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CSDR: New cash penalties regime comes into force on 1 February 2022

Background

Regulation (EU) No 909/2014 (**CSDR**) entered into force in 2014 with an objective of improving securities settlements in the European Union. One of the cornerstones of the CSDR is the introduction of an obligation on central securities depositories (**CSDs)** to impose cash penalties on participants to their securities settlement systems that cause settlement fails[1].

The CSDR itself is supplemented by a number of regulatory technical standards which include **Commission Delegated Regulation 2017/389** (**Delegated Act**) as well as **Commission Delegated Regulation 2018/1229** (**CSDR Settlement Discipline RTS**).

The new cash penalties regime, which is intended to serve as an effective deterrent for participants that cause settlement fails and to incentivize those in the settlement chain to settle trades in a timely manner, enters into force from 1 February 2022. The CSDR defines a settlement fail as "*the non-occurrence of settlement, or partial settlement of a securities transaction on the intended settlement date, due to a lack of securities or cash and regardless of the underlying cause".*

While the regime is structured so that cash penalties will be imposed by the CSD on the relevant "participant" in the CSD responsible for the settlement fail in the first instance, in cases where a trade has failed due to the fault of a party in the settlement chain other than the participant in the CSD, that participant may seek to pass on such penalties to other entities in the settlement chain.

Key Points to Note:

- Cash penalty regime under CSDR enters into force from 1 February 2022
- Cash penalties will be imposed by the CSD on the participant within the CSD responsible for settlement fail
- Where the settlement fail is not due to the fault of the participant itself, it may seek to pass on such cash penalties to other entities in the settlement chain
- Fund management companies should engage with relevant stakeholders to establish whether cash penalties may be borne by the fund and if so agree a framework on how cash penalties will be allocated

[1] Another of the key measures of the new settlement discipline regime established under the CSDR is the introduction of new mandatory buy-in rules. However the European Commission announced in November 2021 that the application of these new rules have been delayed and will not apply from 1 February 2022.

In this briefing, we consider the key aspects of the new cash penalties regime and matters for consideration by fund management companies[2] and, where relevant, the board of directors of externally managed funds[3].

What transactions fall within the scope of the new cash penalties regime?

The cash penalties regime applies to all transactions in transferable securities, money-market instruments, units in collective investment undertakings and emissions allowances which are either:

(i) admitted to trading on an EEA trading venue (including where these instruments are traded OTC); or

(ii) cleared through an EEA central counterparty

in each case regardless of the location of the entity trading such instruments. This means that a non-EEA investment manager trading in-scope transactions will also be impacted under the new regime.

What are the penalties which will be imposed under the new regime?

The recitals to the Delegated Act explain that the level of cash penalties should "*provide incentives to failing participants to promptly settle transactions that fail to be settled*".

Where the settlement fail is due to a failure to deliver financial instruments, the penalty rate which must be applied by the CSD is determined by the type of instrument in question and is closely related to the value of the financial instrument that failed to be delivered. However, where the settlement fail is due to a lack of cash, the relevant transaction will be subject to a penalty rate which is calculated on the basis of costs of borrowing cash.

The annex to the Delegated Act sets down the specific cash penalty rates applicable to settlement fails which range from 1 basis point to 0.5 basis point depending on the type of financial instrument underlying the failed trade. The highest daily penalty rate of 1 basis point will apply to failed trades involving shares which have a liquid market (on the basis that such shares could be bought easily)[4].

How are the penalties imposed by the CSD?

The CSDR Settlement Discipline RTS require CSDs to report cash penalties imposed for failed settlement instructions to participants on a daily basis. This includes providing the participant with details on the account to which each failed settlement refers. This information should allow the participant, where relevant, to assess the extent to which a cash penalty can be passed on to another entity within the settlement chain responsible for the failed trade where the participant itself is not at fault.

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[2] Reference to "fund management companies" in this briefing should be read as including all self-managed Irish domiciled funds.
[3] Other requirements which are imposed on the relevant CSD under the CSDR Settlement Discipline RTS which will also apply from 1 February 2022 are beyond the scope of this briefing.
[4] A "liquid market" is defined under CSDR with reference to the definition applied under Article 2(1)(17)(b) of MiFIR

The net amount of cash penalties to be paid by each failing participant must be charged and collected on at least a monthly basis and must then be re-distributed by the relevant CSD to receiving participants impacted by the relevant settlement fail.

Are there any circumstances in which a fund may bear the costs of cash penalties imposed by a CSD due to a settlement fail of an in-scope transaction executed on behalf of that fund?

This is not addressed under the CSDR legislative framework and no guidance has been issued by the Central Bank to date.

As noted above, net cash penalties under the CSDR settlement discipline regime are charged by the CSD to the account of the relevant participant in the system responsible for the settlement fail in the first instance. However, the participant may to seek to pass on such cash penalties to other entities in the settlement chain where the participant itself is not at fault.

Fund management companies should therefore engage with all relevant stakeholders (which will include for example the fund's depositary and any investment manager appointed to manage the assets of the fund) in order to establish whether any such cash penalties may be borne by a fund under management and, to the extent that this is possible, agree a framework on how cash penalties will be allocated in the event of a settlement fail. To the extent that a fund under management may bear the cash penalties in certain circumstances, the following considerations should be borne in mind:

Consideration of undue costs

Under both the UCITS and AIFMD frameworks, fund management companies are under a legislative obligation to ensure that no "undue costs" are borne by investors in any fund under management.

In circumstances where the cash penalties may be borne by the fund, the fund management company in question should be able to justify this position to the board of directors of the externally managed fund and provide to its competent authority documentary evidence (in the form of board minutes or otherwise) that it has considered the matter and is satisfied that this does not constitute an "undue cost" taking into account the considerations outlined by ESMA in its supervisory briefing on the supervision of costs in UCITS and AIFS published in 2020.

Constitutive document and prospectus

A review of the constitutive document should be carried out to ensure that its existing provisions are sufficiently broad to allow such cash penalties to be borne by the relevant fund.

The prospectus of the relevant fund should also be reviewed to ensure that the existing disclosures are sufficiently broad to capture the fund bearing such cash penalties. When next updating the prospectus of the relevant fund, consideration should also be given as to whether specific disclosure on the cash penalties regime should be included so that investors are clearly informed of the possibility of the fund bearing such costs in certain circumstances.

Governance framework

Fund management companies should be satisfied that an appropriate governance framework is in place which identifies how cash penalties for settlement fails will be allocated to relevant stakeholders, and where relevant, the specific circumstances in which a cash penalty may be borne by the relevant fund. Any such framework should be consistent with the contractual arrangements already in place with each of the stakeholders. To the extent that the finalised framework is not consistent with existing contractual arrangements/service level arrangements, such arrangements may need to be revisited as necessary.

Please get in touch with your usual Dillon Eustace contact if you have any questions arising from this briefing.

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