What Operations Teams Should Know About CSDR

The Central Securities Depositories Regulation (CSDR) is a key regulation impacting settlement of European securities. It complements rules brought in by the European Market Infrastructure Regulation (EMIR) and the Markets in Financial Instruments Directive (MiFID). CSDR seeks to align the authorization and supervision of central security depositories (CSDs) across the EU and to improve settlement discipline in the securities settlement systems that CSDs operate.

While CSDR entered into force across all member states in September 2014, several of the provisions go into effect this year (2019) and the following, which will have implications for all managers who invest in European securities. Yet many asset managers are still struggling to understand the implications of CSDR and the compliance measures they should implement. What follows in this paper is an overview of CSDR and what operations teams should know as deadlines loom.
CSDR Overview

The main objectives of CSDR are to make cross-border settlement processing and safekeeping more efficient and secure through:

- Shorter settlement periods.
- Increased settlement discipline measures (i.e. mandatory cash penalties and ‘buy-ins’ for settlement fails).
- Dematerialization for most securities.
- Strict conduct of business rules for CSDs and strict access rights to CSD services.
- Increased supervisory requirements for CSDs and other institutions providing banking services ancillary to securities settlement.

The regulation’s settlement discipline measures impose obligations on:

- Trading venues to establish procedures that enable confirmation of trade details on the date of execution.
- Investment firms to put in place measures to limit settlement fails.
- CSDs to establish incentives to encourage timely settlement on the securities settlement systems that they operate.

It also introduces penalty fees for failing transactions and forced mandatory buy-ins where a failing participant does not deliver the financial instruments to the receiving participant within the agreed and expected timeframes.

CSDR Timeline

August 2014
- CSDR published in the Official Journal

March 2017
- Regulatory technical standards (RTS) for CSD requirements and settlement internalization reporting published

May 2018
- RTS for settlement discipline published

September 2017
- CSDs filed for CSDR authorization

September 2020
- Entry into force of settlement discipline rules, including buy-ins & penalties

July 12, 2019
- Deadline for first internalized settlement reporting for Q2 2019 – with further quarterly reporting to be provided by the 10th business day of the new quarter

January 2023
- Any new securities shall be issued in book entry

January 2025
- All securities shall be in book entry
What’s Next

CSDR is expected to increase settlement success rates, reduce rates of late settlement, increase transparency into the use of segregated accounts versus omnibus accounts, and increase transparency about CSDs’ and intermediaries’ capability for providing securities settlement services.

Settlement Fails – Use of Standard Settlement Instructions

To maintain bilateral trading relationships, asset servicers and their asset management clients should be supported by having standard settlement instructions (SSIs) which should:

- Include detailed information on custody chains to enable second level matching at the level of the CSD.
- Be validated on regular basis (at least annually) and updated (automatically) upon any change.
- Be “published” on central SSI databases and promoted with the respective reference in trade confirmations.

Cash Penalties

CSDs will be required to establish systems to monitor settlement fails of transactions in financial instruments. Under CSDR, cash penalties will create a standardized and harmonized regime across the EU to be applied in the event of settlement fails.

CSDs will be expected to calculate cash penalties daily for each business day that a transaction fails to be settled after its intended settlement date (ISD). Penalties will roll over from day-to-day until actual settlement. Penalties can be calculated using either Late Fail Matching Penalty (LFMP) or Settlement Fail Penalty (SEFP) definitions. While both LFMP and SEFP calculations can be applied to one transaction, they cannot be applied on the same day. Only one of the two definitions can be used for a single day penalty, determined by the matching timestamp being before or after the cut-off timeline. The penalty will be charged to the participant who was last to update the relevant settlement instruction (e.g. ‘accepted timestamp’ is later than the one of the counterparty’s instruction) for the periods between the ISD and the day of matching of the instruction.

Settlement fail penalties will be calculated for all settlement instructions, free of or against/with payment. This includes “transfer orders” that are:

- Matched prior, on, or after their ISD.
- Failing to settle on and after their ISD.

Fail penalties should be calculated daily for each day of settlement failure. In case of disputes of penalties, there is a 10-business day period after the receipt of the monthly summary of penalties where a penalty can be appealed and, in some cases, adjusted before final penalty settlement is expected. The regulation identifies the below formula to be used to calculate fail penalties:

<table>
<thead>
<tr>
<th>Type of fail security</th>
<th>Penalty rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquid shares</td>
<td>1.00 basis point</td>
</tr>
<tr>
<td>Illiquid shares</td>
<td>0.50 basis point</td>
</tr>
<tr>
<td>SME growth instruments (excluding debt instruments)</td>
<td>0.25 basis point</td>
</tr>
<tr>
<td>SME debt instruments</td>
<td>0.15 basis point</td>
</tr>
<tr>
<td>Debt instruments guaranteed by a sovereign issuer, a third country sovereign issuer; a local government authority; a central bank; any multilateral development bank referred to in Articles 117 (1) and 117 (2) of the CSDR Level 1 text; the European Financial Stability Facility or the European Stability Mechanism</td>
<td>0.10 basis point</td>
</tr>
<tr>
<td>Debt instruments, other than those referred above</td>
<td>0.20 basis point</td>
</tr>
<tr>
<td>All other financial instruments</td>
<td>0.50 basis point</td>
</tr>
<tr>
<td>Fail due to lack of cash</td>
<td>Official overnight interest rate for credit charged by the central bank issuing the settlement currency</td>
</tr>
</tbody>
</table>

Source: ECSDA Guidelines
**Buy-ins**

CSDR establishes a consistent model for execution of a buy-in at the trading level for member states by facilitating the use of buy-in agents to initiate the buy-in where the delivering party has failed to provide the expected securities. This will support the requirement to report the buy-in execution and results to the relevant CSD.

The buy-in process will be initiated following an ‘extension period’ after the intended settlement date. While the rules for the extension period are still under discussion and yet to be finalized, we can expect to see certain timeframes put into place for this. For liquid markets, the extension period is expected to be four days. The extension period will vary by the asset type and the liquidity of the financial instrument concerned. A maximum of seven days is expected, and for instruments traded on small and mid-size enterprise (SME) growth markets, we expect the extension period will be 15 days.

We expect the timeline for a buy-in in a liquid market to look similar to the chart below:

---

**TIMELINE**

<table>
<thead>
<tr>
<th>ISD+3</th>
<th>ISD+4 (Last day of extension period)</th>
<th>ISD+5 (Buy-in date)</th>
<th>ISD+6 – ISD+13</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-warning notification of buy-in is provided.</td>
<td>Mandatory partial settlement based on reaching the last possible day of the extension period.</td>
<td>Buy-in possibility is verified and the receiving party triggers engagement of buy-in agent. Both parties update their instructions to hold status. The buy-in agent takes agent to purchase required securities and informs required parties of the result. The buy-in agent settles the buy-in trade as soon as operationally possible. The original trade is cancelled by both the receiving and failing party. The receiving party informs the CSD of the buy-in result and corresponding cancellation actions.</td>
<td>Invoices are issued by the receiving party to the failing party to balance the cash difference and to pay buy-in costs. The failing party pays the cash difference and buy-in costs by the ISD+13 timeframe.</td>
</tr>
</tbody>
</table>
Further buy-in impacts include:

- SWIFT is actively assessing the changes required to support the buy-in process, including the MT54X settlement messages. The original transaction will also need to be placed on hold once the buy-in process has been initiated.

- For price differentials, should the securities price be above the price for which the original deal was executed, the failing party will be required to pay the difference to the receiving party. In cases where the buy-in price is lower, no further action is required to be taken.

- Should a buy-in not be possible, fails, or is partially settled, cash compensation will be payable by the failing party to the receiving party for the not-settled part of the transaction.

The regulation references consistent settlement failures if the settlement rate of the participant is 15% lower than that of the market, during a relevant number of days (10% of total number of active days) in the preceding 12 months. Securities finance transactions are considered to be exempt because of examples where term periods of less than 30 days would be excluded from the scope of buy-ins.

Internalized Settlement Reporting

The regulation defines that the intermediary who is closest to the CSD (within the scope of internalized settlement) will be responsible for providing a quarterly report to the National Competent Authority (NCA) with a list of transactions settled internally.

Segregation of Omnibus Accounts

The regulation aims for openness and clarity of information on an account level and thus expects for the option of segregation to be applied by CSDs and their participants. It states:

“A participant shall offer its clients at least the choice between omnibus client segregation and individual client segregation and inform them of the costs and risks associated with each option. However, a CSD and its participants shall provide individual clients segregation for citizens and residents of, and legal persons established in, a Member State where required under the national law of the Member State under which the securities are constituted as it stands at 17 September 2014. That obligation shall apply as long as the national law is not amended or repealed, and its objectives are still valid.

CSDs and their participants shall publicly disclose the levels of protection and the costs associated with the different levels of segregation that they provide and shall offer those services on reasonable commercial terms. Details of the different levels of segregation shall include a description of the main legal implications of the respective levels of segregation offered, including information on the insolvency law applicable in the relevant jurisdictions.”

Bottom Line

While the legislation focuses on building CSD best practices for securities settlements, BBH also works to prepare for stronger settlement discipline. Leading up to September 2020, when settlement discipline rules enter into force, BBH will continue to work with CSDs and our sub-custodian network to prepare procedures for potential settlement fails, buy-in activity, and to have associated messaging in place.

What should market participants be aware of?

It is never too early to start preparing to be compliant with the forthcoming phases. Market participants should be prepared to take the following steps:

- Share respective contact lists for day-to-day operational queries (i.e. mismatches, short positions, queries on confirmations, etc.) with the custodian, where not already in place.

- Consider and decide if having segregated accounts or omnibus accounts (on a client level) will put them in a position to best understand collateral obligations, possible buy-ins responsibility, and other factors including clients having transparency for the risks, costs, and operational structures related to choosing either omnibus or segregated account structures.
How BBH can help you with CSDR preparation:

- **Industry engagement.** In the interest of our clients, BBH maintains ongoing dialogue and engagement with CSDs, custodians and their networks, as well as industry associations to ensure alignment in settlement prevention best practices, and overall CSDR readiness. We welcome CSDR questions from our clients to help them prepare for what’s to come.

- **SSI visibility.** BBH provides updates on standing settlement instructions (SSIs) in-line with adjustments required for settlement discipline and potential penalty and buy-in situations. BBH has been a leading advocate of industry solutions such as DTCC’s Global Custodian Direct product (GC Direct) which automates the exchange of SSIs between a custodian’s central repository and the ALERT host, using dedicated ISO 20022 compliant messages. This enhanced custodian-driven workflow enables BBH as global custodian to maintain the SSI data, effectively creating a “golden copy” within the ALERT platform. In experiences in which we have converted our clients to GC Direct, we have seen a significant reduction in failed trade volumes due to incomplete SSIs.

- **Enhanced services.** BBH has developed new value-added services and updated procedures that align with new settlement approaches in CSDR, including enhancements to our Broker Trade Allegement service. This service improves the timeliness of settlement notifications, provides a greater range of notifications, and delivers allegement reporting insights. While it is ultimately the investors managers’ responsibility to ensure timely receipt of instructions by the BBH published deadlines, these enhancements should help reduce trade fail volumes. Given the continued evolution of global markets and regulatory oversight requirements, inclusive of shortened deadlines, mandatory pre-matching requirements and more stringent fail and/or buy-in practices, the need for robust alerts and notifications has never been more important.

For more information on CSDR, please contact your relationship manager.