

CENTRAL SECURITIES DEPOSITORIES REGULATION (CSDR) – SETTLEMENT DISCIPLINE



**FOR FINANCIAL INTERMEDIARIES
AND INSTITUTIONAL INVESTORS**



BNP PARIBAS

The bank
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world

FOREWORD

Central Securities Depositories (CSD) Regulation (CSDR) affects all market participants, wherever located, active in securities settling in European CSDs (including ICSDs). It affects both direct and indirect CSD participants (including CCPs and settlement agents) and both buy and sell-side institutions.

We have closely worked with local and European industry associations (e.g. The Association for Financial Markets in Europe (AFME), the Association of Global Custodians and the European Banking Federation), as well as CSD working groups and user committees, to ensure a consistent and pragmatic implementation of CSDR.

In 2017, we launched a global program to implement CSDR within BNP Paribas Securities Services, including:

- CSD/ICSD requirements and re-authorisation, including but not limited to, record keeping and use of the LEI (Article 29¹), segregation (Article 38), reconciliation (Article 37), CSD participant default rules and procedures (Article 41), operational risk monitoring (Article 45), collateral usage and intraday credit (Article 59) and CSD links
- Internalised settlement reporting (Article 9)
- Settlement discipline regime (SDR), including affirmation/confirmation (Article 6), settlement penalties (Article 7) and buy-in management (Article 7)

With the implementation of the settlement discipline regime (SDR) fast approaching, we are issuing the second edition of our CSDR handbook to share our insight on SDR and its implications for our clients.

We have engaged with clients since the publication of the final SDR text and through this collaborative approach we have scoped changes to our service to support our clients' adaptation to CSDR.

We believe settlement efficiency is key to meet the requirements of SDR. Hence, we are creating a CSDR toolkit for our clients that will describe the best settlement practice (including SWIFT templates) for improving efficiency. We hope this handbook, along with our **CSDR toolkits** will help you prepare for the changes ahead.

¹ Details of this and all other CSDR Articles mentioned in this paragraph can be found in the text of the regulation at the following link: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0909>

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CSDR – WHAT, WHY, WHEN AND WHO

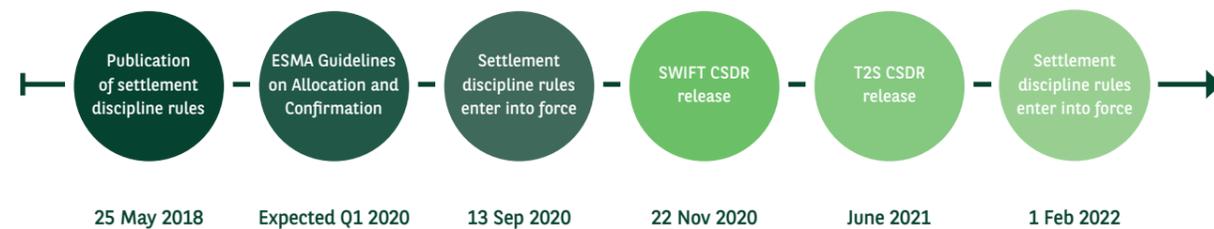
CSDR is European regulation No 909/2014² and aims to improve securities settlement in the EU and within its central securities depositories (CSDs). It applies to all CSDs domiciled in the EU, along with those of Iceland, Liechtenstein and Norway (as incorporated in the European Economic Treaty). Switzerland is subject to certain CSDR provisions via a bilateral agreement. It is expected to apply in the UK throughout any Brexit transitional period.

CSDR is one of several cumulative regulations and actions taken by the European authorities to improve post-trade harmonisation, safety and efficiency, and to enhance the legal and operational conditions for cross-border settlement. It includes actions to reduce and harmonise settlement cycles and to ensure dematerialisation after 2025. It is another brick in the wall.

Its main provisions are:

- Creating a regulatory and prudential regime for CSDs
- Increasing the robustness and resilience of securities settlement arrangements
- Creating a single market for CSD services

CSDR timeline



CSDR has many implications for our clients. These can be broadly categorised as resulting from extended CSD requirements, internalised settlement reporting and the settlement discipline regime.

This handbook focuses on the settlement discipline regime. In our first edition of the CSDR handbook, we provided a brief update of the extended CSD requirements and internalised settlement reporting. For more details, please see the first edition of the CSDR handbook.

<https://securities.bnpparibas.com/insights/csd-r-handbook.html>

² <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0909>

Extended CSD requirements

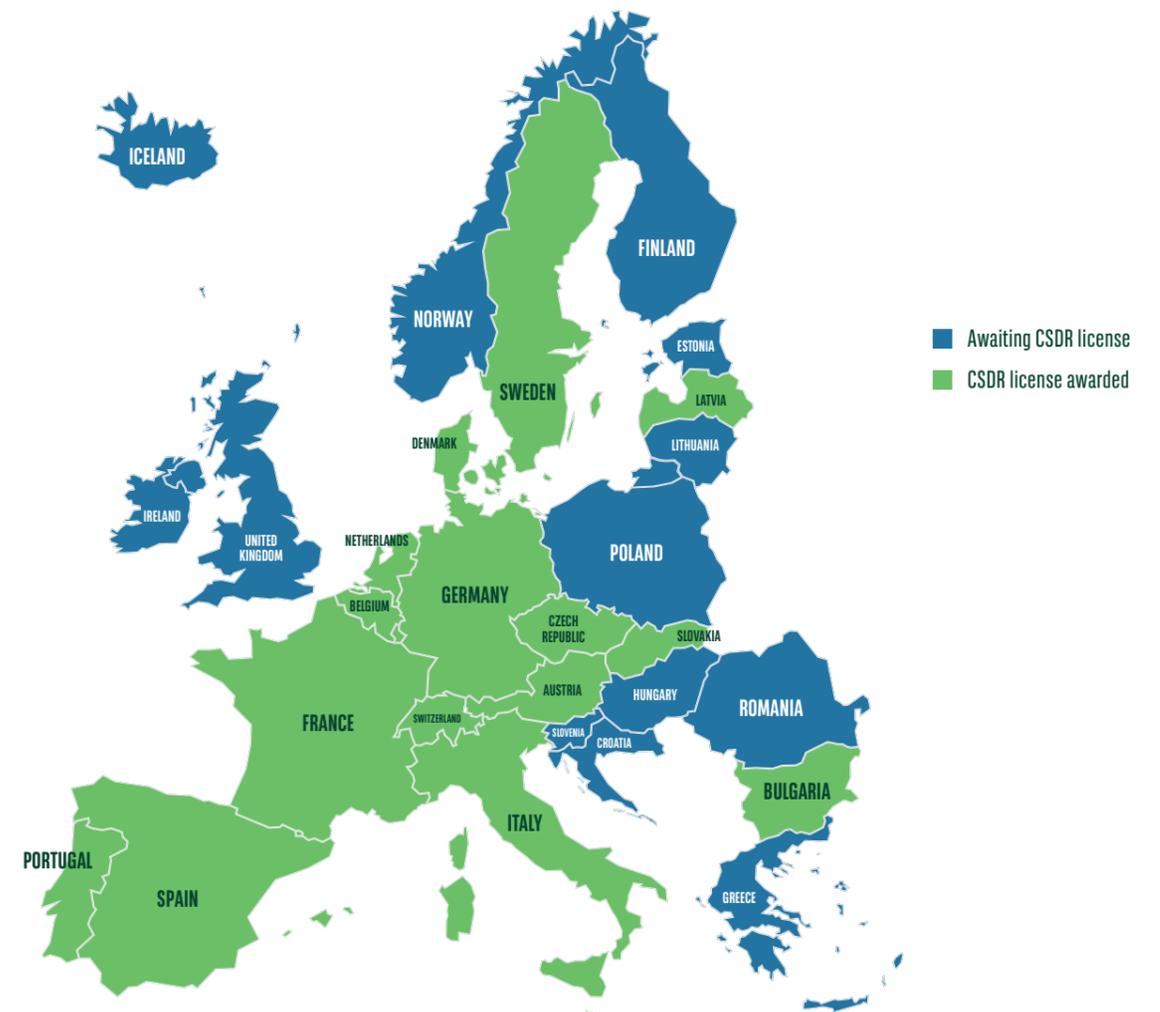
CSDR primarily addresses the regulation of CSDs. It does so through providing:

- Strict prudential, organisational and conduct of business rules for CSDs
- Strict access rights to CSD services
- Increased prudential and supervisory requirements for CSDs and other institutions providing banking services ancillary to securities settlement
- Protection of securities of CSD participants and their clients
- Enhanced legal and operational conditions for cross-border settlement

Under CSDR, each European CSD, including the ICSDs, was required to apply to their National Competent Authority (NCA) for re-authorisation. We are closely monitoring the re-authorisation process with all CSDs. The list of CSDs authorised so far can be found on the ESMA website.

https://www.esma.europa.eu/sites/default/files/library/esma70-151-889_csd_register.pdf

Authorisation of CSDs in Europe under CSDR



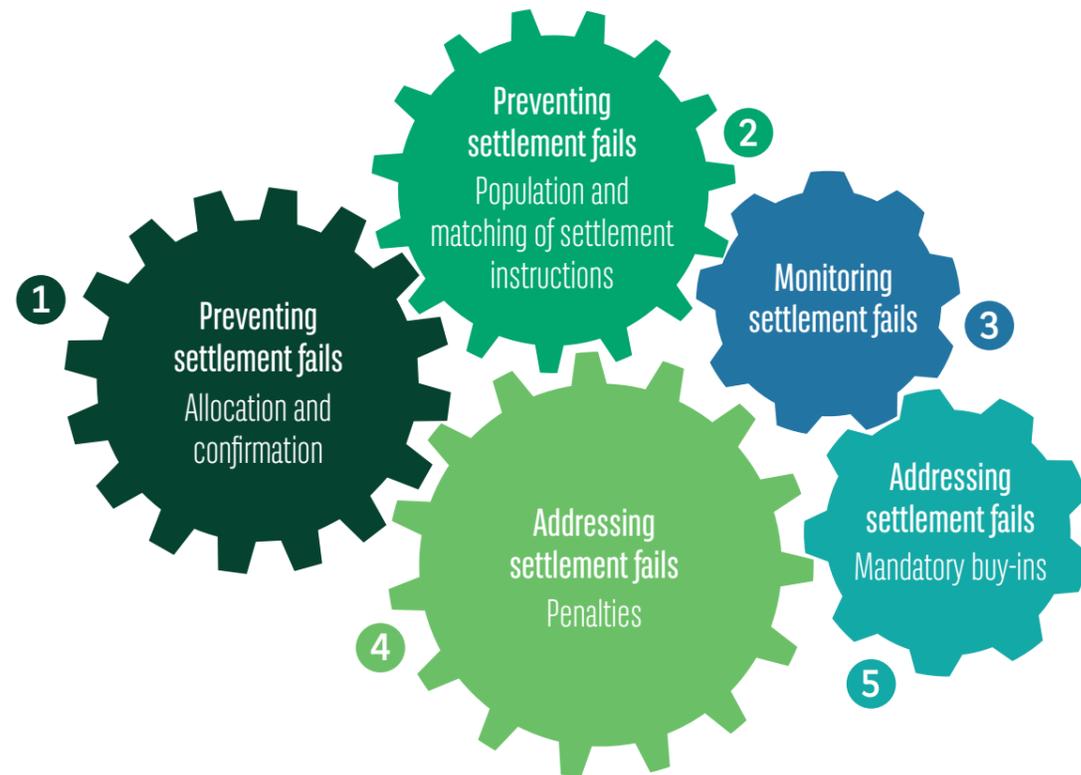
Internalised settlement reporting

CSDR Article 9 provides that settlement internalisers (any institution which executes transfer orders on behalf of clients or on its own account other than through a securities settlement system) report to the NCA of their place of establishment, on a quarterly basis, the aggregated volume and value of all securities transactions which they settle outside securities settlement systems.

Settlement internalisers were required to send the first report to their NCA by 12 July 2019 for the period from 1 April 2019 to 30 June 2019. Now these reports are sent on a quarterly basis.

SETTLEMENT DISCIPLINE REGIME

Settlement discipline regime (SDR) affects all market participants. It harmonises aspects of the settlement cycle and introduces new rules for cash penalties and buy-ins. Trading parties, central counterparties (CCPs) and trading venues will also be impacted and will have to directly comply with all measures relating to cash penalties for settlement failures and mandatory buy-ins.



1. Preventing settlement fails – allocation and confirmation

CSDR Article 6 provides that MiFID II investment firms shall take measures to limit the number of settlement fails by ensuring that, in good time before the intended settlement date, they have arrangements with their professional clients for:

- The prompt communication of the allocation of securities for the transaction
- The confirmation of that allocation
- The confirmation of the acceptance or rejection of terms of the transaction

Delegated Regulation 2018/1229³ provides for professional clients of MiFID II investment firms to send the written allocation and confirmation electronically. It also provides for:

- Timeframe for issuance:
 - Written allocation and confirmation required by close of business on the same day on which the transaction has taken place or by 12.00 CET on the following business day
 - Written confirmations to be issued within two hours of receipt of the written allocation
- Content, including, but not limited to:
 - Type of transaction (i.e. purchase or sale of securities, collateral management, securities lending/borrowing, repurchase or other transactions) in a ISO format/code
 - Standard settlement instructions (SSI) (i.e. the identifier of the entity where either the cash or the securities are held and the names and number of the securities/cash accounts to be credited/debited)

2. Preventing settlement fails – population and matching of settlement instructions

Delegated Regulation 2018/1229 defines:

- The full list of matching criteria to be introduced by CSDs
- The transaction types that CSDs shall require their participants to use
- The tolerance level to be introduced by CSDs (i.e. €2 for settlement amounts of up to €100,000 and €25 for settlement amounts of more than €100,000⁴)

ESMA also requires CSDs to:

- Set up a bilateral cancellation facility for matched transactions
- Offer continuous real-time matching
- Set up hold and release mechanisms
- Recycle settlement instructions that resulted in a settlement fail
- Allow for partial settlement



Changes will be required to both SWIFT settlement instruction templates (MT540-3) and how they are processed along the custody chain.

³ https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2018.230.01.0001.01.ENG&toc=OJ:L:2018:230:TOC

⁴ For settlement instructions in other currencies, the tolerance level per settlement instruction shall be of equivalent amounts based on the official exchange rate of the ECB, where available.

3. Monitoring settlement fails

CSDR Article 7 provides that each CSD shall establish a system that monitors settlement fails of transactions in financial instruments and provide regular reports to its NCA, as to the number and details of settlement fails and any other relevant information, including the measures to be taken by CSDs and their participants to improve settlement efficiency.

To monitor settlement fails, each CSD will be required to gather information, including but not limited to:

- The type of transaction (i.e. purchases and sales, securities lending and borrowing, collateral, repo and other)
- The type of settlement instruction (i.e. free of payment, versus payment, with payment and payment free of delivery)
- The type of securities account connected to the fail transaction (participant's own account, participant's client individual account and participant's client omnibus account)



CSDs are required to report to their NCA the ten participants with the highest rate of settlement fails in the month covered by their report.

Although the exact formula to identify the CSD participants with the highest rate of fails is yet to be defined by the CSDs, it is understood that it will be calculated per CSD participant's LEI by adding the number (or value) of all matched instructions that failed to settle on the intended settlement date ISD (including late matching fails) divided by the total number (or value) of settled instructions.



Clients are encouraged to analyse their settlement behaviour including fail reasons, patterns and late matching situations at the level of their underlying clients. Additionally, clients are encouraged to clean up their "aged" failing instructions prior to SDR entering into force.

4. Addressing settlement fails – penalties

CSDR Article 7 provides that each CSD shall establish procedures to facilitate the settlement of transactions in financial instruments that are not settled on the intended settlement date. These procedures shall provide for a penalty mechanism which will serve as an effective deterrent for participants that cause settlement fails.

Cash penalties for settlement failure will be calculated and applied as follows:

- To matched instructions, even if on hold
- Calculated daily and collected monthly with participants notified of details on a daily basis
- Redistributed to the receiving participants that suffered the fail on a net basis monthly, with participants notified of details on a daily basis

5. Addressing settlement fails – mandatory buy-ins

CSDR Article 7 provides that a buy-in process shall be initiated if a failing participant does not deliver the financial instruments to the receiving participant within four business days of the intended settlement date (the 'extension period'). Where the transaction relates to a financial instrument traded on a Small and Medium-sized Enterprises (SME) growth market, the extension period shall be 15 days unless the SME growth market decides to apply a shorter period.

There are some exemptions:

- The extension period may be increased from four business days up to a maximum of seven business days depending upon the asset type and liquidity of the financial instruments concerned
- For operations composed of several transactions, including securities repurchase or lending agreements, the buy-in process shall not apply if the intended settlement date (ISD) of the second transaction is set within 30 business days after the ISD of the first transaction

These exemptions shall not apply to transactions for shares cleared by a CCP.

SDR SCOPE

This overview of the instruments, transactions and CSDs in scope of SDR is our own interpretation of the regulation and recommendations informed through discussions in the industry task forces we have engaged in.

Participants

CSDR affects all market participants, wherever located, which are active in securities that settle within a European CSD (including ICSDs). It will affect both direct and indirect CSD participants (including CCPs and settlement agents) and both buy and sell-side institutions.

CSDs

All European CSDs, including ICSDs, are in scope. ESMA maintains a list of such CSDs on its website:

https://www.esma.europa.eu/sites/default/files/library/esma70-151-889_csd_register.pdf.

Instruments

There is not an agreed list of instruments in scope. Whilst we are waiting for ESMA's confirmation, we believe the following instruments to be in scope, as defined in the ECSDA⁶ framework:

- All CSD-eligible MiFID II/MIFIR financial instruments:
 - Admitted to trading or traded on a EU trading venue or
 - Cleared or eligible for clearing by a EU CCP
- Excluding shares when their principle trading venue is located in a third country

The relevant MiFID II/MIFIR financial instruments types are:

- Transferable securities [i.e. equity-and bonds (like) instruments (including ETFs) and securities giving a right to buy or sell any of those]
- Money market instruments
- UCITS
- Emission allowance

⁵ The European Securities and Markets Authority (ESMA) is the European Union financial regulatory agency and European Supervisory Authority

⁶ European Central Securities Depositories Association (ECSDA) is the official association of the Central Securities Depository industry in Europe



We recommend clients use the “Classification of Financial Instrument (CFI)⁷” code to compile the universe of instruments in scope.

Transactions

Cash penalties will apply to all matched settlement transactions that fail to settle on intended settlement date. We believe the following transactions are out of scope (although we await confirmation from ESMA):

- Settlement transactions that do not represent “transfer orders” according to the Settlement Finality Directive
- Corporate Action transactions on stocks
- Technical instructions (e.g. T2S automatic realignments)

If a failing trading party does not deliver the financial instruments to the receiving trading party, a buy-in should be initiated. ESMA is still to confirm the list of transactions in scope. However, based on our interpretation of the regulation and recommendations discussed in the industry task force we have engaged in, we believe the following transaction types to be subject to buy-ins:

- Purchases and sales
- Securities lending transactions⁸
- Repurchase transactions⁹
- Collateral transactions

All other transactions which do not represent a “trade” (e.g. portfolio transfers) should not qualify for a buy-in since the buy-in would not be an effective way to discharge the obligations of the parties. However, further clarification is expected from ESMA in the upcoming months.



Clients should include the transaction type in their settlement instruction, using the relevant codes in qualifier 22F::SETR// in sequence E of the MT540-3 SWIFT messages or in the equivalent field in Neolink.

LIFECYCLE OF A FAILING TRANSACTION POST-CSDR

Considering the post-CSDR lifecycle of a settlement transaction illustrates the impact that SDR will have and provides an overview of changes that clients will need to implement to comply (according to our own interpretation of the regulation and recommendations agreed in the industry task forces we have engaged in).

In this example, we consider a failing transaction in a liquid share which has been traded over the counter (OTC) with a t+2 settlement cycle.

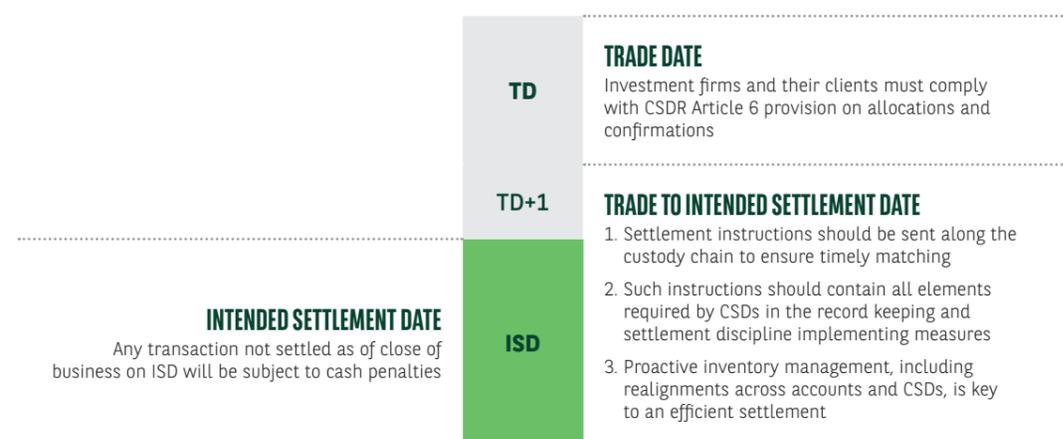
⁷ <https://www.anna-web.org/standards/cfi-iso-10962/>

⁸ For operations composed of several transactions, the buy-in process shall not apply if the intended settlement date (ISD) of the second transaction is set within 30 business days after ISD of the first transaction

⁹ For operations composed of several transactions, the buy-in process shall not apply if the ISD of the second transaction is set within 30 business days after the ISD of the first transaction

	TD	TRADE DATE Investment firms and their clients must comply with CSDR Article 6 provision on allocations and confirmations
	TD+1	TRADE TO INTENDED SETTLEMENT DATE 1. Settlement instructions should be sent along the custody chain to ensure timely matching 2. Such instructions should contain all elements required by CSDs in the record keeping and settlement discipline implementing measures 3. Proactive inventory management, including realignments across accounts and CSDs, is key to an efficient settlement
INTENDED SETTLEMENT DATE Any transaction not settled as of close of business on ISD will be subject to cash penalties	ISD	
The extension period is defined as four business days from the ISD	ISD+1	EXTENSION PERIOD 1. During this time, any failing transaction will continue to accrue daily penalties
Where a transaction relates to a financial instrument traded on a SME growth market, the extension period shall be 15 days unless the SME growth market decides to apply a shorter period	ISD+2	2. On the final day of the extension period (e.g. ISD+4 for liquid shares), the receiving party is mandated to accept any partial delivery offered
The extension period may be increased to a maximum of seven business days depending upon the asset type and liquidity of the financial instruments concerned	ISD+3	3. Partial settlement and fail coverage is key to reduce the risk of buy-in
	ISD+4	
	ISD+5	BUY-IN PERIOD 1. At the end of the extension period, the receiving trading party is mandated to assess if the buy-in is possible
The buy-in period (intended as the timeframe for the delivery of the financial instruments) is defined as: Four business days after the extension period for shares that have a liquid market	ISD+6	2. If the buy-in is not possible, the receiving trading party shall request the failing trading party to pay the cash compensation. If the buy-in is possible, the receiving trading party will need to initiate the buy-in by appointing a buy-in agent on ISD+5
Seven business days after the extension period for financial instruments other than shares that have a liquid market	ISD+7	3. If the buy-in is successfully executed, the receiving trading party is to inform the CSD, via the chain of custody, without delay
Seven business days after the extension period for financial instruments traded on SME growth markets	ISD+8	4. If the buy-in is unsuccessful or only partially successful, the receiving trading party is to decide whether to defer or receive a cash compensation
CASH COMPENSATION (POST BUY-IN PERIOD)	ISD+9	
	ISD+10	DEFERRAL PERIOD (OPTIONAL) Where the buy-in is unsuccessful or only partially successful, the receiving party can decide to defer the buy-in for another window of four or seven business days depending on the financial instrument
The length of the deferral period is the same as detailed above for the buy-in period	ISD+11	
	ISD+12	
CASH COMPENSATION (POST DEFERRAL PERIOD)	ISD+13	

Trade date to intended settlement date



Settlement instructions

Settlement instructions (MT540-543) should contain all elements required by CSDs, in line with ESMA provisions in the record keeping and settlement discipline implementing measures, as they may have an impact on the way penalties are calculated and/or determine whether a buy-in is applicable. These elements include, but are not limited to:

Transaction type – SETR

To enable CSDs to identify and classify the transaction types, settlement instructions need to include the relevant code in 22F::SETR//.

Based on our interpretation, the most frequently used transactions types are:

- Purchase or sale of securities (SETR//TRAD)
- Securities lending/borrowing (SETR//SECL and SETR//SECB)
- Repurchase (SETR//REPU, SETR//RVPO, SETR//TRPO, SETR//TRVO, SETR//BSBK and SETR//SBBK)
- Collateral (SETR//COLI, SETR//COLO and SETR//CNCB)



Clients' instructions should include the transaction type ISO code that most accurately reflects the underlying economics of the transaction. This is required to determine if a buy-in is applicable.

ESMA has not yet validated the list of codes. AFME has submitted a Q&A for clarifying which transaction types are out of scope of buy-ins (as a buy-in would not be an effective way to discharge the obligations of the parties).

Only some CSDs have published the list of SETR codes they will support post implementation of SDR. As of February 2020, the published lists of SETR codes are not aligned.

Place of clearing – CLEA

Settlement instructions related to cleared transactions, not instructed by the CCP (under power of attorney) should specify the place of clearing (94a::CLEA) to meet CSDs' record keeping requirements.

Place of trading – TRAD

Settlement instructions related to trades booked on a SME market will need the place of trading 94a:: TRAD//EXCH/ to allow the CSDs to apply lower penalty rates. The list of current authorised SME markets can be found on the ESMA website: https://registers.esma.europa.eu/publication/searchRegister?core=esma_registers_upreg

To view the full list, set the filter in selection field "SME" to "YES" and press "Search". To see the applicable MIC code, open the detailed view "More Info".

Static data and SSIs

Incorrect securities details and standing settlement instructions (SSIs) are a common cause of mismatching or late matching. Although CSDR and the implementing regulation do not mandate accurate reference data, a review of instrument data and SSIs will help improving settlement efficiency.



Including SSIs in the allocation and confirmation process should encourage investment firms to check they have the correct information for their clients.

Settlement efficiency

Market participants are encouraged to review their settlement efficiency to improve their matching and settlement rates and reduce the risk of penalties and buy-ins. This will be further encouraged by the CSDs reporting the ten participants with the highest rate of settlement fails to their NCAs.

Inventory management

The main reason for transactions not settling on their ISD is the lack of securities. As a result, we urge clients to proactively manage their inventory by:

- Reconciling their holdings with their settlement agent (paying particular attention to the place of safekeeping)
- Proactively realigning positions across CSDs and ICSDs and familiarising themselves with cross border procedures and deadlines
- Using the "hold and release" and "partial release" functionalities to reduce late matching fail penalties
- Utilising fails coverage programmes

Intended settlement date to the end of the extension period

	TD	TRADE DATE Investment firms and their clients must comply with CSDR Article 6 provision on allocations and confirmations
	TD+1	TRADE TO INTENDED SETTLEMENT DATE 1. Settlement instructions should be sent along the custody chain to ensure timely matching 2. Such instructions should contain all elements required by CSDs in the record keeping and settlement discipline implementing measures 3. Proactive inventory management, including realignments across accounts and CSDs, is key to an efficient settlement
INTENDED SETTLEMENT DATE Any transaction not settled as of close of business on ISD will be subject to cash penalties	ISD	
The extension period is defined as four business days from the ISD Where a transaction relates to a financial instrument traded on a SME growth market, the extension period shall be 15 days unless the SME growth market decides to apply a shorter period The extension period may be increased to a maximum of seven business days depending upon the asset type and liquidity of the financial instruments concerned	ISD+1 ISD+2 ISD+3 ISD+4	EXTENSION PERIOD 1. During this time, any failing transaction will continue to accrue daily penalties 2. On the final day of the extension period (e.g. ISD+4 for liquid shares), the receiving party is mandated to accept any partial delivery offered 3. Partial settlement and fail coverage is key to reduce the risk of buy-in

CSDR Article 7 provides that each CSD shall establish procedures to facilitate the settlement of transactions in financial instruments that are not settled on the ISD. These procedures shall provide for a penalty mechanism which will serve as an effective deterrent for participants that cause settlement fails.

To ensure such procedures are consistent across CSDs, ECSDA has published a CSDR penalties framework available at the following link: https://ecsda.eu/wp-content/uploads/2019/11/2019_11_Framework_Settlement.pdf

Settlement instructions matched prior to, on or after the ISD and failing to settle on or after the ISD, will incur penalties, even if on hold. Cash penalties will be applied as follows:

- A Late Matching Fail Penalty (LMFP) is applied if matching takes place after the ISD. Such penalties are applied once on the day the transaction is matched but calculated retroactively from the ISD until the actual matching date
- A Settlement Fail Penalty (SEFP) is applied to a non-settled matched transaction on or after its ISD. Once the settlement instruction is matched, penalties are applied from the earliest of the ISD or the matching date (when matching took place after the ISD and no settlement occurred on the matching date) to the date of actual settlement or cancellation of the instruction. SEFP is applied in addition to LMFP. Such penalties are applied daily for each business day the transaction fails to settle

Penalty Rates

CSDs will apply the ESMA penalty rates as explained below and published in the Delegated Regulation 2017/389¹⁰:

Type of fail	Rate
1. Settlement fail due to a lack of shares that have a liquid market within the meaning of point (b) of Article 2(1)(17) of Regulation (EU) No 600/2014, excluding shares referred to in point 3	1.0 basis point
2. Settlement fail due to a lack of shares that do not have a liquid market within the meaning of point (b) of Article 2(1)(17) of Regulation (EU) No 600/2014, excluding shares referred to in point 3	0.5 basis point
3. Settlement fail due to lack of financial instruments traded on SME growth markets , excluding debt instruments referred to in point 6	0,25 basis point
4. Settlement fail due to a lack of debt instruments issued or guaranteed by: (a) a sovereign issuer as defined in Article 4(1)(60) of Directive 2014/65/EU (b) a third country sovereign issuer (c) a local government authority (d) a central bank (e) any multilateral development bank referred to in the second sub paragraph of Article 117(1) and in Article 117(2) of Regulation (EU) No 575/2013 of the European Parliament and of the Council (f) the European Financial Stability Facility or the European Stability Mechanism	0.10 basis point
5. Settlement fail due to a lack of debt instruments other than those referred to in points 4 and 6	0.20 basis point
6. Settlement fail due to a lack of debt instruments traded on SME growth markets	0.15 basis point
7. Settlement fail due to a lack of all other financial instruments not covered in points 1 to 6	0.5 basis point
8. Settlement fail due to a lack of cash	Official interest rate for overnight charged by the central bank issuing the settlement currency with a floor of 0 (zero)

¹⁰ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017R0389>

Formulas to be applied for penalty calculation

Once a failing settlement instruction has been identified as subject to SEFP, the penalty will be calculated depending on:

- The type of transaction formed by the two matched settlement instructions using reference data
- The penalty rate of the ISIN or discount rate (Central Bank interest rate on cash) for the financial instrument exchanged by the transaction
- Whether the instrument is to be delivered to or received by the counterparty

When a settlement fail reason “lack of securities” has been identified by the CSD, no additional fail check for a “lack of cash” will be made by the CSD.

The following table summarises the basis for calculating the penalty amount for each type of transaction:

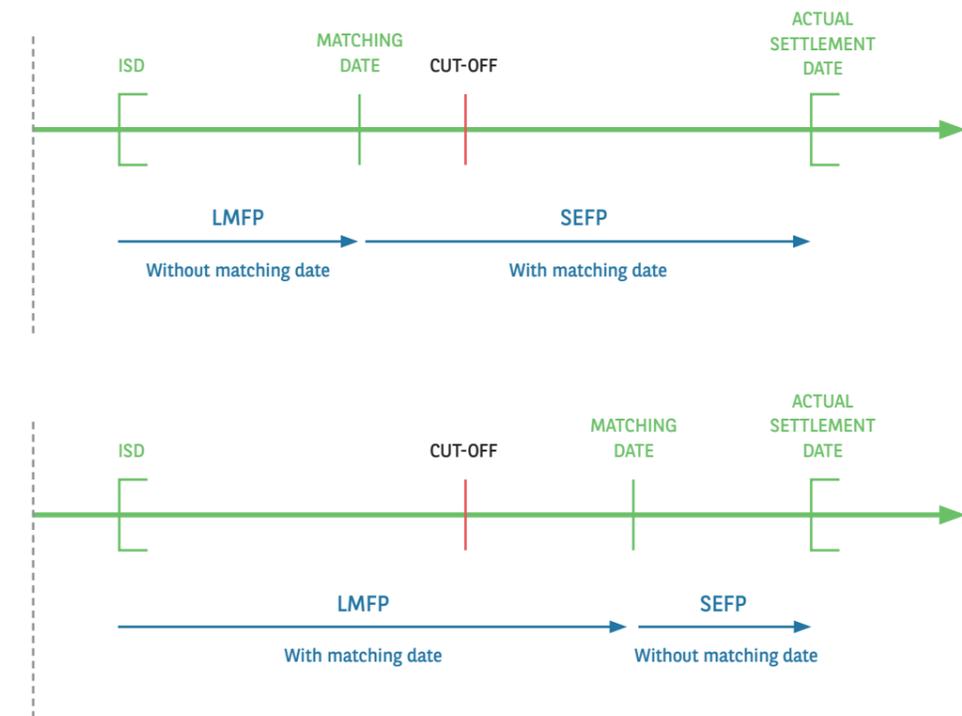
TYPE OF TRANSACTION	SEFP	CALCULATION METHOD	PARTY TO BE PENALISED
DELIVERING VERSUS PAYMENT (DVP) DELIVERING FREE OF PAYMENT (DFP) RECEIVING FREE OF PAYMENT (RFP)	Penalty based on the quantity of securities failed to be delivered and Security penalty rate of the relevant asset type	Security Penalty rate *Reference price *Quantity	Delivering party
RECEIVING VERSUS PAYMENT (RVP)	Penalty based on the quantity of securities failed to be delivered and the discount rate of the relevant currency	Cash Discount Penalty rate *Reference price *Quantity	Delivering party
DEBITING PAYMENT FREE OF DELIVERY (DPFOD) CREDITING PAYMENT FREE OF DELIVERY (CPFOD)	Penalty based on the amount of cash failed to be delivered and the discount rate of the relevant currency	Cash Discount Penalty rate *Cash Amount failed to be delivered	Receiving party
DELIVERY WITH PAYMENT (DWP) RECEIVING WITH PAYMENT (RWP)	Penalty will be the sum of: – Penalty based on the quantity of securities failed to be delivered and Security penalty rate of the relevant asset type; and – Penalty based on the amount of cash failed to be delivered and the discount rate of the currency	Security Penalty rate *Reference price *Quantity + Cash Discount Penalty Rate *Cash amount failed to be delivered	Both parties will be imposed with a SEFP (i.e. the delivering party will be charged with “lack of securities” penalties and the receiving party with “lack of cash” penalties)

For settlement instructions matched only after the relevant cut-off of their ISD, LMFP shall be calculated only once, on the business day when they are matched, but considering all the previous business days where the instruction failed to settle due to the late matching.

The LMFP is charged to the last participant to enter or modify the relevant settlement instruction, for the period between the ISD and the matching date of the instruction.

The number of days used in the formula to calculate the LMFP depends on whether the transaction can still settle on the business day when the instruction is matched or not:

- When the instruction can still settle on the business day when it is matched, the LMFP is calculated for each business day from the ISD until, and excluding, the business day when the instruction is matched.¹¹ The matching date is excluded from the LMFP and included in the SEFP
- When the instruction can no longer settle on the business day when it is matched, the LMFP is calculated for each business day from the ISD until, and including, the business day when the instruction is matched. The matching date is included in the LMFP and excluded from the SEFP



Clients are encouraged to analyse their settlement behaviour, including the practice of instructing back-dated trades, prior to SDR entering into force.

¹¹ In case the instruction does not settle on the business day when it is matched (even if it was possible because it arrived before the cut-off) then, a separate calculation will have to be performed for an additional SEFP

Examples of penalty calculation

Securities: delivery of 2,000 FIAT Chrysler Automobiles NV ordinary shares against a payment of €28,800.00.

CSD: Monte Titoli

Settlement status: the delivery failed due to the lack of securities for two business days after ISD.

As these are liquid shares, the applicable penalty rate is 1.0 bps.

The reference prices to be applied for the penalty calculation are: day 1, €14.70 and day 2, €13.93

The penalty is calculated as follows:

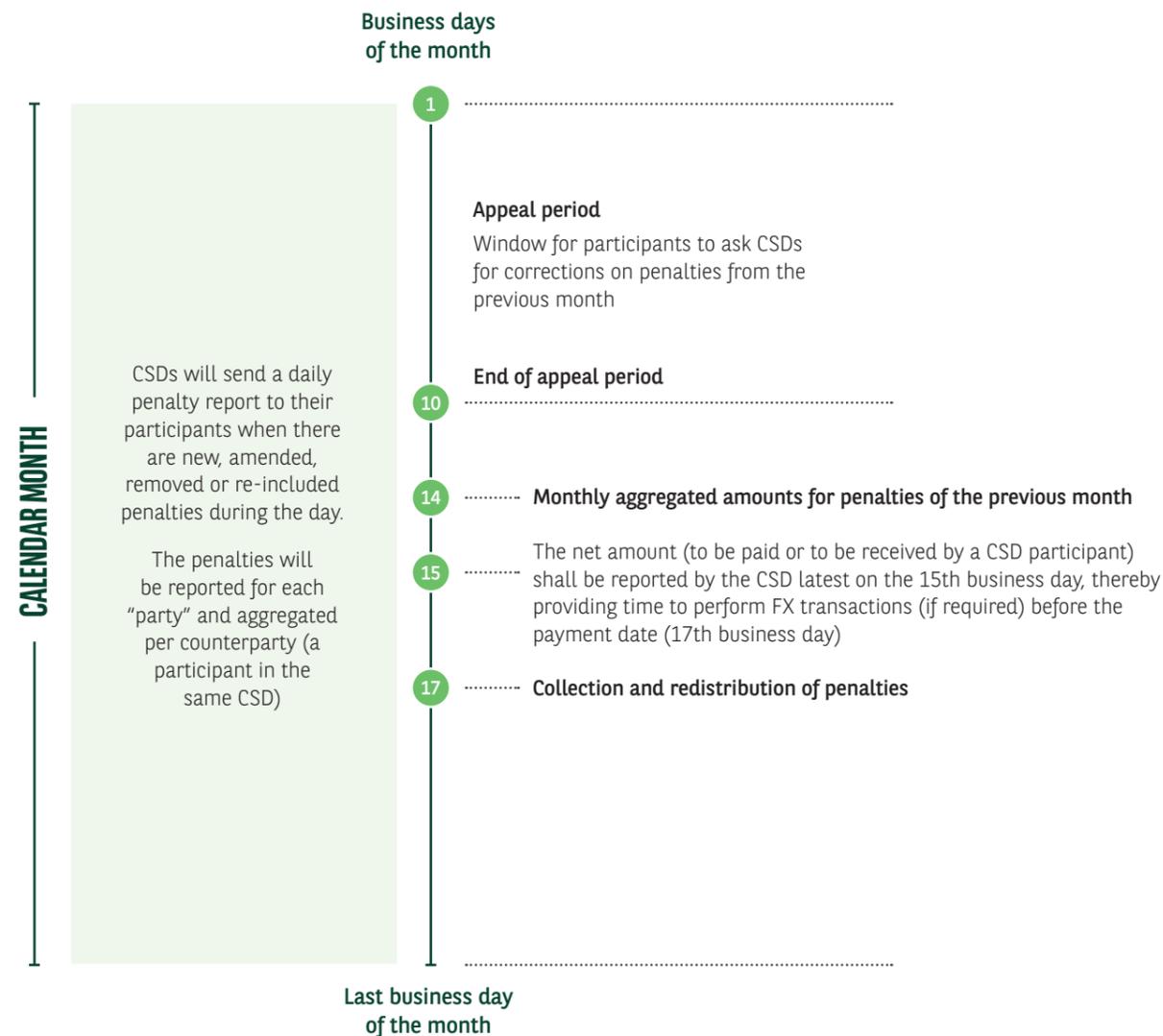
Penalty day 1: 2,000 shares x 0.01% x €14.70 = € 2.94

Penalty day 2: 2,000 shares x 0.01% x €13.93 = € 2.79

Total penalty amount = €5.73

The penalty is paid by the party failing to deliver the securities to the party suffering from the failure to receive the securities.

Penalties calendar and reporting



Daily calculation

Penalties are to be calculated by CSDs on a daily basis and collected monthly, with participants to be notified of the details on a daily basis.

CSDs will calculate daily penalties for each instruction that failed to settle on its intended settlement date (SEFP) or matched after its intended settlement date (LMFP) applying the following business days calendars:

- The CSD's own settlement calendar
- The payment system calendar of the relevant currency

A new ISO20022 message has been developed to facilitate the daily reporting of cash penalties. The existing ISO15022 messages MT537 and MT548 have been adapted by SWIFT to cover penalty-related information by introducing a "PENA" sequence.

As of February 2020, only a few CSDs have confirmed the format and the content of their daily reporting (i.e. which SWIFT message and optional fields in such message they intend to use). We intend to process the reporting we receive from CSDs and sub-custodians and to assign any penalties/bonuses to the settlement transaction they refer to.

We will provide daily penalties reporting to clients via MT537 PENA or the equivalent reports in our Neolink web portal. Our MT537 PENA will contain the following details (please note that the message design/content may still change due to ongoing discussions at Securities Market Practice Group and with CSDs):

Subsequence D1, Penalties per Currency:

- Currency code
- Penalty computation date
- Counterparty CSD

Subsequence D1a, Penalties per Counterparty:

- Identification of the counterparty
- Counterparty role (CSD, CSD participant, CCP, etc.)
- Bilateral Net Amount per counterparty

Subsequence D1a1, Penalty Details:

- Individual Reference of the Penalty
- Common Reference of the Penalty
- Penalty Type (SEFP or LMFP)
- Computed Amount Flag (whether included in the Global Net Amount or not)
- The Status of the Penalty (ACTV = active or REMO = removed/inactive)
- Reason code for active, updated or cancelled penalties
- The Penalty Amount
- The Calculation Method
- The Number of Days applicable

Subsequence D1a1A, Calculation Details:

- The Penalty Date
- MRED Indicator (whether a reference data is missing or not)

Subsequence D1a1A1, Financial Instrument Attributes (Only if Calculation Method is SECU):

- The ISIN of the Financial instrument
- The Liquidity Indicator
- The SME Growth Market Indicator
- The Security Penalty Rate applied
- Source of price quotation
- Data of price calculation
- FX rate in case of currency conversion

Subsequence D1a1B, Related Transaction:

- The Account Owner Reference (will be the Sender's Message Reference of the relevant settlement instruction)
- The Account Servicer Reference

Subsequence D1a1B1, Transaction details:

- Transaction type
- Intended settlement date
- Client' safekeeping account
- Transaction indicator – Settlement & Clearing or Corporate Action
- Securities' way
- Payment method (FOP or AP)
- Posting quantity
- Posting cash amount
- Acknowledgment time stamp
- Matching time stamp

Appeal period

CSDs will have a dedicated appeal period for participants to assess single SEFP calculations.

The reasons for appeals are listed in the ESMA CSDR Q&As:

- ISIN suspension from trading or settlement (e.g. due to "undue creation or deletion of securities" reconciliation issues)
- 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
- Technical difficulties at the CSD level which prevent settlement (e.g. failure of the infrastructure components, cyber-attacks, network problems)

Our interpretation of ESMA's feedback is that a price difference cannot be considered a valid reason for appeal.

In order to appeal, sufficient information needs to be provided by the CSD participant to the CSD, covering at least:

- The reference of the penalty
- The details of the failed transaction
- The reason for the appeal
- The expected penalty amount and calculation details to be applied

According to the ECSDA framework, each CSD will design its own appeal processes. As of February 2020, the CSDs have not released the procedural details.

Monthly aggregated amounts

On the 14th business day of the following month, the CSDs will report the monthly aggregated amounts for the penalties of the previous month. The CSD will sum all the cash penalties (per currency, per counterparty) that each participant can expect to be credited or debited with. If the net result is a credit, the participant can expect a cash payment from this counterparty. If the net result is a debit, the participant will have to pay this counterparty.

Only a few CSDs have confirmed the format and the content of their monthly reports. We plan to process the reporting we receive from CSDs and sub-custodians and to perform reasonable checks against the penalties/bonuses that have been accrued on a daily basis. We will provide monthly penalties reporting to clients via MT537 PENA or the equivalent reports in our Neolink web portal.

Monthly payment (collection and redistribution)

On the 17th business day of the following month, the CSDs (and their participants) will perform the payment process (i.e. the CSDs will collect and redistribute the penalties amongst participants).

CSDs will use different models for the processing of penalty payments (depending on whether they have a banking license and other national specificities). The processes for payments intra and across CSDs may also differ.

The following possible payment models were identified in the ECSDA framework:

- CSD triggers direct debits and/or cash transfers
- CSD generates payment free on delivery (PFOD) instructions
- Cash is transferred using a payment bank

On the 17th business day of each month, we will issue an invoice compiling all CSDR penalties and bonuses accrued the previous month. Unless otherwise agreed, we will then credit/debit the relevant cash account via direct debit. We can either credit/debit the main cash account used for the settlement activity or any other nominated cash account.

Partial settlement

Article 23 of Delegated Regulation 2018/1229 provides that where, on the last business day of the extension period, some of the relevant financial instruments are available for delivery, the relevant trading parties shall partially settle the initial settlement instruction.

To meet this requirement and also reduce the overall penalty exposure, we encourage clients to use the "partial release" and "partial settlement" functionalities. Details of the SWIFT formats to be used to support these functionalities will be available in our toolkit.

Outstanding matters

Delegated Regulation 2018/1229 provides that penalties should not be charged by the CSD if a CCP is either a failing or receiving participant. Instead, the CSD shall provide the CCP, on a daily basis, with the calculation of the cash penalties for the failed settlement instructions that the CCP has submitted to the CSD. The CSD shall ensure that the CCP requests the clearing members that caused the settlement fails to pay the cash penalties and redistributes the cash penalties received to the clearing members that suffered from the CCP's failure to deliver the relevant securities. Every calendar month, the CCP shall report to the CSD the penalties collected and redistributed.

However, as of January 2020, the European Association of CCP Clearing Houses (EACH) has been discussing with ESMA about transferring their penalties reporting and collection obligations to CSDs.

After the end of the extension period

<p>The buy-in period (intended as the timeframe for the delivery of the financial instruments) is defined as:</p> <p>Four business days after the extension period for shares that have a liquid market</p> <p>Seven business days after the extension period for financial instruments other than shares that have a liquid market</p> <p>Seven business days after the extension period for financial instruments traded on SME growth markets</p>	ISD+5	<p>BUY-IN PERIOD</p> <ol style="list-style-type: none"> At the end of the extension period, the receiving trading party is mandated to assess if the buy-in is possible If the buy-in is not possible, the receiving trading party shall request the failing trading party to pay the cash compensation. If the buy-in is possible, the receiving trading party will need to initiate the buy-in by appointing a buy-in agent on ISD+5 If the buy-in is successfully executed, the receiving trading party is to inform the CSD, via the chain of custody, without delay If the buy-in is unsuccessful or only partially successful, the receiving trading party is to decide whether to defer or receive a cash compensation
	ISD+6	
	ISD+7	
	ISD+8	
CASH COMPENSATION (POST BUY-IN PERIOD)	ISD+9	
<p>The length of the deferral period is the same as detailed above for the buy-in period</p>	ISD+10	<p>DEFERRAL PERIOD (OPTIONAL)</p> <p>Where the buy-in is unsuccessful or only partially successful, the receiving party can decide to defer the buy-in for another window of four or seven business days depending on the financial instrument</p>
	ISD+11	
	ISD+12	
CASH COMPENSATION (POST DEFERRAL PERIOD)	ISD+13	

CSDR Article 7 provides that a buy-in process is initiated if a failing participant does not deliver the financial instruments to the receiving participant within four business days of the intended settlement date (the 'extension period'). Where the transaction relates to a financial instrument traded on a SME growth market, the extension period shall be 15 days unless the SME growth market decides to apply a shorter period.

There are some exemptions:

- The extension period may be increased from four business days up to a maximum of seven business days depending upon the asset type and liquidity of the financial instruments concerned
- For operations composed of several transactions, including securities repurchase or lending agreements, the buy-in process is not applied if the intended settlement date (ISD) of the second transaction is within 30 business days after the ISD of the first transaction

These exemptions shall not apply to transactions for shares cleared by a CCP.



Since Delegated Regulation 2018/1229 refers to trading parties, the industry has assumed that if a settlement instruction do not represent a trade (e.g. portfolio transfer), then it should be deemed to be out of scope for a buy-in.

ESMA is still to confirm the list of transactions in scope for buy-ins. However, based on our interpretation of the regulation and recommendations discussed in the industry task force we have engaged in, we believe the following transactions types to be subject to buy-ins:

- Purchases and sales
- Securities lending transactions
- Repurchase transactions
- Collateral transactions

Delegated Regulation 2018/1229 includes specific rules for:

- Buy-ins on transactions cleared by a CCP
- Buy-ins for transactions not cleared by CCP but executed on a trading venue
- Buy-ins for transactions not cleared by CCP and not executed on a trading venue
- Calculation and payment of cash compensation
- Payment of the buy-in costs and related price differences

Prerequisites to initiate a buy-in

For transactions not cleared by a CCP, prior to initiating a buy-in, the receiving trading party is to check that:

- The trade is matched on a CSD or ICSD
- The trade is failing due to lack of securities on the part of the seller and/or the transaction being "on-hold"
- The buy-in is possible:
 - The financial instrument still exists and
 - The failing trading party or the failing trading venue member is not subject to insolvency proceedings

Buy-in not possible

Where the buy-in is not possible, the CCP, the receiving trading venue member or the receiving trading party shall notify the failing party of the results of the verification (as explained in the previous paragraph) and provide details of the cash compensation amount calculated in accordance to these provisions:

- For settlement instructions against payment: the difference between the market value of the relevant financial instruments on the business day before the payment of the cash compensation and the settlement amount included in the failed settlement instruction where that settlement amount is lower than that market value
- For settlement instructions free of payment: the difference between the market value of the relevant financial instruments on the business day before the payment of the cash compensation and the market value of those financial instruments on the day of their trade, where the market value of those financial instruments on the day of their trade is lower than on the business day before the payment of the cash compensation

For transactions cleared by a CCP, the CCP shall collect the cash compensation from the failing clearing members and pay it to the receiving clearing members.

Where transactions have not been cleared by a CCP, the failing trading venue member/failing trading party shall pay the cash compensation to the receiving trading venue member/receiving trading party.



Once the payment of the cash compensation is complete, the original failing transaction should be cancelled.

Buy-in is possible

Where the buy-in is possible, the receiving trading venue member/receiving trading party shall appoint a buy-in agent on the business day following the expiry of the extension period (ISD+5) and notify the failing trading party accordingly. For trades cleared by a CCP, the CCP will launch an auction or appoint a buy-in agent.



As a custodian, we will not offer any buy-in agent service. Clients will have to appoint their own buy-in agent.

Upon receipt of the buy-in notification, the failing clearing member/failing trading venue member/failing trading party shall ensure that the original failing settlement transaction is put on hold. Clients should instruct with a MT530 or Neolink equivalent to put the original transaction on hold. Details of the SWIFT formats to support this process will be available in our toolkit.

Upon receipt of the buy-in notification, the failing trading venue member/failing trading party may only deliver the financial instruments to the buy-in agent where the buy-in agent gives its prior consent.

The CCP/receiving trading venue member/receiving trading party shall notify the results of the buy-in to the clearing members/ failing trading venue member/failing trading party at the latest on the last business day of the buy-in period (intended as the timeframe for the delivery of the financial instruments) defined as:

- Four business days after the extension period for shares that have a liquid market
- Seven business days after the extension period for financial instruments other than shares that have a liquid market
- Seven business days after the extension period for financial instruments traded on SME growth markets

The CCP/receiving trading venue member/receiving trading party shall ensure that the relevant CSD receives the information without undue delay.



We expect clients (where they are the receiving trading venue member or receiving trading party) to instruct their buy-in transactions via MT541 using SWIFT code BYIY in qualifier 22F::SETR// (sequence E).

The CCP/receiving trading venue member/receiving trading party shall provide the following information to the CSDs (via the custody chain, where applicable):

- Successful Buy-in:
 - Number of securities bought-in
 - Price of securities bought-in
 - Value of securities bought-in
 - Cancellation of original settlement instructions
- Failed Buy-in:
 - Number of failed securities
 - Price used as basis for cash compensation
 - Cash compensation indicator and cash amount
- Partially Executed Buy-in:
 - All of the above
 - New settlement instructions for non-delivered securities, indicating they are related to a buy-in



CSDs have not yet advised how they should be informed that a buy-in has taken place and whether it has been fully or partially successful. We are working with AFME to allow for notification via a new version of the MT530 which is due to be implemented, subject to the relevant SWIFT approvals, in the SWIFT Release 2020.

Where the buy-in is either fully or partially successful, the buy-in notification shall include the quantity and price of the bought-in financial instruments. Where the buy-in fails in part or in full, the notification shall include the cash compensation amount, unless that notification specifies that the execution of the buy-in is deferred.

Where the execution of the buy-in is deferred, the CCP/receiving trading venue member/receiving trading party shall notify the results of that deferred buy-in to the clearing members/failing trading venue member/failing trading party at the latest on the last business day of the "deferral period". The CCP/receiving trading venue member/receiving trading party shall ensure that the relevant CSD receives the information notified without undue delay. The results of the deferred buy-in shall be communicated as per the rules described above for the buy-in. A buy-in can only be deferred once.

The CCP/receiving trading venue member/receiving trading party shall accept and pay for the bought-in financial instruments. The CCP/receiving and the failing trading venue members/trading parties shall ensure that the following is carried out at the end of each business day on which the receiving clearing member/receiving trading venue member/receiving trading party receives the instruments:

- The settlement instructions for the settlement fail are cancelled
- New settlement instructions are entered into the securities settlement system for any non-delivered financial instruments

Where the buy-in is not successful or only partially successful, the failing trading venue member/failing trading party shall pay the cash compensation to the other party. For transactions cleared by a CCP, the CCP shall collect the cash compensation from the failing clearing members and pay it to the receiving clearing members.

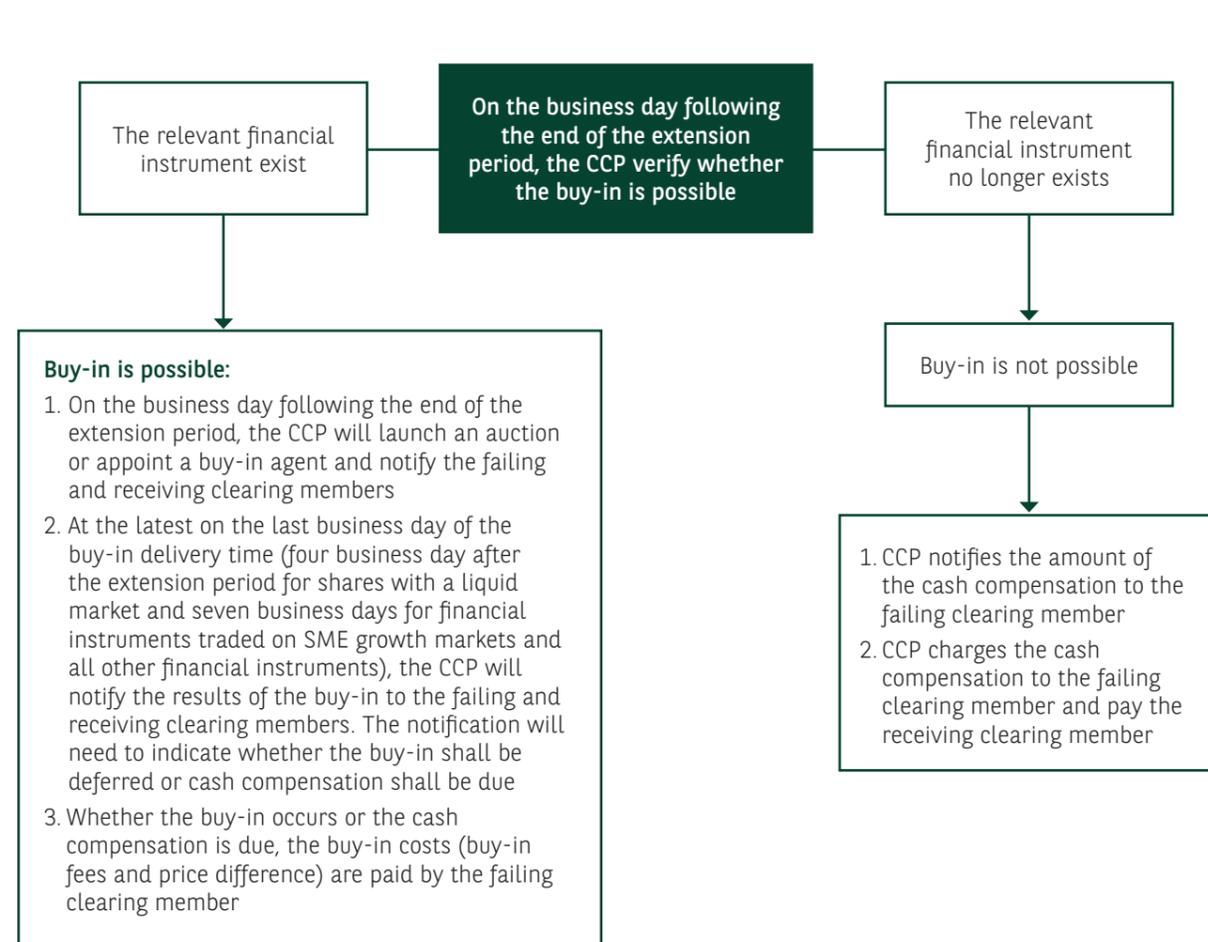
Where the price of financial instruments agreed at the time of the trade is lower than the price effectively paid for those financial instruments, the failing clearing members, failing trading venue members or failing trading parties shall pay the price difference to the CCP, receiving trading venue members or receiving trading parties, as applicable. Where transactions are cleared by a CCP, the price difference shall be collected from failing clearing members by the CCP and paid to the receiving clearing members. Where the price of the shares agreed at the time of the trade is higher than the price effectively paid for those shares, the corresponding difference shall be deemed paid.

The failing clearing members, failing trading venue members or failing trading parties, as applicable, shall reimburse the entity that executes the buy-in for all amounts paid in accordance with the buy-in process, including any execution fees resulting from the buy-in.

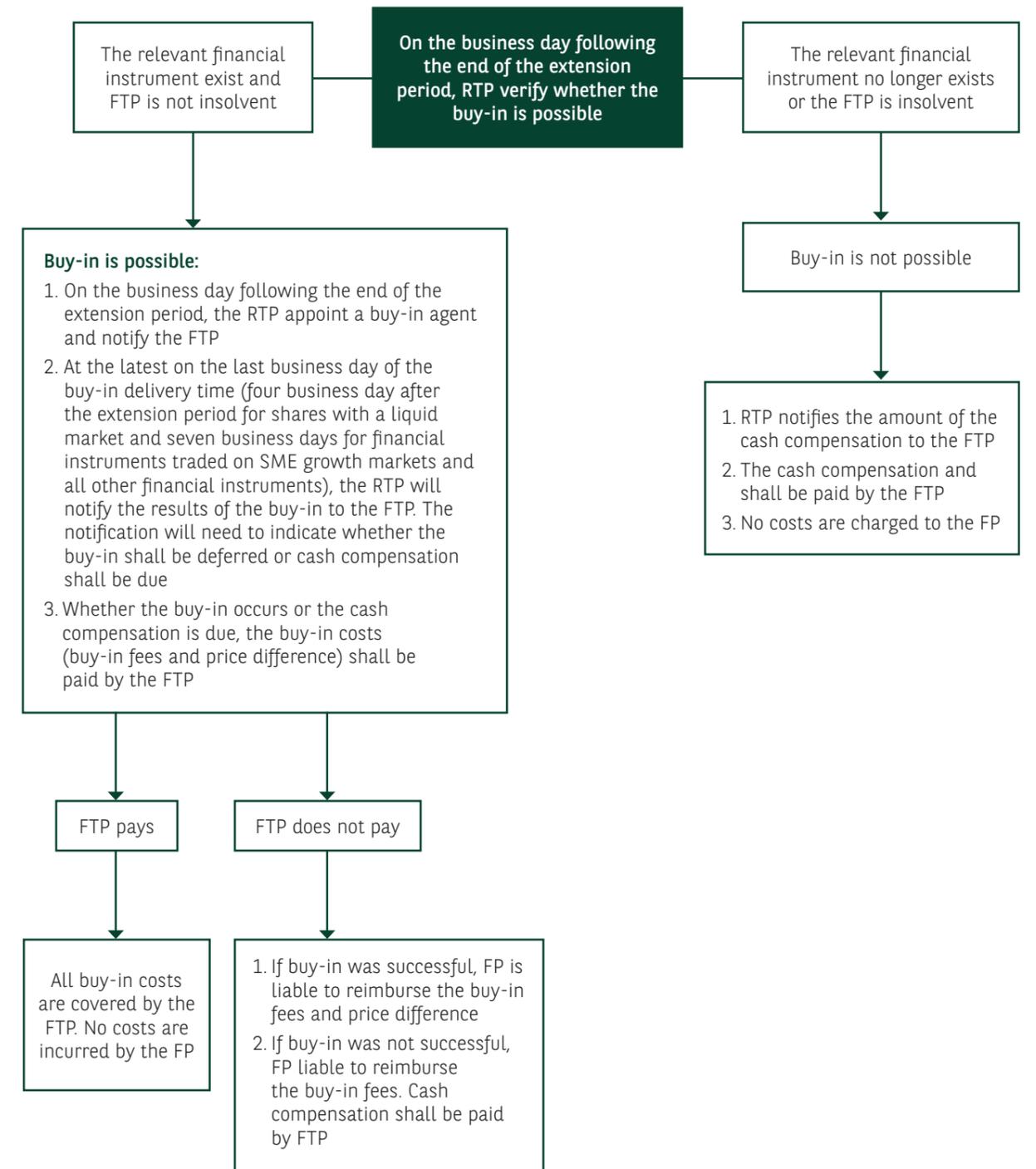
Examples of transaction flow for buy-ins

In case of a transaction cleared by the CCP, the buy-in process will be centralised by the CCP itself.

CCP cleared transactions



Non-cleared transactions



Glossary:

FTP – failing trading party – trading party that causes settlement fails
 FP – failing participant – participants that cause settlement fails
 RTP – receiving trading party – trading party suffering the settlement fail



Although the failing trading party is responsible for most obligations arising from buy-ins, the CSD participant is deemed responsible for the successful completion of buy-ins resulting from transactions not executed on a trading venue and not cleared by a CCP (as described below).

Contractual provisions

Article 25 of Delegated Regulation 2018/1229 provides that parties in the settlement chain shall establish contractual arrangements with their relevant counterparties that incorporate the buy-in process requirements as defined in CSDR and its implementing regulation. Each party in the settlement chain shall ensure that the contractual arrangements established with its relevant counterparties are enforceable in all relevant jurisdictions.

The CSD participants shall establish the necessary contractual arrangements with their clients to ensure that the buy-in requirements set out in CSDR are enforceable in all the jurisdictions to which parties in the settlement chain belong.

We are currently reviewing our contractual provisions to comply with this requirement. We will provide more information on this matter in spring 2020.

CONCLUSION

Our extended CSDR settlement services

Following discussions with clients, we have developed our settlement services including:

- Management reporting. We are adding new information to our existing settlement reports to assist clients to monitor their settlement efficiency. We intend to highlight transactions that have been penalised and the type of penalties applied
- Fails coverage. We offer comprehensive fails coverage, where we lend stock to our clients undertaking turnaround transactions, where required to avoid a failing settlement. This is available with our local custody service
- Allocation of CSD penalties. As agent, we will pass on CSD penalties charged by and received from CSDs. We will assign each penalty to the relevant settlement instruction and also reconcile the monthly aggregated amounts debited/credited by each CSD with the amounts accrued from their daily reports
- Penalty services on internalised settlement transactions. It is unclear if CSDR penalties should be applied to internalised transactions¹². However, if they are not, those parties whose transactions have been internalised within a failing settlement chain would break the flow of fines. In such cases, there is a risk of penalising a trading party that may not be at fault. Hence, with appropriate client's authorisation, we will calculate and report CSDR penalties on internalised settlement transactions. We will credit/debit them as long as both parties have provided the relevant authorisation
- Buy-in alerts – We will monitor our clients failing settlement transactions and advise them of upcoming buy-ins on the last business day of the extension period

We welcome the opportunity to discuss these services with our clients in order to address the settlement discipline requirements. To join this dialogue, or seek additional guidance on CSDR and its impacts, please contact your relationship manager.

¹² An instruction by a client of the settlement internaliser to place at the disposal of the recipient an amount of money or to transfer the title to, or interest in, a security or securities by means of a book entry on a register, or otherwise, which is settled by the settlement internaliser in its own books and not through a securities settlement system

FOR ADDITIONAL INFORMATION, PLEASE CONTACT

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