



The European Union Central Securities Depositories Regulation (“CSDR”)

August, 2021

CSDR is the 3rd pillar in the post financial crisis regulatory overhaul (alongside MiFID II and EMIR). Some parts of CSDR have already been implemented since its adoption in 2014, with the next phase covering the Settlement Discipline Regime.

This briefing note will outline the key impacts of the Settlement Discipline Regime implementation and how it may impact how you do business with J.P. Morgan.

Effective date of Settlement Discipline Regime: **1st February 2022**

Goal of CSDR: To increase the safety and efficiency of securities settlement in the European Union. It aims to achieve this through harmonizing & enforcing certain aspects of the settlement cycle to prevent settlement fails.

The two key instruments it aims to achieve this through are: Settlement **Penalties** and **Mandatory Buy-ins**

Will I be in scope for CSDR? If you conduct business with in-scope financial instruments which settle on an [EU-authorized Central Securities Depositories \(CSDs\)](#). This regulation therefore has potential extra-territorial impact on our clients outside of the European Union.

Are OTC and Exchange Traded derivatives in scope? We are awaiting further guidance from the European Commission (EC) and European Securities and Markets Authority (ESMA) to clarify the scope and impact of the Settlement Discipline Regime on OTC and Exchange Traded derivatives.

Are corporate actions in scope? No

Are New Issue or Debt Conversions in scope? Potentially, but this is unclear at present due to lack of regulatory guidance issued by EC/ESMA

Regulatory Update (July 1, 2021): The European Commission stated in its [report](#) published on the 1st July 2021 that it is undertaking a further consultation on the implementation of the Settlement Discipline Regime. We are now awaiting the European Commission’s response on whether there will be changes to the rules or any movement of implementation dates. In the interim we continue to plan for the roll out of the Settlement Discipline Regime phase of CSDR.

We will keep you informed if changes are confirmed

Will there be documentation impact for you from CSDR?

Yes. You will be notified in **October 2021** of any changes to your documentation. We expect this to be minimal for our Markets clients. We will endeavor to be consistent with all industry body standards and are working to ensure a smooth and simple documentation delivery for CSDR.



Penalties

<p>What is the penalty regime?</p>	<p>The penalty regime imposes cash penalties for transactions that are not settled on the intended settlement date (ISD). Article 7 of CSDR stipulates that:</p> <p><i>“Cash penalties shall be calculated on a daily basis for each business day that a transaction fails to be settled after its intended settlement date until the end of a buy-in process”.</i></p> <p>The time period between ISD and the point at which a buy-in process is triggered is known as the extension period. The duration of the extension period is determined by the instrument’s liquidity.</p>
<p>How do I determine if a security is liquid or illiquid?</p>	<p>CSDR establishes that for the purposes of the Settlement Discipline Regime, the MiFID II liquidity classification should be utilized to identify liquid and illiquid instruments. (Art 7.15(d))</p> <p>ESMA publishes these metrics on their FITRS database with calculations updated every year in March. The maximum extension period stands at 4 business days for liquid shares, 7 business days for illiquid shares and other types of instruments and 15 days for SME growth market instruments.</p>
<p>How are penalty rates calculated?</p>	<p>Penalties are calculated on a daily basis and charged/credited by CSDs to participants on a monthly basis.</p> <p>Daily rates for settlement fails range from 0.15 to 1.0 basis point depending on the type of instrument. Please refer to Annex 1 of the EU delegated regulation 2017/389 for full details.</p>
<p>Can a transaction be cancelled after ISD but prior to a Buy-in?</p>	<p>Yes. Our current understanding is that should both parties agree, the transaction can be cancelled without triggering the mandatory buy-in.</p> <p>Article 7 of the Settlement Discipline states - Cancellation facility, CSDs shall set up a bilateral cancellation facility that enables participants to bilaterally cancel matched settlement instructions that form part of the same transaction.</p>
<p>Who determines which side of the transaction is at fault?</p>	<p>CSDs shall establish a system that enables them to monitor the number and value of settlement fails for every intended settlement date, including the length of each settlement fail expressed in business days. That system shall, for each settlement fail, collect information such as the reason for the settlement fail, based on the information available to the CSD.</p> <p>Complete details under Article 13 (Details of the system monitoring settlement fails) found in the CSDR Settlement Discipline Regime.</p>



Is there a mechanism to challenge or appeal a penalty decision?	Yes. Participants can raise a dispute with the relevant CSD on penalty calculations, or raise a bilateral discussion with their counterparty if they do not believe they are at fault for the failure of the trade. https://www.afme.eu/
Who is responsible for issuing a penalty?	The CSD is responsible to identify, generate, assign and invoice all CSDR Penalty Charges for eligible trades.
Who can claim for a specific penalty?	<p>Claims on a specific trade Penalty Charge is a process between the parties on the trade.</p> <p>Further guidance on the operational process for claims between JPM and our clients will be issued once we have further clarity.</p>

Mandatory Buy-ins

What is a Mandatory Buy-In?	<p>ESMA defines a mandatory buy-in as a contractual remedy available to the purchasing counterparty to a financial transaction in the event that the selling counterparty fails to deliver the purchased securities.</p> <p>The purpose of the mandatory buy-in is to restore the counterparties to the transaction to the economic position they would have been in had the original transaction settled.</p> <p>This applies in addition to any other discretionary buy-in process currently in place.</p>
Who is responsible for initiating a Buy-In?	Buy-Ins are initiated by the receiving party with the appointment of a neutral third party, a buy-in agent. The role of the buy-in agent is to source the outstanding securities on behalf of the failing party and deliver to the receiving trading party.
Who will appoint the Buy-In Agent?	The receiving trading venue member shall appoint a buy-in agent on the business day following the expiry of the extension / deferral period and notify the failing trading venue member thereof.
Can I appoint more than one Buy In Agent especially if the first one is not successful and deferral is initiated?	Our current understanding is that there are no regulatory impediments to appointing different buy-in agents, although not simultaneously for the same transaction. Parties are required to coordinate their actions in order to limit the number of buy-ins, preserve market liquidity and avoid situations where the receiving party receives a financial instrument twice.



<p>What is a Pass-on and are they relevant to me?</p>	<p>Where a trading party has a failing inward receipt of in scope securities and a contingent ('linked') onward delivery of the same securities, a potential pass-on situation exists. The trading party will need to confirm that both of the linked transactions are within scope of the mandatory buy-in obligation. Where the intended settlement date for both receipt and onward delivery is the same, the trading party can satisfy its buy-in obligations by notifying both its failing delivering counterparty and its onward receiving counterparty that a pass-on chain exists. It should do this at (or before) the end of the extension period related to the failing receipt. In this way, a pass-on chain is created.</p> <p>For a pass-on chain to exist, the linked receipts and deliveries must be for the same security (ISIN). The trade sizes or nominal amounts may be different, in which case each pass-on would apply to the smaller amount of the linked transactions. <u>(Current guidance – further guidance expected as part of the European Commission consultation)</u></p>								
<p>How is the Price Difference on a Buy-In calculated?</p>	<p>Where the price of financial instruments agreed at the time of the trade is lower than the price effectively paid the failing parties shall pay the price difference to the receiving trading venue members or receiving trading parties or CCP, as applicable.</p> <p>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.</p> <p>Where the price of the shares agreed at the time of the trade is higher than the price effectively paid the corresponding difference shall be deemed paid.</p> <table border="0" data-bbox="524 1213 1247 1270"> <tr> <td><u>Security</u></td> <td><u>No of shares</u></td> <td><u>Original Trade Price</u></td> <td><u>Buy-in price</u></td> </tr> <tr> <td>ISIN 123</td> <td>1000</td> <td>EUR 100</td> <td>EUR101</td> </tr> </table> <p>Cash Compensation would be (No of shares x original trade price) – (no of shares x buy-in price) = 100,000 – 101000 = EUR1000 cash compensation to be paid. Plus any other fees, interest etc.</p>	<u>Security</u>	<u>No of shares</u>	<u>Original Trade Price</u>	<u>Buy-in price</u>	ISIN 123	1000	EUR 100	EUR101
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<p>What is the term 'asymmetry' referring to?</p>	<p>Asymmetry refers to the difference in price between the 2 legs of the trade. In order to ensure everyone in the chain is compensated, profit needs to be spread along the chain to keep parties at the same position they would have been had all transactions settled correctly.</p>								



How can you minimize settlement failures?

Your overall target should be to bring the settlement matching's finality as soon as possible in the lifecycle of the trade, at the allocation and confirmation process level. CSDR requires that firms ensure clients are sending transactional information within stated timeframes in order to settle transactions in a timely manner.

Therefore you should:

- ✓ Evaluate – Regularly analyze operating processes to identify weakness.
- ✓ PSET – communicate Place of Settlement to your broker during allocation;
- ✓ Electronic Allocation & Instructions – Ensure you use Straight through processing mechanisms, with your broker and custodian.
- ✓ Pricing – up to date commission rate schedule with your broker;
- ✓ Early Matching – utilize key services in place to support Hold & Release & Auto Partial.
- ✓ Standard Settlement Instructions Accuracy – Up to date and stored in a shared electronic repository
- ✓ Monitoring – capability to understand and analyze your counterparties
- ✓ Recovery – efficient exception management and communication channel.



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