cash penalty by the CSD is not always correct.

The methodology CSDs use to allocate debit penalties to the party "at fault" does not always reflect who caused the issue. For example, entity A matches a trade late because entity B provided incorrect SSIs until post settlement date. CSD sees entity A matching the trade late and allocates them the debit even though entity B is at fault.

Based off this we can consider the below definitions:

> ***Correct direction penalty*** *- Most penalties will be processed in the correct direction as the CSD identifies the part at fault (e.g. a party is short of stock or genuinely matches late)*
>
> ***Incorrect direction penalty*** *– The CSD identifies wrong party at fault (e.g. late match due to counterpart providing correct SSIs late) and processes the penalty in the incorrect direction.*

Due to this, the true cause of any given cash penalty may need to be investigated/verified to know who is truly at fault. The nature of settlement fails currently means that it's difficult to assess who is at fault without manually investigating each underlying trade.

Investigation - Materiality

Considering the above, market participants face a choice in following a CSD's (potentially incorrect) allocation or investigating and looking to bi-laterally rectify the penalty. The investigation is often manual so at low values, the cost of investigating will often exceed the penalty itself for both debits and credits.

Reimbursement - Custody fees

If an asset manager does the investigation and determines that a client has received a debit for which they are not at fault, they may look to reimburse the debit. The processing of this reimbursement will incur a custodian fee which is often greater than the value of the penalty.

Reimbursement – Bilateral claim de-minimis.

Given the CSD allocation of cash penalties is not always correct, AFME have created guidelines[1] for bilaterally claiming back the penalty from the recipient of the receipt, including a de-minimis guideline threshold of EUR 500. Generally market participants, including the buy-side and the IA, agree the need for a bi-lateral claim de-minimis and support AFME's guidelines. It's important to note that the bilateral claims process seeks only to recover the penalty amount that was debited that the party who initiated the claim was not "at fault" for, and not to reverse the direction of the claim.

This guideline can create an issue where an end investor will not accept an incorrect debit of anything below EUR 500, but the party genuinely at fault will not accommodate the claim due to the guideline threshold. The investment manager will sometimes have to cover the debit for the client, despite not having caused the settlement fail and with few avenues for financial recourse.

Competing local laws

Some countries world-wide have differing local laws which may impact CSDR cash penalties.

For example, some KVG funds in Germany may insist on a EUR 5 debit cash penalty being reimbursed as they argue they cannot bear debits under local laws, despite the operational costs and custody fees being much higher than the reimbursement value and leading to an overall negative impact. Different jurisdictions may dictate or allow for different approaches, making it difficult to set a default approach.

Custodian/Prime broker approach

In view of the above, some of the custodians in the more sensitive jurisdictions offer to take all cash penalties, so nothing reaches the end investor.

For entities largely receiving net credits of cash penalties this may seem counter-intuitive, but often this offer is seen as favourable as it removes to operational burden and consideration of the above sensitivities from the asset manager and end investor.

In the same vein, it is frequent to observe that small and medium sized asset managers prefer to give up their potential credits to their custodian. This situation occurs when the asset managers assess that its potential credit represents less than ca. EUR 300k yearly (i.e. EUR 25k monthly) of monitoring costs. This threshold would need to be assessed with more accuracy and confirmed. Based on recent industry feedback it would be composed of

1. Staff cost (operations, treasury, accounting, regulatory): EUR 150k yearly
2. IT costs (systems, disclosures, prospectus): EUR 100k yearly
3. Custodian costs (reconciliations, transfers): EUR 50k yearly

Hence, the asset manager is not keen on investing this amount of money to receive a credit amount inferior to its investment in the above monitoring costs.

[1] https://www.afme.eu/Portals/0/CSDR%20Settlement%20Discipline%20-%20Bilateral%20Penalty%20Claims%20January%202022%20.pdf?ver=2022-01-27-093047-930

Competing considerations

A firm's approach is then further coloured by other competing considerations:

- Treating all clients equally/fairly.
- Preventing undue costs. In some cases, either of a cash penalty debit or the investigation and reimbursement itself could be considered an undue cost.
- Protecting client assets (it is unclear if a CSDR cash penalty is a client asset).
- The differing approaches of any custodians & prime brokers up the chain.

5. Scenarios

Below are two scenarios with regards to CSDR cash penalties, showing some of the potential negative outcomes to the end investor. Though they are designed with an asset manager-client relationship in mind, it could reflect any relationship where the party processing the penalty is not purely transmitting the penalty.

These scenarios are also discussed with the generally shared observation that the buy-side accounts are in net credit.

Scenario A

Scenario A looks at a situation where the end investor account has suffered a debit that is not subject to a bilateral claim (e.g. the custodian or manager are genuinely at fault).

"Correct direction" low value cash penalty of EUR 5.00		
1. Account (e.g. pension fund) sees 100 CSDR cash penalties over a month, with 80 credit re-distributions and 20 debit penalties.		
2. Account is net credit for EUR 500 on the monthly payment, with the 100 penalty values ranging from EUR 0.50 to EUR 100		
3. Considering one payment of EUR 5.00 amongst the rest:		
Potential approaches		**Outcome**
Don't investigate / reimburse	Due to low value of EUR 5, value is not investigated or reimbursed	- End investor may suffer debit when not at fault.
Investigate & don't reimburse	Investigate debit to client. Value is not reimbursed as value < custody fees	- End investor suffers debit when not at fault. - Additional operational costs which may be passed to the account
Investigate & reimburse	Investigate value and reimburse as client was not at fault for EUR 5.00 penalty	- End investor suffers higher custody fee than cash penalty - Additional operational costs which may be passed to the account

In looking at reimbursement of a debit for which the end account is not at fault, entities face the above considerations, with all the options taken leaving some possible negative outcomes.

Whilst this scenario has been considered with a debit as focus, it could equally consider a small credit which may or may not be due to the end investor.

Scenario B

Scenario B - "Incorrect direction" penalty		
1. Entity 1 (broker) provides correct SSIs to entity 2 (investment manager/end investor) only after settlement date.		
2. Entity 2 last to amend trade and CSD therefore sees entity 2 at fault		
3. Entity 2 suffers the "incorrect direction" CSDR debit, whereas entity 1 who is at fault, receives the credit.		
Penalty level	**Likely scenarios/resolution**	**Outcome**
If penalty > EUR 500	Entity 2 will investigate penalty with custodian and broker and negotiate with entity 1 for reimbursement of the cash penalty	Significant operational effort to be net flat.
If penalty < EUR 500	Entity 2 may investigate and attempt reimbursement of penalty but broker will likely refuse and point to the AFME EUR 500 threshold. Either IM or end investor to absorb debit	End investor or IM suffers debit when not at fault.

When looking to resolve an incorrect direction penalty, the bilateral claims document of AFME will come into force. This recommends a de-minimis threshold of EUR 500 for parties looking to initiate a bi-lateral claim and only seeks to reclaim the value of the penalty, leaving both accounts net flat.

This means for any “incorrect direction” cash penalties below EUR 500, the party genuinely at fault will receive a credit and will benefit from causing the settlement fail as they may not agree a bilateral claim below this figure, but the penalty will still be processed by the CSD.

6. Counterarguments

The disincentive aspect

It’s acknowledged that the CSDR settlement discipline regime is designed to bring down all fails, and not just those above a certain threshold. Whilst it could be argued that installing a de-minimis may remove the incentive for the biggest offenders to improve their processes, the counterargument is that these will not be prioritised for resolution anyway. Brokers, who we understand may be facing large numbers of net debits comprised of an array of values, are likely to have a relatively high threshold to write-off low value cash penalties and will look to resolve and solve for the larger values.

We appreciate too, that some of the operational impact of processing these penalties could be a further deterrent behind settlement fails, but these are also felt by some of the entities being failed into who may have little influence in resolving the root cause of the settlement fail.

Easing the operational pressure by introducing a de minimis, thereby removing the operational pressure of investigating, processing and reconciling cash penalties faced may give firms the capacity to further investigate and solve for root cause and better improve settlement rates.

Complexity of implementation

We appreciate that introducing another facet to a regime the CSDs have already found difficult to implement may seem counter-intuitive in seeking a more operationally proportionate model. We

believe, however, that any system infrastructure efforts that have to be undertaken by CSDs would be far less than the amount of time spent on low value credits or debits by entities across the spectrum.

A particular area of focus may be reference prices, where trades failing within an ICSD often uses a different reference price and therefore has a different CSDR cash penalty value to that of a local CSD; with a de-minimis possibly creating a scenario where an entity in the middle of a settlement fail chain charged a cash penalty but doesn't receive from the ongoing failing party. This, however, is already a problem that needs to be solved, with a de-minimis merely highlighting the issue further.

Account is net credit

It may also seem counter-intuitive to raise this if the buy-side and their clients are largely net credit. This may also be considered in a few ways:

- It is preferable to have no transactions rather than to receive a credit where the end investor has not been inconvenienced and an offsetting debit where the end investor is not at fault and which could potentially be seen as "harmful".
- Depending on the size of the net penalty and the values that comprise it, it is often more expensive to process an immaterial credit than to take the choice away altogether.
- The non-failing party has not been impacted by the fail of the original trade, so should not be presumed to be due the net credits of these trades.

To this point, it's worth highlighting the point made by the European Central Bank (ECB), in observing that the settlement discipline regime should be based on the principle of proportionality and that the *"review of the settlement discipline regime should take as its starting point the aim of sanctioning only those settlement fails that result in adverse financial effects for the counterparty of the failing party"*[2].

Introduction of an industry de-minimis like the AFME bilateral claim guideline

A possible option for all industry entities is to create guidelines that suggest not investigating and automatically posting anything below a certain value (e.g. EUR 500 as used in the bilateral claim guidelines), rather than CSDs withholding payment.

This would not be as effective as entities in different worldwide jurisdictions will have different requirements based on domestic laws which require actions if the values are posted. Similarly there would be many different approaches on what any threshold may be if it came from industry bodies, whereas it would have to be adhered to if it comes from legislators and regulators.

Finally, it may still include situations where the end investor suffers debits where they are not at fault, even if they are for a relatively low value. This is clearly something that should be prevented.

[2] https://www.ecb.europa.eu/pub/pdf/other/en_con_2022_25_f_sign~5d1a092f24.en.pdf

7. Conclusion

With the above in mind, we believe the introduction of a de-minimis for CSDs to apply to cash penalties before processing them would provide a more operationally proportional system, whilst still providing sufficient incentive to improve the settlement infrastructure within European CSDs.

Whilst a de-minimis will not solve for all the issues outlined in this document, and there may still be manual investigations and negotiations necessary; the penalties remaining will be of sufficient size to make investigating and processing the credits operationally viable to those bring failed into and of sufficient size to continue to make the debits a disincentive to those that are failing.

Other legislation adopted across European markets take into account operational proportionality. An example of this is EMIR uncleared margin requirements, where initial margin only needs to be posted once a trading entity reaches a defined notional amount of derivatives (EUR 8bn) and only once a sufficient minimum margin calculation has been reached (EUR 50mm). We believe CSDR would benefit from a similar consideration.

We would welcome the data from ESMA and further collaboration across all market stakeholders to discuss on whether they agree for a de-minimis and on what the best value is for it to be set at as there are cases for a few different values.

- *A threshold of **EUR 500** may remove some of the negative scenarios incurred under scenario B, where a party not at fault suffers an unrecoverable debit, but it is also possibly too high to provide a disincentive for a significant number of trades.*

- *A threshold of EUR **25-50** may be more akin to custody processing fees but some of the negative impacts in this document may still be seen (such as an "incorrect direction cash penalty of < EUR 500 in scenario B).*

- *The market may still find a de-minimis of **EUR 5-10** useful, but this may still leave values lower than custody fees and may diminish the value of a de-minimis in the first place.*