

The AFG federates the asset management industry for 60 years, serving investors and the economy. It is the collective voice of its members, the asset management companies, whether they are entrepreneurs or subsidiaries of banking or insurance groups, French or foreigners. In France, the asset management industry comprises 700 management companies, with €4600 billion under management and 102,000 jobs, including 27,000 jobs in management companies.

ESMA launched a [Consultation Paper](#) (CP) on December 15th, 2023 proposing different options to amend the existing penalty mechanism under [Regulation \(EU\) n° 909/2014](#) (CSDR). Settlement efficiency is an important subject for AFG members which have implemented the CSDR penalty mechanism for a few years now. We support regulatory efforts to further improve it through adequate measures of which penalties are one.

As such, we want to thank ESMA for the opportunity to raise our views on this CP. This paper is meant to accompany our response with our key messages below.

I- ACCESS TO RELEVANT DATA

In its CP, ESMA indicates that it hasn't got sufficient data at its disposal and mentions that a more detailed impact analysis will be published at a later stage. The authority also requires CSDs to provide data and trends through the CP. Despite lacking data, ESMA proposes significant changes to the penalty mechanism.

The penalty mechanism demanded great efforts from the industry in terms of cost and operational processes and still today in the processing of penalties. We therefore believe that proposing changes to the penalty rates and introducing new features must respond to a clear need and based on relevant data and on a thorough impact assessment which is not available at this stage.

Furthermore, cash penalties have been effective since February 2022 and in the meantime, we have had market events that do not allow us to have a clear picture of the impacts of the mechanism on the reduction of fails. However, we have noted a slight decrease of fails during that period and we can certainly conclude that the introduction of penalties forced the industry to take interest in the level of settlement efficiency and forced them to invest in resources improving their settlement processes. To see if this positive trend is in fact due to the mechanism, we would need a longer period of observation and relevant data in our possession.

More broadly, the penalty mechanism needs to be assessed considering the root causes of fails to be able to address them properly. We see three main causes for fails related to: (i) structural, (ii) operational and (iii) behavioural factors. Penalties play as an incentive to prevent and address failures in the settlement of securities transactions by sanctioning a party who's at the origin of a default. Such mechanism seems less useful or even inadequate where a settlement fail cannot directly be attributed to the parties' behavior.

Data will allow us to understand these causes and address them in the best possible way, which might not necessarily be by increasing penalty rates.

II- NECESSITY TO MAINTAIN A SIMPLE, EASILY IMPLEMENTABLE MECHANISM

ESMA proposes a total review of the mechanism with new structural features such as convexity, progressivity, and a high raise in the level of rates (600% and even higher in some cases). As already mentioned, this proposal is too much of a change considering the lack of data at our disposal and the lack of sufficient hindsight and could have damaging effects on the liquidity and on the EU's

competitiveness and on principles such as the immunisation of parties (imbalance between what is paid and received notably with the introduction of progressivity and in case of partial settlement).

The buy-side, who's generally net recipient of the cash penalties, is faced with demanding efforts to process these penalties that are usually of short periods (1 or 2 days) and of low amount.

Overall, the mechanism must be based on the existent, remain simple, easily explainable and easy to implement. Indeed, its necessary that all parties along the chain understand the aim of penalties, their functioning and how they are calculated.

Furthermore, the mechanism must be flexible enough so that if penalty rates are found to have adverse impacts on the level of efficiency, they can be modified without waiting for a 3-year level 1 review. Introducing progressivity/convexity/extreme rates would imply a gigantic market project which does not respond to this overall objective to get quick positive results on the level of settlement efficiency.

As an alternative approach to what is considered by ESMA, it might be interesting to reflect on the opportunity to introduce a de minimis threshold set at CSD level and by which the CSD would withhold cash penalties where the value of the penalty does not reach a certain amount. If introduced, it is however essential to maintain an analysis of responsibility, to ensure that market participants who fail on a regular basis but never cross the threshold because of the low value of their fails, are still identified at CSD level.

III- OTHER TOOLS THAT SHOULD BE ENVISAGED

Raising the level of penalties is probably not the only tool that should be considered. We rather need to focus on the structural causes of fails and consider other more appropriate tools.

Indeed, settlement efficiency cannot only be measured by behavioral aspects but must consider the impacts our fragmented market can have, the level of liquidity the efficiency of IT processes etc.

If penalties are a great tool to resolve behavioral fail, they aren't always adequate. Discussions should also be focused on auto-partial settlement and hold & release functions that must be deployed through all CSDs and jurisdictions in a harmonized manner and be facilitated for market participants. Furthermore, although a high degree of improvement has been made in that way, we should focus on continuing to improve automatisations and avoid manual interventions. Notably a more dynamic way of updating SSIs, harmonising holding policies and allowing a better realignment of positions when acting at cross-border level should be envisaged.

IV- OTHER CONSIDERATIONS

ESMA's options would take time to implement as it requires a complete change of paradigm. We can see that the penalty mechanism's effects are not yet fully visible we therefore need to leave it more time to prove itself.

Finally, if amending the current mechanism, ESMA must keep in mind other ongoing or future project and notably the move to T+1 in the US and the potential move by the EU (see. [Commissioner Mairead McGuinness' speech at the Commission's roundtable on the shortening of the settlement cycle in the EU](#)). Indeed, in addition to investment constraints, reducing the settlement cycle might, at least on a short term, have damaging effect on the level of efficiency due to an increased number of fails. In a long term, we might see positive impact because of the obligations for parties to automate their processes in order to respect new market deadlines. In any case, other regulations might have an impact on settlement efficiency (might it be positive or negative) and must be considered to avoid contradictions and to help prioritise between projects.

