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

December, 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 Disciple 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**

Regulatory Update (Nov 29, 2021):

Delay to Mandatory Buy-ins. ESMA (European Securities and Markets Authority) issued a statement on the 17th December that expects National Competent Authorities (NCAs) not to prioritise supervisory actions in relation to the application of the CSDR **Mandatory Buy-ins regime.**

Mandatory Buy-ins will be subject to further industry consultation as noted by the European Commission stated in its report published on the 1st July. We will inform you of any further developments of Mandatory Buy-ins when we are made aware of them.

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Most frequently asked questions:

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.

Will there be documentation impact for you from CSDR?

Yes. For our Markets clients you will receive a CSDR Notice in early January 2022 relating to the allocation and confirmation of certain transactions. The notice is based on the short form language developed by AFME.

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 you 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.

Penalties

What is the penalty regime?	The penalty regime imposes cash penalties for transactions that are not settled on the intended settlement date (ISD). Article 7 of CSDR stipulates that: *"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*". 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.
How are penalty rates calculated?	Penalties are calculated on a daily basis and charged/credited by CSDs to participants on a monthly basis. 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.
Who determines which side of the transaction is at fault?	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. Complete details under Article 13 (Details of the system monitoring settlement fails) found in the CSDR Settlement Disciple Regime.
Who is responsible for issuing a penalty?	The CSD is responsible to identify, generate, assign and invoice all CSDR Penalty Charges for eligible trades. It is the CSD which will issue the relevant penalty to the failing counterparty to the trade.
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 'Bilateral claims' with their counterparty if they do not believe they are at fault for the failure of the trade. AFME have also outlined a potential Market Practice.
Who can claim for a specific penalty?	Claims on a specific trade Penalty Charge is a process between the parties on the trade.
What is JPMorgan's approach to the Bi-Lateral Claims process under CSDR?	JPMorgan will be distributing communications to clients regarding details of the Bi-Lateral Claims process prior to the February 1st 2022 CSDR Compliance Date.

To overcome possible disputes - will a new claim policy be implemented?	In the context of bilateral claims, a review will be carried out in conjunction with Trade associations and the current claims processing.
Will the penalty regime impact the ability to issue interest claims? (i.e. will the interest claims need to be adjusted down by the amount of penalty received)?	No
Will interest claims be reduced by the amount of penalty charge?	No
If the principal venue for trading is located in a 3rd country will any exemptions apply?	No.
Are penalties applicable if you settle through an ICSD (Euroclear)?	Yes
Will penalties be calculated where a corporate event is the cause for trade failure?	We expect penalties to still be levied.
Penalty Rates: Will rates used be available for use by clients?	Penalty rates are available in the ESMA technical advice report.
For historical trades, will penalties apply from original Intended Settlement Date or from 1st Feb 2022?	Penalties will apply from the date that the regulation goes live 1st Feb 2022.

Will J.P. Morgan Prime Brokerage be passing on any penalties that J.P. Morgan benefit from/have to pay in relation to failed trades for J.P. Morgan Prime Brokerage's clients' Equity Swap give up trades?	No, J.P. Morgan Prime Brokerage would not pass on any penalties as a result of failed give up trades.
If we place a trade on hold/release after S+0 will it still be eligible for penalties?	Yes, if it's matched. It is important to note that the party placing the trade on hold would be deemed to be cause of the trade fail.
Should trades be matched before they are placed on hold?	Trades do not need to be matched prior to placing on hold. JPM will send client trades on hold to allow matching to take place while not releasing for settlement - e.g. when a client is short of securities / cash.
How do I determine if a security is liquid or illiquid?	CSDR establishes that for the purposes of the Settlement Disciple Regime, the MiFID II liquidity classification should be utilized to identify liquid and illiquid instruments. (Art 7.15(d)) 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.
Can a transaction be cancelled after ISD?	Yes. Our current understanding is that should both parties agree, the transaction can be cancelled. 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.
Is there any further resources to read about the penalties regime?	AFME has published extensively on this topic here

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