CSDR Penalties

Regulation, Best Practices Updates & Use Cases Guideline
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1 Document History

<table>
<thead>
<tr>
<th>Change Date</th>
<th>Content Change</th>
</tr>
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<tbody>
<tr>
<td>6 Dec 2021</td>
<td>First draft for distribution</td>
</tr>
<tr>
<td>21 Dec 2021</td>
<td>Comments and member feedback added from working group 13 Dec 2021. Reordering of assumption in document to facilitate future discussion. Consolidation of sub-sections Timeframe and Minimum Thresholds Provisional/additional draft text is shown in red.</td>
</tr>
<tr>
<td>25 Jan 2022</td>
<td>Changes to reflect member comments over the Christmas period. Best practice changes from previous draft reflected in purple. Please note that these have been aligned where possible with other trade associations.</td>
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2 Introduction

This document, for circulation to ISLA members, will be used to facilitate discussions regarding Central Securities Depository Regulation (CSDR) penalty related best practices.

On validation of this document, its content will be transferred to the ISLA Best Practice Handbook for wider review and consumption.

It is important to note that this guide is a recommendation of best practices from industry members and the Securities Lending Trade Association and is a voluntary set of practices.
3  CSDR Regulatory Articles

This chapter details the relevant sections of CSDR regulation that may be referred to in this paper.

3.1  Level 1 Text


3.2  Level 2 Texts


3.3  Level 3 Guidance

➢ ESMA Questions & Answers

3.4  Types of Penalty

Late Matching Fail Penalty (LMFP) - Applies to any instruction matched after the relevant cut off, on Intended Settlement Date (ISD). The penalty will be charged to the last participant to instruct/modify the trade.

Settlement Fail Penalty (SEFP) - Applies to matched settlement instructions that fail to settle. It applies from ISD or, if late matched, the business day that the instruction matches & will continue to apply each day it fails to settle, until actual settlement/ cancellation. The penalty will be charged to the participant responsible for the fail, according to the CSD.
3.5 Penalty Rates

<table>
<thead>
<tr>
<th>Instrument Type</th>
<th>Daily Penalty Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquid Shares*</td>
<td>1.0 basis points</td>
</tr>
<tr>
<td>Non-liquid Shares</td>
<td>0.5 basis points</td>
</tr>
<tr>
<td>Shares traded on SME-Growth Market venue</td>
<td>0.25 basis points</td>
</tr>
<tr>
<td>SSA Bonds</td>
<td>0.1 basis points</td>
</tr>
<tr>
<td>Other Bonds</td>
<td>0.2 basis points</td>
</tr>
<tr>
<td>Bonds traded on SME-Growth Market venue</td>
<td>0.15 basis points</td>
</tr>
<tr>
<td>All other instruments</td>
<td>0.5 basis points</td>
</tr>
<tr>
<td>Fail due to lack of cash</td>
<td>Official overnight interest rate of the currency issuer</td>
</tr>
</tbody>
</table>

*Liquid Shares as defined in point (b) of Article 2(1)(17) Regulation (EU) No. 600/2014 in the Markets in Financial Instruments Regulation.

3.6 Summary of CSDR Penalties

- Cash Penalty to be applied to all matched failing trades
- Penalty calculated at the end of each business day, post ISD, until Actual Settlement Date,
- Penalties will apply to instructions matched after ISD
- Calculation is applied by the CSD and reported to market participants daily
- Penalties are collected and redistributed monthly by the CSD
- The CSD will debit the party at fault and credit the corresponding counterparty
- The CSD may not always be able to identify the correct party at fault, hence market participants will need to issue a bilateral claim between trading parties
- Both participants can be penalised with SEFP if both parties prevent settlement, for example, one trading party is short of the security (insufficient) and the other trading party has a held instruction on the other side
- LMFPs & SEFPs can apply to the same settlement instruction, but not on the same business day
- Internalised settlement instructions are NOT in scope unless the Settlement Internaliser chooses to independently calculate and apply the penalty
4  Best Practices

4.1  Claims Issuance & Settlement

Although penalties are calculated by the CSD daily, the distribution of penalties will occur the following month.

Penalty Business Day (ECSDA Framework) – ‘to be used for the penalties-specific monthly reporting, appeals, and payment processing by a CSD. The term was introduced in the Framework in March 2020 at the request of CSD customers, in order to ensure a consistent counting of days across CSDs and to limit differences in the penalties lifecycle across multiple CSDs.’

10th Penalty Business Day
End of appeal period for penalties received by CSD participants in the previous month

14th Penalty Business Day
CSD provides list of previous month’s amalgamated penalties to participants

15th Penalty Business Day
CSD informs participants of total net amounts (Debit or Credit)

17th Penalty Business Day
CSD collects and redistributes penalties accordingly

Please see below original best practice text as of November 2021, with proposed amendments following member feedback and alignment with other associations, marked in purple below. The original text has been partially drawn from ISITC standards (see Appendix 6.1 ISITC Claims Process) however, in relation to CSDR claims, separate deadlines for claims issuance have been created. The below best practice amendments are intended to create a unified claims process that incorporates CSDR and other general claims processes.

ISLA Best Practice Handbook reference:

Original Text:

Counterparties should aim to issue claims within 30 days but within a maximum of 60 days of the settlement of the sale.
The recommended minimum claim is EUR500 or equivalent, or as bilaterally agreed (prior to activity). The receiving party must endeavour to pay the claim within the same time frames of 30 days where possible and within a maximum of 60 days.

The claim issuer should provide the following information on claims:

* Date, time, and the name of the borrower contact to whom the recall was issued
* Trade and settlement date of recall
* Actual settlement date of recall
* Security ID and description
* Quantity recalled
* Cash amount of recall (based on sale price)
* Claim calculation (i.e., cash amount of recall, interest rate, days of fail/100/360 or 365 depending on market)
* Reason for claim
* Payment instructions

Claims should be sent the claim as a PDF with signature via e-mail. The recipient should acknowledge receipt within 24 hours via return e-mail.

**New Text:**

For CSDR, counterparties should issue their claim(s) within 30 calendar days from the CSD penalty issuance. Please note that the proposed deadlines for CSDR triggered claims may be amended as the process matures.

For non-CSDR related claims, counterparties should issue their claim(s) within a maximum of 60 days from the claim inception date for example, the final settlement of a sale that triggered a recall.

It is recommended that one claim is raised per instruction. Claims should only be initiated when actual settlement has occurred.

The recommended minimum claim is 500 EUR or equivalent per instruction, or lower if bilaterally agreed (prior to activity). Parties may also agree consolidation of multiple failing transactions to pass a 500 EUR threshold. For example, if a penalty for a failing instruction is below the value of 500 EUR however, it fails for a number of days and the total cost of the penalty > EUR 500, this would be considered a reasonable claim.

The receiving party must endeavour to pay the claim within 30 days where possible and within a maximum of 60 days, from the CSD penalty issuance.

Claims should be sent electronically or via e-mail, preferably in PDF format, with signature. The recipient should acknowledge receipt of the claim within 24 hours.

Once the claim has been agreed by both trading parties, payment should be made within 5 business days. The claim issuer must confirm receipt of payment to formally close the claim.
The claim issuer should provide the following information:

- Claim Initiator Name & BIC
- Trade Date of failing instruction
- Intended Settlement Date
- Actual Settlement Date
- Security ID (ISIN) and Description
- Quantity
- Cash Currency & Value – Settlement value or recall value
- Claim Reference – PCOM or other relevant reference
- Claim Calculation (i.e., cash value, interest rate, No. of days of failing instruction)
- Claim/Penalty Currency
- Claim/Penalty Amount
- Reason for claim
- Payment Details – SSI's
4.2 Netting of Claims

CSDR penalties may accumulate both credits and debits therefore, resulting claims should represent a net amount per instruction.

**ISLA Best Practice Handbook** reference:

**New Text:**

Regarding a single failing event, claiming parties should incorporate and consider relevant credits and debits that may apply for each failing instruction.

Regarding total claims between parties, where applicable, parties should agree a net settlement – i.e., a single cash flow to resolve multiple claims within the same penalty period.

It is the objective of CSDR to penalise the failing party to the trade to promote more efficient settlement across EU capital markets and therefore, claims as a result of this, should not unduly enrich either party.

4.3 Partialling

CSDR Mandatory Buy-ins contained text requiring the partial settlement of failing transactions on ISD+4. However, as of December 2021, ESMA has called for NCA’s to deprioritise buy-in supervision see **ESMA announcement** therefore, partialling in this section, refers to manual or auto-partial services offered by CSDs.

Partial settlement criteria on a trade-by-trade basis using SWIFT partial settlement indicator MT540
- :22F::STCO//NPAR: no partial allowed
- :22F::STCO//PART: partial on the quantity/nominal value for free of payment instructions and partial on the countervalue for against payment instructions

**ISLA Best Practice Handbook** reference:

**Original Text:**

Counterparties should endeavour to settle partial sales of stock wherever possible (see IBP-307) and should accept partial returns or recalls.

Auto-partial facilities should be applied by default for failing securities lending trades where its use does not disadvantage the failed-to party.

Parties may bilaterally agree to time or quantity limitations to provide sufficient opportunity to maintain collateral or other controls.
The T2S settlement system provides Partial Hold Release functionality which should be used as noted in SMPG Market Practices.

**New Text:**

Automatic Partial Settlement is a facility to settle incremental quantities of a failing transaction.

Auto-partial facilities should be applied by default for failing securities lending trades where its use does not disadvantage either party.

Parties may bilaterally agree to time or quantity limitations to provide sufficient opportunity to maintain collateral or other controls.

The T2S settlement system provides Partial Hold Release functionality which should be used as noted in *SMPG Market Practices*.

### 4.4 Liability Cap

Where a securities lending transaction fails to settle, causing a downstream related transaction of a larger quantity to also fail, penalties **should not** be passed on, that exceed the quantity/value of the original lending transaction.

**ISLA Best Practice Handbook** reference:

**Text: (No proposed Changes)**

Counterparties will only be liable for 'sale fail' costs for the portion of the sale that fails due to an outstanding loan position, which has been recalled and not delivered in the required timeframe.

It should be noted that in some markets, additional charges may be incurred for late settlements. Where these charges are incurred due to a failing recall, the failing party is liable. Equally if overdrafts are incurred, the impacted party may consider raising a claim for any costs from the failing party. (IBP-140)

It was acknowledged in previous working groups, that in some scenarios, parties may consider claiming for larger amounts greater than the value of the loan position, as a result of a failed onward sale. It was determined however, that this scenario would not be added to Best Practice, and it would have to be bilaterally agreed between trading parties.
4.5 Sale Notifications

No specific Practice Guidance regarding the timing of Sale Notifications as at 27 January 2022. Proposed new text added into IBP-339.

**ISLA Best Practice Handbook** reference:

**New Text:**

Although best practice may recommend guide cut-off times, it is recognised that counterparts to a loan will want to retain a flexible approach. However, should notifications, instructions and settlement occur outside the recommended guide-times, parties should acknowledge that settlement will be on a best-efforts basis.

It should also be noted that to avoid any backdating of activity, instructions should be processed/instructed on the date they are negotiated.

The recommended cut-off times are therefore:

**New Loans** - Should be instructed on trade date, no later than 1 hour prior to the relevant market cut-off. Collateralisation of new loans will occur at different times relative to the trade and settlement. See the section "Processes for Collateral" in the ISLA Best Practice Handbook for best practice timing.

**Returns** - Notification of a loan return should be processed electronically and where possible via an electronic platform, no later than 1 hour prior to the relevant market cut-off.

4.6 Collateral Movements

**ISLA Best Practice Handbook** reference:

**Text: (No proposed Changes)**

Collateral and the subsequent trade leg, should be agreed, instructed, and delivered prior to the Delivery Versus Payment (DVP) cut-off of the related settlement market. The DVP deadline has been chosen for cut-off, being earlier than the Free of Payment (FOP) deadline. This earlier deadline then allows onward deliveries and sufficient tolerance to avoid any mandatory penalty or buy-in.

Ad-hoc or late agreement will be done on a best-efforts basis.
5 Use Cases

In previous working group meetings, it was noted that a wide array of use cases may exist, driven by the type of party to a trade, nuances of collateral management and platforms used.

Feedback from queries and previous working groups determined that a firm’s management of CSDR penalties, will fall on one of two possible approaches:

- Manual fails management and CSDR penalty consideration
- Automated functionality to track, attribute and manage CSDR penalties systemically.

In relation to use case discussions, ISLA have received a steady stream of potential use cases that, as of December 2021, number more than twenty unique examples for consideration. However, in focus group meetings held in December 2021, it was agreed that to agree a standard approach, provide guidance for any potential legal documentation work, and generate best practices, there should be summary level statements that cover ~80% of expected use cases.

Therefore, the group’s primary focus was to draft and validate high level practices, sufficient to progress with required legal work. Further consideration of unique use cases, to support firms intending to encode use case driven outcomes, may be done at a future time, and may then be considered as candidate functions, in the development of the Common Domain Model (CDM).

5.1 Use Case Status as of January 2022

The working group has concluded that detailed use cases for penalties are not required at this time. Individual use cases will be discussed at a future date pending decisions made post go live.

The Legal Steering Group has also confirmed that they do not wish to proceed with amendments to the Global Master Securities Lending Agreements (GMSLA), as a result of CSDR penalties at this time. This decision will be reviewed post go live, to understand if contractual amendments to Master Agreements are necessary, or whether the best practices for bilateral claims processes operate efficiently.
6 Appendix

6.1 ISITC Claims Process

https://isitc.org/market-practices/claims-and-compensation-market-practice

See 8.1 Appendix A: Best Practice Timeframes

### 8.0 Appendix

#### 8.1 Appendix A: Best Practice Timeframes (Summary of 6.4.1-8)

##### 8.1.1 Compensation Claims

<table>
<thead>
<tr>
<th>Action</th>
<th>Days</th>
<th>Cumulative Days</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.1 Initial claim issuance</td>
<td>60</td>
<td>60</td>
</tr>
<tr>
<td>4.3 Initial claim acknowledgement (*)</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>4.4 Onward claim transmission to Third Party</td>
<td>10</td>
<td>70</td>
</tr>
<tr>
<td>4.5 Onward claim acknowledgement by third party (*)</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>4.7 Claim investigation/settlement</td>
<td>20</td>
<td>90</td>
</tr>
<tr>
<td>4.8 Claim escalation</td>
<td>30</td>
<td>120</td>
</tr>
</tbody>
</table>

##### 8.1.2 Over Draft Charges and Disputes

<table>
<thead>
<tr>
<th>Action</th>
<th>Days</th>
<th>Cumulative Days</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over Draft Fee Charged by Bank to Account</td>
<td>1st Business Day</td>
<td>1</td>
</tr>
<tr>
<td>Claim investigation/Discussion with Counter-Party</td>
<td>60</td>
<td>60</td>
</tr>
<tr>
<td>Notify Bank in Dispute</td>
<td>30</td>
<td>90</td>
</tr>
<tr>
<td>IM and Bank work on Resolution</td>
<td>30</td>
<td>120</td>
</tr>
<tr>
<td>4.8 Claim escalation</td>
<td>30</td>
<td>150</td>
</tr>
</tbody>
</table>

##### 8.1.3 TMPG Fails Charge Claims

<table>
<thead>
<tr>
<th>Action</th>
<th>Business Days</th>
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</thead>
<tbody>
<tr>
<td>4 Custodian delivers TMPG Fails charge report to IM</td>
<td>1</td>
</tr>
<tr>
<td>4.1 Initial claim issuance</td>
<td>10</td>
</tr>
<tr>
<td>4.3 Initial claim acknowledgement (*)</td>
<td>7</td>
</tr>
<tr>
<td>4.7 Claim investigation/settlement</td>
<td>Upon receipt until last business day of month in which it was issued</td>
</tr>
<tr>
<td>4.8 Claim escalation</td>
<td>If still outstanding after the last business day of the month in which it was issued</td>
</tr>
</tbody>
</table>