FEBRUARY 2024

AFG'S RESPONSE TO ESMA'S CONSULTATION

Technical Advice on CSDR Penalty Mechanism

AFG

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.

The AFG commits to the growth of the asset management industry, brings out solutions that benefit all players in its ecosystem and makes the industry shine and develop in France, Europe and beyond, in the interests of all. The AFG is fully invested to the future.

I - Introduction

AFG welcomes the opportunity given by ESMA to answer its consultation on Technical Advice on CSDR Penalty Mechanism.

Settlement efficiency is an important subject for AFG members which have implemented the CSDR penalty mechanism for a few years know. We support regulatory efforts to further improve it through adequate measures of which penalties are one.

However, we would like to raise a few preliminary remarks in regards to this consultation. We are particularly doubtful about the timing chosen by ESMA for this consultation where we understand that ESMA has at present not the necessary data available and wishes to use this consultation partly to request data from CSDs (i.e. Q21). Despite lacking data, reasonable analysis and thorough impact assessment, ESMA proposes to amend the existing penalty mechanism by significantly raising the actual rates and the introduction of a calculation methodology based on progressivity. Without comprehensive data and analysis of root causes of fails, we do not understand on which factors ESMA has based its assumptions and proposals to increase penalty rates. Yet, it seems essential for our members to have a clear understanding on the effectiveness of the mechanism before proposing any change that could once more, have considerable impact on liquidity and the EU's competitiveness.

We agree that two years since the entry into application of the penalty mechanism might indeed not be a sufficient period to assess the efficiency, or on the contrary, potential inefficiency of the penalty mechanism. Anyway, we need ESMA and CSDs data to have a clear view of the situation per asset class and therefore be able to make coherent proposals/answer this consultation. Stronger cooperation between actors is key, notably regarding the distribution of data, to better calibrate necessary developments.

Instead of raising the level of penalties, introducing progressivity or convexity based penalty models, we believe ESMA should first try to understand the root causes of fails. To set the appropriate measures/targeted tools, it is of paramount to identify what needs to be addressed and its causes. We see three main causes for fails related to: (i) structural, (ii) operational and (iii) behavioural factors. As the initial objective of the penalty mechanism is to play as an incentive to prevent and address failures in the settlement of securities transactions by imposing penalties on 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' behaviour. Indeed, not all settlement fails are equally avoidable and some flexibility is appropriate. As such, we need to make a clear distinction between fails due to behavioural causes and those where even highest punitive rates would not be capable to reduce them before raising the penalties. At this stage it seems that a vast majority of fails are due to structural inefficiencies stemming from fragmentation of our post trade ecosystem notably.

Overall, asset managers and market participants invested a lot in the implementation/set up of the cash penalty mechanism, which had the benefit of raising focus on settlement efficiency. Noting that the buy-side is generally net recipient of cash penalties and that processing them throughout the whole chain demands operational investment and may end up in additional costs for these market participants. It's therefore important not to

make any significant change/developments that would require them to implement a whole new mechanism. If any change is required by ESMA, it should be built on the existent, and be kept as a simple, easily explainable mechanism, that ensures a level playing field between actors and that focuses on the root causes of fails and on other measures to address them.

Finally, if amending the current mechanism, we 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 McGuiness' 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. Increasing the level of penalty rates can therefore be extremely dangerous for EU participants in terms of competitiveness notably.

All our below answers to ESMA's questions must be read in light of our above key messages.

II - Questions

Q1 Do you agree with ESMA's proposal? Which Option is preferable in your view? Please also state the reasons for your answer.

N/A

Q2 Do you have other suggestions? If yes, please specify and provide arguments.

N/A

Q3 Do you agree with the approach followed for the Option you support to incorporate proportionality in the Technical Advice? If not, please provide an indication of further proportionality considerations, detailed justifications and alternative wording as needed.

N/A

Q4 What costs and benefits do you envisage related to the implementation of each Option? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Option		
	Qualitative description	**Quantitative description/ Data**
Benefits		

	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: **- One-off** **- On-going**	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

N/A

Q5 **As a CSD, do you face the issue of accumulation of reference data related to Late Matching Fail Penalties (LMFPs), that may degrade the functioning of the securities settlement system you operate? If yes, please provide details, including data where available, in particular regarding the number and value of late matching instructions, as well as for how many business days they go in the past from the moment they are entered into the securities settlement system, and the percentage they represent compared to the overall number and value of settlement fails on a monthly basis (please use as a reference the period June 2022 – June 2023).**

N/A

Q6 **What are the causes of late matching? How can you explain that there are so many late matching instructions? What measures could be envisaged in order to reduce the number of late matching instructions?**

N/A

Q7 **Do you agree with ESMA's proposal to establish a threshold beyond which more recent reference data shall be used for the calculation of the related cash penalties to prevent the degradation of the performance of the systems used by CSDs? Please also state the reasons for your answer.**

N/A

Q8 **Do you agree with the threshold of 92 business days or 40 business days in order to prevent the degradation of the performance of the systems used by CSDs? Please specify which threshold would be more relevant in your view:**

a)92 business days;
b)40 business days;
c)other (please specify).

Please also state the reasons for your answer and provide data where available, in particular regarding the number and value of late matching instructions that go beyond 92 business days, 40 business days in the past or another threshold you think would be more relevant, and the percentage they represent compared to the overall number and value of settlement fails on a monthly basis (please use as a reference the period June 2022 – December 2023).

Although this question mainly concerns CSDs, AFG understands that the current system works well. CSDs are based on a threshold of 92 business days and the ECB on a threshold of 40 business days which seems to suit them. As a general remark we see no point in making costly developments to modify what works today. One way to go could be to incorporate those practices into the regulation.

Q9 Do you agree that the issuer CSD for each financial instrument shall be responsible for confirming the relevant reference data to be used for the related penalties calculation? Please also state the reasons for your answer.

N/A

Q10 In your view, where settlement instructions have been matched after the intended settlement date, and that intended settlement date is beyond the agreed number of business days in the past, the use of more recent reference data (last available data) for the calculation of the related cash penalties should be optional or compulsory? Please also state the reasons for your answer.

N/A

Q11 Do you have other suggestions? If yes, please specify, provide drafting suggestions and provide arguments including data where available.

N/A

Q12 Do you agree with the approach followed to incorporate proportionality in the Technical Advice? If not, please provide an indication of further proportionality considerations, detailed justifications and alternative wording as needed.

N/A

Q13 What costs and benefits do you envisage related to the implementation of the approach proposed by ESMA? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Approach proposed by ESMA		
	Qualitative description	**Quantitative description/ Data**

Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: **- One-off** **- On-going**	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

N/A

Q14 If applicable (if you have suggested a different approach than the one proposed by ESMA), please specify the costs and benefits you envisage related to the implementation of the respective approach. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Approach proposed by respondent (if applicable)		
	Qualitative description	**Quantitative description/ Data**
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: **- One-off** **- On-going**	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

N/A

Q15 Based on your experience, what has been the impact of CSDR cash penalties on reducing settlement fails (by type of asset as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389 since the application of the regime in February 2022? Please provide data and arguments to justify your answer.

We have seen a slight decrease in the level of fails in some asset classes (equities probably because of partial settlement notably, bonds) since the implementation of penalties. However, the cash penalty mechanism is effective since February 2022 and in the meantime, we have had market events that do not allow us to have a clear vision of the impacts of the mechanism on the reduction of fails. As ESMA itself says, we lack sufficient background to consider if it has been effective enough.

However, we can conclude it had the merit to keeping fails at an acceptable level and forced the industry to take interest in the level of settlement efficiency notably by investing resources in improving their settlement processes.

More broadly, settlement fails need to be assessed considering their root causes for market participants and regulatory measures to be able to address them properly. Indeed, fails can be due to several underlying effects i.e.

- structural fails (due to market fragmentation, market liquidity, cross-border cut-offs etc.);
- behavioural fails (late confirmations, incomplete information, manual interventions) ; and
- operational fails (IT issues, failure to realign positions between different locations in sufficient time).

Setting higher penalties is not the only answer and might not be the appropriate one considering the cause of the fail. The aim of penalties is to incentivise parties to settle on time and correctly and, when considering a defaulting party, to incentivise it to quickly put in place remedial actions. However, we do not see how higher cash penalties could have the intended effect when talking about fails due to structural issues and which can't be directly attributed to one party's behaviour.

We must also have in mind the US move to T+1 which enters into force in May 2024. Market participants in the EU are currently investing into systems and processes to support confirmation, allocation, and affirmation in a shorter timeframe. These investment might improve settlement efficiency. This should also be reflected in ESMA's data and should be taken into account before changing any features of the current penalty mechanism.

Q16 In your view, is the current CSDR penalty mechanism deterrent and proportionate? Does it effectively discourage settlement fails and incentivise their rapid resolution? Please provide data and arguments to justify your answer.

As mentioned in our response to Q.15, and because we lack relevant data to make a proper analysis, it is hard to assess if the current penalty mechanism is deterrent and proportionate enough.

Raising the level of penalties is probably not the only response. We rather need to focus on the structural causes of fails in order to assess which appropriate tools would be the answer to prevent those fails from happening. Considering the already good level of settlement efficiency and the remaining fails, it seems that they are mostly due to structural issues that can't be addressed with economic incentives i.e. penalties.

If ever the mechanism is to be modified, we stress the need to keep a simple regime and to not overcomplicate what already exists i.e. introducing progressivity and convexity could have strong undesired impacts. Indeed, the introduction of penalties has already demanded a great effort from the industry. We need to build on the existent regime notably considering that most fails are of one or two days and on low volumes compared to the

overall volume negotiated. Furthermore, we do not think that raising penalties will have a powerful deterrent effect. As described in our following answers, we believe that setting up tools to facilitate existing processes could be a better way to go. On the contrary, if penalties are increased, there's a chance that costs will be passed on to all market participants and ultimately to the end investor.

Q17 What are the main reasons for settlement fails, going beyond the high level categories: "fail to deliver securities", "fail to deliver cash" or "settlement instructions on hold"? Please provide examples and data, as well as arguments to justify your answer.

We believe distinction should be made between behavioural (manual interventions, incomplete information), operational (IT issues, failure to realign positions between different locations in sufficient time) and structural factors (liquidity issues i.e. not being able to deliver because not able to borrow, market-stress conditions).

First, it should be noted that asset managers are generally net recipients of cash penalties, as the principal cause of a trade failing is usually when the broker is short because of a lack of securities.

For asset managers, the main reasons for failing to deliver securities is generally because of Standard Settlement Instructions (SSI) mismatches or differences on economic data (data quality being a high prerogative for settlement efficiency). Another reason could also be because of positions that need to be realigned from one market to another due to a split of positions.

The main reason for fail to deliver cash on the other hand is because of the failure of a funding trade higher up the chain leaving no cash available.

Q18 What tools should be used in order to improve settlement efficiency? Please provide examples and data, as well as arguments to justify your answer.

To avoid settlement fails, the market needs liquidity. Therefore, improving liquidity management tools are expected to have a positive impact on settlement efficiency. For instance, we believe that all CSDs should be able to offer/facilitate partial settlement on an automated basis which is currently not the case. Indeed, partial settlement allows the selling party, who's unable to deliver the total amount of securities in due time, to propose to deliver the purchasing party the amount currently available until it is able to deliver the full amount. As a result, the delivering party will only fail on the proportion of securities that are missing.

Other tools such as allowing hold & release, shaping, auto-borrow could be a solution and could be framed by market practices to avoid any misuse.

Furthermore, although a high degree of improvement has been made in that way, we should focus on continuing to improve automatization 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.

AFG would also like to stress the extremely EU fragmented ecosystem and that would require to be rationalised and harmonised to contribute to greater efficiency e.g. improve CSDs interoperability, harmonising cut-offs etc.

Q19 What are your views on the appropriate level(s) of settlement efficiency at CSD/SSS level, as well as by asset type? Please provide data and arguments to justify your answer.

It is impossible at our own level to say what would be an acceptable level of settlement efficiency. As pointed out by ESMA in the consultation paper, "*100% settlement efficiency may not be a realistic target*". This is highly true considering the complex structure of European markets, the number of different jurisdictions and the fact that some fails might not be attributed to behavioural causes but to structural aspects, liquidity issues and market events that can usually not be anticipated nor measured. We believe that the right level of settlement efficiency is reached when fails happen on an exceptional basis and due to causes beyond the party's control (structural causes). That basis being different depending on the asset class.

Q20 Do you think the penalty rates by asset type as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389 are proportionate? Please provide data and arguments to justify your answer.

As already mentioned above, the lack of hindsight since the implementation of the cash penalty mechanism, and the limited data in our possession, prevent us from providing an appropriate answer to this question. We however do not believe that raising the level of penalties will allow a better settlement efficiency as the great majority of remaining fails are due to structural causes. Any changes in the rates of penalties should be carefully assessed so that any potential raise has no adverse impacts and does not introduce a disproportionate sanction in view of amounts at stake.

Q21 Regarding the proportionality of the penalty rates by asset type as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389, ESMA does not have data on the breakdown of cash penalties (by number and value) applied by CSDs by asset type. Therefore, ESMA would like to use this CP to ask for data from all EEA CSDs on this breakdown, including on the duration of settlement fails by asset type.

N/A

Q22 In your view, would progressive penalty rates that increase with the length of the settlement fail be justified? Please provide examples and data, as well as arguments to justify your answer.

For the penalty mechanism to meet its objectives i.e. improve the level of settlement efficiency, it needs to be simple, easy to operate, understandable by every market participant, client. We strongly believe that introducing progressivity in the level of rates could be extremely dangerous for the below reasons:

- It increases complexity without real added value and might increase the level of disputes;
- It can have an impact on liquidity and therefore on associated costs without improving the liquidity;
- It has indirect impacts on attractiveness;
- It makes it impossible for participants to reconcile penalties and pass them to their clients and undermines the principle of immunisation (balance between penalties paid and received for the non-defaulting party);
- It demands enormous efforts of implementation and investment for numerous actors of the chain. Setting higher penalties is a change of CSD's parameters whereas introducing progressivity would require a fundamental change that would take time to set and would be extremely cumbersome to deploy on the long term. Il would also demand high costs from all other participants (CCPs, intermediaries, asset managers etc.);
- As already stated, the volume of settlement fails is higher on the first two days, progressivity would therefore have no positive impact;
- The mandatory buy-in regime than can be forced on to defaulting participants in case of an inadequate level of settlement efficiency can already be seen as a progressive measure;
- It would be challenging to implement and therefore will not be quickly operational.

AFG also wants to stress that ESMA provides no analysis or impact assessment on the utility that progressive penalty rates would have on settlement efficiency.
The mechanism must in any case 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 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.

Q23 What are your views regarding the introduction of convexity in penalty rates as per the ESMA proposed Option 2 (settlement fails caused by a lack of liquid financial instruments)? Please justify your answer by providing quantitative examples and data if possible.

As previously explained in Q22, the regime needs to be simple if we want it to be effective and comprehensible. Convexity only brings greater complexity. Furthermore, we do not see the rational/economic justification behind this proposal. The existing characteristics/features of the mechanism seem appropriate and need to be maintained.

Q24 Would it be appropriate to apply the convexity criterion to settlement fails due to a lack of illiquid financial instruments as well? Please justify your answer by providing quantitative examples and data if possible.

No, it wouldn't. As explained above, we believe that convexity would only bring more complexity to the penalty mechanism and would therefore not help in reducing settlement fails.

Q25 What are your views regarding the level of progressive penalty rates:

a) as proposed under Option 1?
b) as proposed under Option 2?

As previously stated, we are against any progressive rate or convexity criterion as it would be too complex to explain, set up and monitor. In addition, it would generate adaptation costs that would be disproportionate when compared to the benefits for market participants.

Considering the level of fails proposed by ESMA in its options, we want to reiterate the fact that no analysis/impact assessment has been made and that could justify increasing penalties and even less so to the extremely disproportionate level proposed by ESMA e.g. multiplying the current rate by 25, as proposed for day 6 and beyond.

Setting too high penalties could threaten European markets' competitivity and could be dangerous in a T+1 world where participants will have less time to fulfil their operational obligations and thus, could be subject to a higher level of fails at least in the short term.

Moreover, imposing higher penalties may discourage the use of partial settlement which could on the contrary, be a nice tool to improve settlement efficiency.

Q26 If you disagree with ESMA's proposal regarding the penalty rates, please specify which rates you believe would be more appropriate (i.e. deterrent and proportionate, with the potential to effectively discourage settlement fails, incentivise their rapid resolution and improve settlement efficiency). Please provide examples and data, as well as arguments to justify your answer. If relevant, please provide an indication of further proportionality considerations, detailed justifications and alternative proposals as needed.

As already stated before, we do not believe that setting different/higher penalty rates will have a game changing/decisive effect on the level of settlement efficiency. We need to give the current system more time to prove itself as the lack of evidence data shows that we are unable to explain why it would not be sufficiently appropriate as it is. In the meantime, we should rather encourage the automation of processes, the harmonisation of platforms, the instantaneous exchange of data and increase recourse to partial settlement for instance, through more binding rules.

Furthermore, for the mechanism to work effectively it needs to be flexible in terms of the rates applied. For instance, we must be able to react quickly in case of new market conditions and if we observe that the rate applied are disproportionate given the objective to be achieved.

Q27 What are your views regarding the categorisation of types of fails:

a) as proposed under Option 1?
b) as proposed under Option 2?

Do you believe that less/further granularity is needed in terms of the types of fails (asset classes) subject to cash penalties? Please justify your answer by providing quantitative examples and data if possible.

Overall, the existing categorisation of penalty rates by asset types seems relevant enough as it distinguishes different instruments with different post-trade processes and takes into account the different level of liquidity amongst certain asset classes.

However, regarding ETF, the idea proposed in option 1 to have a specific category for those products seems to be a good one as it would enable better focus on these instruments and allow more appropriate rates to be set. We indeed observe a higher level of fails on ETF. Anyway, it is primary to get data to have a better understanding of the root causes of those fails (are they avoidable, intentional ?) and on which underlying assets are more concerned (illiquid ?). Regarding the root causes, they seem to be mainly due to structural limitations. ETF markets are extremely fragmented as one ETF can be traded and settled on various venues and through various CSDs across the EU.

However, rates as proposed in the CP are disproportionate and could have damaging effects for EU capital markets. A punitive penalty regime will have the undesired effect of increasing trading costs on these products and therefore reduce liquidity.

In view of the US move to shorten the settlement cycle to T+1 and the misalignment of primary vs. secondary market settlement for some ETFs, we would require removing ETF primary transactions from the CSDR regime from May this year.

Option 2 implies a complete overhaul of the methodology which should absolutely be avoided. We need to promote continuity and simplicity in the mechanism.

Q28 What costs and benefits do you envisage related to the implementation of progressive penalty rates by asset type (according to ESMA's proposed Options 1 and 2)? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Progressive penalty rates (by asset type) - ESMA's proposal Option 1	**Please see ESMA's proposed Option 1 in Section 5.3 of this CP.**	
	Qualitative description	**Quantitative description/ Data**
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: **- One-off** **- On-going**	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Progressive penalty rates (by asset type) - ESMA's proposal Option 2	**Please see ESMA's proposed Option 2 in Section 5.3 of this CP.**	
	Qualitative description	**Quantitative description/ Data**
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: **- One-off** **- On-going**	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

As we strongly believe that progressivity in the rates applied is a bad idea for numerous reasons previously explained, we will not be answering the questions on progressive cash penalties rates.

Q29 Alternatively, do you think that progressive cash penalties rates should take into account a different breakdown than the one included in ESMA's proposal above for any or all of the following categories:

(a) asset type;
(b) liquidity of the financial instrument;
(c) type of transaction;
(d) duration of the settlement fail.

If you have answered yes to the question above, what costs and benefits do you envisage related to the implementation of progressive penalty rates according to your proposal? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

See answer to Q28.

Progressive penalty rates – respondent's proposal *(if applicable)*		
	Qualitative description	**Quantitative description/ Data**
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

Compliance costs: **- One-off** **- On-going**	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

Q30 Another potential approach to progressive penalty rates could be based not only on the length of the settlement fail but also on the value of the settlement fail. Settlement fails based on instructions with a lower value could be charged a higher penalty rate than those with a higher value, thus potentially creating an incentive for participants in settling smaller value instructions at their intended settlement date (ISD). Alternatively, settlement fails based on instructions with a higher value could be charged a higher penalty rate than those with a lower value. In your view, would such an approach be justified? Please provide arguments and examples in support of your answer, including data where available. What costs and benefits do you envisage related to the implementation of this approach? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

As previously stated, we believe it is best to keep a simple mechanism and have the same penalties regardless of the value of the settlement fail. Indeed, having penalties based on the value of the instruction could have potential undesired impacts when resorting to partial settlement or shaping for instance (different rates applied to each partial settlement hindering the immunisation principle).

Progressive penalty rates – based on the length and value of the settlement fail	**Settlement fails based on lower value settlement instructions could be charged a higher penalty rate than those based on higher value settlement instructions**		**Settlement fails based on higher value settlement instructions could be charged a higher penalty rate than those based on lower value settlement instructions**	
	Qualitative description	**Quantitative description/ Data**	**Qualitative description**	**Quantitative description/ Data**
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

Compliance costs: - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

Q31 Besides the criteria already listed, i.e. type of asset, liquidity of the financial instruments, duration and value of the settlement fail, what additional criteria should be considered when setting proportionate and effective cash penalty rates? Please provide examples and justify your answer.

We reiterate our opposition to progressivity and believe that no additional criteria should be added except for ETF, as the current mechanism looks already granular enough.
Indeed, it already distinguishes between asset types and, for equities and debt instruments, considering their level of liquidity. Furthermore, we do not support the introduction of the category "type of transaction" as it refers to the original transaction whereas penalties are applied on the settlement instruction. Adding it would require high level of investment for CSDs and along all market practices. Finally, setting a duration criterion comes down to setting progressivity which, as previously developed, is not an adequate solution.

Q32 Would you be in favour of the use of the market value of the financial instruments on the first day of the settlement fail as a basis for the calculation of penalties for the entire duration of the fail? ESMA would like to ask for the stakeholders' views on the costs and benefits of such a measure. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

We believe the existing way works well i.e. evolution with regards to the market value of the financial instruments. Changing the actual methodology would be extremely burdensome where we do not see any interest to do so. Furthermore, it would hinder the immunisation principle where neutrality in the level of fails must be insured throughout the whole chain.

Use the market value of the financial instruments on the first day of the settlement fail as a basis for the	

calculation of penalties for the entire duration of the fail		
	Qualitative description	**Quantitative description/ Data**
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: **- One-off** **- On-going**	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

Q33 How should free of payment (FoP) instructions be valued for the purpose of the application of cash penalties? Please justify your answer and provide examples and data where available.

We see no reason to change the actual way. FoP instructions valuations do not seem to pose any particular constraints and are in line with how DvP instructions are valued.

Q34 Do you think there is a risk that higher penalty rates may lead to participants using less DvP and more FoP settlement instructions? Please justify your answer and provide examples and data where available.

DvP and FoP are two different settlement methods that do not meet the same needs i.e. DvP provides simultaneity in the exchange of cash vs. securities whereas with FoP, the delivery or receipt of the securities is not linked to a corresponding transfer of cash. It must also be noted that FoP generally requires manual processing which creates more risk. We therefore see no potential interest for participants to stop using DvP in favour of FoP.

Q35 ESMA is considering the feasibility of identifying another asset class subject to lower penalty rates: "bonds for which there is not a liquid market in accordance with the methodology specified in Article 13(1), point (b) of Commission Delegated Regulation (EU) 2017/583 (RTS 2)". The information on the assessment of bonds' liquidity is published by ESMA on a quarterly basis and further updated on FITRS. However, ESMA is also aware that this may add to the operational burden for CSDs that would need to check the liquidity of bonds before applying cash penalties. As such, ESMA would like to ask for the stakeholders' views on the costs and benefits of such a measure. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Applying lower penalty rates for illiquid bonds		
	Qualitative description	**Quantitative description/ Data**
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: **- One-off** **- On-going**	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

Although identifying another asset class on illiquid bonds, and that would be subject to lower penalty rate, seems to be a good idea, it looks overcomplicated in practice as today, data is not directly available by CSDs. For this to be effective, we would need to be certain that the data are immediately available in an automated fashion. Anyway, it depends on the CSD's capacity to change its processes.

Q36 Do you have other suggestions for further flexibility with regards to penalties for settlement fails imposed on illiquid financial instruments? Please justify your answer and provide examples and data where available.

If any other flexibility option must be introduced, we stress the need for it to remain simple, easy to explain, to implement, and which maintains the principle of immunisation.
One way to go could be to exclude highly illiquid bonds from the scope of the cash penalty mechanism.

Q37 How likely is it that underlying parties that end up with "net long" cash payments may not have incentives to manage their fails or bilaterally cancel failing instructions as they may "earn" cash from penalties? How could this risk be addressed? Please justify your answer and provide examples and data where available.

In theory this risk could potentially be true if penalties were set at an extremely high level. However, for the majority of players the risk of non-settlement is way higher, and all actors have the same objective to obtain the highest level of settlement efficiency.

In addition, asset managers must take all reasonable steps to obtain the best possible result for their clients, considering the likelihood of execution and settlement of the order (MiFID II – best execution principle). It's therefore not in their interest to prevent settlement or select "bad" brokers, as they could end up being in non-compliance of the regulation. Last, it is not in their interest to push for defaults as this could have the effect of evicting some brokers from the market.

We therefore see no risk in practice of this case happening.

Q38 How could the parameters for the calculation of cash penalties take into account the effect that low or negative interest rates could have on the incentives of counterparties and on settlement fails? Please provide examples and data, as well as arguments to justify your answer.

We agree that there can be an interaction between the rate environment and the effectiveness of the cash penalty regime. One counterparty may be less incentivised to solve a settlement fail (e.g. get back the missing securities in the market as soon as possible) if the penalty amount is less expensive than the natural cost of failing.

One option that can be reflected on and that might mitigate the effect of low or negative interest rates could be to have a flat rate that is pegged to the funding rate, maybe slightly above this rate, to ensure that failing is more costly than to borrow securities. However, and as previously explained, we need data from ESMA and CSDs to understand the level of efficiency and the root causes of fails before envisaging this kind of mechanism. Indeed, if we found out that most remaining fails are due to structural causes and not behavioural, we would suggest looking further into other tools instead of amending the penalty mechanism.

Q39 To ensure a proportionate approach, do you think the penalty mechanism should be applied only at the level of those CSDs with higher settlement fail rates? Please provide examples and data, as well as arguments to justify your answer. If your answer is yes, please specify where the threshold should be set and if it should take into account the settlement efficiency at:

a) CSD/SSS level (please specify the settlement efficiency target);
b) at asset type level (please specify the settlement efficiency target); or
c) other (please specify, including the settlement efficiency target).

As it is the case today, we believe that the penalty mechanism should be applied to all CSDs in the same manner and irrespective of the level of fails. Indeed, maintaining a level playing field between actors is paramount to avoid any arbitrage and to avoid hindering the principle of immunisation i.e. considering the settling of numerous instructions across different CSDs.

Q40 Please specify what costs and benefits you envisage regarding the application of the penalty mechanism only at the level of the CSDs with higher settlement fail rates. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Application of the penalty mechanism only at the level of CSDs with lower settlement fail rates	

	Qualitative description	Quantitative description/ Data
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: **- One-off** **- On-going**	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

See Q.39. We do not believe that setting penalties only at the level of CSDs with higher fails is a good idea therefore we do not see merit in answering this question.

Q41 Do you think penalty rates should vary according to the transaction type? If yes, please specify the transaction types and include proposals regarding the related penalty rates. Please justify your answer and provide examples and data where available. Please specify what costs and benefits you envisage related to the implementation of your proposal. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Penalty rates shouldn't vary according to the transaction types as they are not a matching criterion e.g. repos, buy and sell back transactions are not identified in T2S. See our response to Q°31.

Applying penalty rates by transaction types		
	Qualitative description	**Quantitative description/ Data**
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: **- One-off** **- On-going**	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

Q42 Do you think that penalty rates should depend on stock borrowing fees? If yes, do you believe that the data provided by data vendors is of sufficient good quality that it can be relied upon? Please provide the average borrowing fees for the 8 categories of asset class depicted in Option 1. (i.e. liquid shares, illiquid shares, SME shares, ETFs, sovereign bonds, SME bonds, other corporate bonds, other financial instruments).

Asset managers are not always able to use securities lending as UCTIS have limitations in terms of borrowing of securities and some CSDs do not offer it as they do not all have a banking licence. However we believe that incentivising actors to resort to borrowing is a good idea. At that point, directly linking/indexing penalties to stock borrowing fees might bring too much complexity in terms of implementation. However, after having received sufficient data from ESMA and CSDs and having assessed it properly, notably on the root causes of fails, it might be interesting to reflect on the idea to have a flat rate that is pegged to the funding rate, maybe slightly above this rate, to ensure that failing is costlier than to borrow securities. On that point, it will be interesting to see how a dynamic rate modelled on the US treasury TPMG could be a potential idea to implement. This model allows to mitigate both the impacts of a low or negative interest rate environment. Again, this reflection must be thoroughly assessed and we haven't got sufficient data at present to envisage it immediately.

Q43 Do you have other suggestions to simplify the cash penalty mechanism, while ensuring it is deterrent and proportionate, and effectively discourages settlement fails, incentivises their rapid resolution and improves settlement efficiency? Please justify your answer and provide examples and data where available. Please specify what costs and benefits you envisage related to the implementation of your proposal. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Our message regarding the current penalty mechanism is precisely that it shouldn't be revised as there is insufficient data today to measure its real effects. In addition, we believe it has the intended effect on behavioural fails and considering the large implementation/operational costs it had for market participants. As such, we are against the introduction of progressivity, convexity, higher rates and, as developed above, efforts should be concentrated on other tools than the penalty mechanism.

Respondent's proposal (if applicable)		
	Qualitative description	**Quantitative description/ Data**
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: **- One-off** **- On-going**	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

Q44 Based on your experience, are settlement fails lower in other markets (i.e USA, UK)? If so, which are in your opinion the main reasons for that? Please also

specify the scope and methodology used for measuring settlement efficiency in the respective third-country jurisdictions.

As it has been previously discussed and notably during the ESMA workshop on settlement efficiency, or through our response to the call for evidence on a shorter settlement cycle, it is extremely complicated to compare two markets with such different structures. In the US, the trading, clearing and settlement are concentrated in a few financial market infrastructures, and they have no comparable CSDR regime. In Europe on the contrary, we have many CSDs, CCPs, currencies, a principle of irrevocability, which complexifies the whole settlement process. It is also quite complicated to conduct a clear assessment of the current settlement efficiency as there is no universal methodology.

However, this conclusion states out the need to rationalise our market to make it simpler, more interconnected and automate our processes as far as possible and does not prevent us from assessing how some interesting/efficient functionalities of other markets could have a positive impact on our own settlement efficiency i.e. tools like partial settlement, hold & release etc.

Q45 Do CSD participants pass on the penalties to their clients? Please provide information about the current market practices as well as data, examples and reasons, if any, which may impede the passing on of penalties to clients.

As a default is usually not due to CSD participants (intermediaries), the latter pass-on penalties to their clients. When part of a bigger chain, those clients might themselves be intermediaries and not the defaulting party and may also have to pass-on the penalties further down the chain. This rule is subject to two exemptions. One for retail clients and the other one for fund distribution (end investors). Both exemptions should be maintained.

Q46 Do you consider that introducing a minimum penalty across all types of fails would improve settlement efficiency? Is yes, what would be the amount of this minimum penalty and how should it apply? Please provide examples and data, as well as arguments to justify your answer.

We believe that setting minimum penalty rates across all types of fails is not a good idea :

- It doesn't take into account the size of the trade i.e. big or small orders, block trades and individual trades;
- It would incur big development for a hypothetical purpose;
- It completely ignores the root cause of the fail;
- It might impact the use of partial settlement as a party would be applied a minimum penalty to its partial which may result in higher penalties then in a situation with no partial settlement;
- Could lead some actors to stop treating low volumes and therefore have an impact on liquidity and on end investors/retail clients.

As an alternative approach, 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 withholds cash penalties where the value of the penalty does not reach a certain amount, which could

potentially be the same as the one set up in AFME's market practice on bilateral claims (i.e. under this threshold no cash penalties are generated and no debits flow through the system). Indeed, the buy-side is subject to high cost when it comes to processing penalties that are usually of short period and low amount. However, if a de minimis threshold is introduced, it is essential to maintain an analysis of responsibility below the threshold, 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.

Q47 What would be the time needed for CSDs and market participants to implement changes to the penalty mechanism (depending on the extent of the changes)? Please provide arguments to justify your answer.

The time that market participants will need to implement any change will depend on the nature of the changes to be implemented. We reiterate the importance of keeping a simple penalty mechanism as it is set up today and which can be easily implemented, easily reviewed and understandable. If we complexify it too much, it will take time to set and might no longer be relevant when it comes into force. If and when ESMA decides to modify its penalty regime, it is vital that it specifies the terms and conditions in light of other ongoing or future projects (prioritise) to avoid overloading work for the industry.

Q48 Since the application of the RTS on Settlement Discipline, how many participants have been detected as failing consistently and systematically within the meaning of Article 7(9) of CSDR? How many of them, if any, have been suspended pursuant to same Article?

This question is for CSDs as their datas are not publicly disclosed.

Q49 In your view, would special penalties (either additional penalties or more severe penalty rates) applied to participants with high settlement fail rates be justified? Should such participants be identified using the same thresholds as in Article 39 of the RTS on Settlement Discipline, but within a shorter timeframe (e.g. 2 months instead of 12 months)? If not, what criteria/methodology should be used for defining participants with high settlement fail rates? Please provide examples and data, as well as arguments to justify your answer.

As stated in Q39, we need to maintain a level playing field between actors therefore applying different penalties (additional or higher) on participants with high settlement fail is not a good idea. Furthermore, it goes against the immunisation principle.

Q50 How have CSDs implemented working arrangements with participants in accordance with article 13(2) of the RTS on Settlement Discipline? How many participants have been targeted?

N/A

Q51 Should the topic of settlement efficiency be discussed at the CSDs' User Committees to better identify any market circumstances and particular context

of participant(s) explaining an increase or decrease of the fail rates? Please justify your answer.

We hope that settlement efficiency is already being discussed at the CSDs' User Committees and that they did not wait for ESMA's consultation. In France settlement efficiency has been discussed for years and fails are being monitored closely.
It would however be constructive to create a committee where all market participants are represented and are able to have a productive exchange to see how best should settlement efficiency be addressed.

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Zone de texte

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