EUROPEAN PRINCIPAL TRADERS ASSOCIATION

29 February 2024

FIA EPTA Response to ESMA's Consultation Paper on Technical Advice on the CSDR Penalty Mechanism

(ESMA74-2119945925-1634)

Executive Summary

The European Principal Traders Association (FIA EPTA) represents Europe's leading Principal Trading Firms. Our members are independent market makers and providers of liquidity and risk-transfer for markets and end-investors across Europe. FIA EPTA works constructively with policy-makers, regulators and other market stakeholders to ensure efficient, resilient and trusted financial markets in Europe.

FIA EPTA welcomes the opportunity to respond to ESMA's Consultation on Technical Advice on the CSDR Penalty Mechanism ("the Consultation"). We are supportive of effective measures to improve settlement discipline and efficiency in Europe, particularly in light of discussions concerning shortening settlement cycles.

Timing of review

In considering ESMA's commentary and conclusions in the Consultation, we note that the existing penalty mechanism under CSDR has only been in force for a relatively short period of time and over that time, European markets have gone through significant periods of volatility and change, including in response to the Covid-19 crisis and the ensuing higher interest rate environment. The Commission has asked ESMA to assess the effectiveness of the current penalty mechanism and propose, if justified, changes to the structure or severity of the current penalty mechanism and consider alternative methods of calculating cash penalties. Given that the Settlement Discipline regime entered into force on 1 February 2022, a year of volatile market conditions which inherently results in higher settlement fails, our members question whether there is sufficient data to conduct such an assessment and propose changes to the regime. We note that ESMA, also, recognizes the need for a longer observation period to perform a meaningful assessment. It would appear, therefore, to be premature to make a change to the current penalty regime. We would recommend that ESMA take a conservative and measured approach to proposing changes to the Commission and allow sufficient time to assess the impact of the current regime before making dramatic changes to the design or rate of penalties applicable under CSDR.

FIA EPTA's response to the Consultation focusses specifically on ETF markets.

Structural issues in European ETF markets

FIA EPTA members believe the majority of ETF settlement failures in Europe are caused by structural issues rather than behavioural ones and therefore if ESMA does consider it timely and necessary to substantially revise the CSDR penalty mechanism, its proposals should focus on addressing actionably avoidable fails. Extra penalizing of unavoidable, inadvertently failed settlements only does extra harm to the markets as a whole, especially to the end-investor, and will not address the issue CSDR aims to solve.

This is particularly the case in ETF markets where structural complexity concerning settlement can often lead to settlement taking place after the ISD. These complexities include:

there is no one single centralized place of settlement; and

- primary creation of ETFs by liquidity providers to meet customer demand results in complex settlement requirements in relation to the instruments underlying the ETF, particularly for ETFs referencing global instruments.

ETFs may not settle on ISD driven by their primary market structure and the fact they can reference underlying assets which are listed outside of the region and therefore may be more difficult to source or operate on a different settlement timetable.

Possible measures to encourage more timely settlement include:

- Reduced fragmentation and increased interoperability of European post trade processes – many late settlements may originate from uncertainty stemming from the many places ETFs may settle;
- Initiatives to improve ETF borrow markets – which are underdeveloped versus cash equities and potentially harmed further by large increases to CSDR penalties;
- Smaller creation unit sizes; and
- Recognition of the unique role of market makers – given ETFs are a highly fragmented product, the market relies on market makers to intermediate liquidity. Further flexibility should be afforded them to ensure they can stitch together various fragmented liquidity demands without the threat of costs that would harm their ability to perform this important function.

The progressive penalty rates proposed in the Consultation pose significant risk of having a detrimental impact on liquidity provision and investor interest in trading these products. This is of grave concern to our members given steps by other jurisdictions to improve the competitiveness of their markets and the ability for investors to easily trade (and switch between trading) different cross listings of the same ETF in the EU, UK and Switzerland.

ETFs offer EU investors an opportunity to obtain simple cost-efficient exposure to global markets via instruments subject to the EU regulatory framework and therefore investment in these products should be encouraged, particularly retail investment. The global nature of ETFs contributes to settlement complexity but should not result in punitive penalties being applied when such penalties are not an appropriate or effective means of addressing the reasons for settlement failures with respect to ETFs.

Proportionality as a core principle

We agree that proportionality should be a core principle shaping ESMA's proposals. Accordingly, any steps taken to adjust the penalty mechanism should take into account the root causes of settlement fails with penalty rates focusing only on addressing actionably avoidable fails rather than fails caused by structural issues in the European post-trade environment. Implementing broader post-trade reforms to improve efficiency, such as mandating consent to partial settlement, would have wider and more substantial benefits for improving settlement discipline and overall post-trade efficiency, which is particularly important in light of discussions regarding shortening settlement cycles in Europe.

The proposals, set out in the consultation paper, are likely to result in far higher costs of trading, most likely in the form of wider spreads which will be passed on to end investors and most acutely impacting retail investors, contrary to broader EU CMU policy objectives aimed at stimulating retail participation in EU capital markets. At the same time, the penalty fees are unlikely to materially improve settlement fail rates in ETF markets as they are caused by structural issues, not behavioural issues and therefore high penalty rates will not be an effective disincentive to fail. Our members would also question the timing for making any changes as the US is due to migrate to a T+1 settlement cycle and the UK is discussing a similar move, given the resulting settlement cycle mismatches this will result in additional unavoidable settlement fails. This will further disincentivise investment in EU financial markets.

Further we note that CSDR is the designated European regulatory framework designed to address settlement discipline and the cash penalties regime is prescribed and enforced under this regulation. Accordingly, FIA EPTA members believe that any breach of the requirements on market participants under CSDR should be dealt with solely and exclusively within the CSDR regulatory framework. In particular, such a breach should not be permitted to give rise to liability for fines or penalties levied for that same breach by any other body claiming jurisdiction or right to recourse with respect to it including a market infrastructure provider.

Alternative proposal

If ESMA believe that it is necessary to increase penalty rates, we believe proportional approach should be adopted which takes into account structural factors impacting settlement failure rates of particular financial instruments by including a different treatment for ETFs and market makers. We strongly recommend that ESMA does not implement progressive penalty rates due to the likely detrimental impact on liquidity and costs in European ETF markets. Instead, we consider a flat penalty rate, subject to review and revision by ESMA, to be more appropriate at incentivizing settlement discipline whilst supporting ongoing growth and investment in EU capital markets. In formulating this approach, we believe ESMA would benefit from further consultation with the industry to develop a solution suitable to cater for the unique characteristics of ETF markets.

Q1: Do you agree with ESMA's proposal? Which Option is preferable in your view? Please also state the reasons for your answer.

No comment

Q2: Do you have other suggestions? If yes, please specify and provide arguments.

No comment

Q3: Do you agree with the approach followed for the Option you support to incorporate proportionality in the Technical Advice? If not, please provide an indication of further proportionality considerations, detailed justifications and alternative wording as needed.

No comment

Q4: What costs and benefits do you envisage related to the implementation of each Option? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

No comment

Q5: As a CSD, do you face the issue of accumulation of reference data related to Late Matching Fail Penalties (LMFPs), that may degrade the functioning of the securities settlement system you operate? If yes, please provide details, including data where available, in particular regarding the number and value of late matching instructions, as well as for how many business days they go in the past from the moment they are entered into the securities settlement system, and the percentage they represent compared to the overall number and value of settlement fails on a monthly basis (please use as a reference the period June 2022 – June 2023)

No comment

Q6. What are the causes of late matching? How can you explain that there are so many late matching instructions lasting during a very long period? What measures could be envisaged in order to reduce the number of late matching instructions?

The most common causes of late matching, of settlement instructions, is a mismatch of settlement location and incorrect SSI setups (inaccurate / incomplete standard settlement instructions). The mismatch of settlement location is especially present for ETFs given their highly fragmented listing environment. One ETF may be listed many times across Europe to suit local investor preferences and allow for listings in different currency lines. These trading lines may settle into many different locations, including ICSDs or local depositories and uncertainty over place of settlement between two counterparties can delay matching.

We would recommend that the EU either mandate or minimize the number of fields that brokers are required to populate. In particular, we recommend that "Place of Settlement" is made a mandatory field in the matching (allocation/affirmation) process. The current inconsistency in systems used by market participants results in field population data (essential and, at times, non-essential) being mismatched which results in delays or failed trades. Mandating or minimizing fields would improve post-trade efficiency across the market.

In addition, our members still experience clients holding back settlement instructions from the market until ISD and some until they able to settle the full trade (although this happens much less so since the introduction of penalties fees). In order to provide sufficient time to resolve settlement instruction discrepancies and to ensure these do not impact on settlement efficiency on ISD, our members would recommend the introduction of a requirement for trades to be affirmed and instructed in the market on trade date, similar to the US market.

Late matching is also caused by issues with allocation instructions. Currently in Europe, whilst most market participants use CTM, Swift or FIX messaging for allocation instructions, a significant number of market participants still use email or Bloomberg Messenger to convey this information. As manual instructions are subject to human error this continues to be a sub-optimal way of conveying allocation details and prone to causing delays in the settlement matching process. That said, we would recommend mandating a requirement for confirmation and allocations to be communicated in a machine-readable format.

Q7: Do you agree with ESMA's proposal to establish a threshold beyond which more recent reference data shall be used for the calculation of the related cash penalties to prevent the degradation of the performance of the systems used by CSDs? Please also state the reasons for your answer.

No comment

Q8: Do you agree with the threshold of 92 business days or 40 business days in order to prevent the degradation of the performance of the systems used by CSDs? Please specify which threshold would be more relevant in your view: a)92 business days; b)40 business days; c)other (please specify). Please also state the reasons for your answer and provide data where available, in particular regarding the number and value of late matching instructions that go beyond 92 business days, 40 business days in the past or another threshold you think would be more relevant, and the percentage they represent compared to the overall number and value of settlement fails on a monthly basis (please use as a reference the period June 2022 – December 2023).

No comment

Q9: Do you agree that the issuer CSD for each financial instrument shall be responsible for confirming the relevant reference data to be used for the related penalties calculation? Please also state the reasons for your answer.

No comment

Q10: In your view, where settlement instructions have been matched after the intended settlement date, and that intended settlement date is beyond the agreed number of business days in the past, the use of more recent reference data (last available data) for the calculation of the related cash penalties should be optional or compulsory? Please also state the reasons for your answer.

It is our members view that there needs to be a clear understanding of what data will be used, at what point in time, in order for all parties involved in the settlement process to know the penalty implication of failing to match on time. Allowing for the determination of an element of the calculation to be optional will result in ambiguity and differences dependent on the CSD/situation/other factors. In order to ensure that the penalty regime remains implemented in a harmonized, transparent manner, our members would prefer no optionality regarding reference data to be provided within the regime.

Q11: Do you have other suggestions? If yes, please specify, provide drafting suggestions and provide arguments including data where available.

No comment

Q12: Do you agree with the approach followed to incorporate proportionality in the Technical Advice? If not, please provide an indication of further proportionality considerations, detailed justifications and alternative wording as needed.

No comment

Q13: What costs and benefits do you envisage related to the implementation of the approach proposed by ESMA? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

No comment

Q14: If applicable (if you have suggested a different approach than the one proposed by ESMA), please specify the costs and benefits you envisage related to the implementation of the respective approach. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

No comment

Q15: Based on your experience, what has been the impact of CSDR cash penalties on reducing settlement fails (by type of asset as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389 since the application of the regime in February 2022? Please provide data and arguments to justify your answer.

FIA EPTA members have not necessarily seen a notable reduction in settlement fails as a consequence of cash penalties being introduced. Many of the fails and resulting fines are unavoidable because of structural reasons such as where liquidity providers need to create ETF units in the primary market to satisfy investor demand, namely when:

- The fund's standard creation settlement timeline is longer than T+2
  - This is often the case for ETFs with a large portion of Asian market underlyings due to the differing time zone of such underlyings.
- The sale occurs after the fund's primary market has closed
  - ETF creation cut-off times are often earlier than exchange closing times meaning trading may still occur after this point
- There is a fund holiday
  - These are situations where the home markets of a significant portion of an ETF's underlying assets are closed, and accordingly the ETF's primary market is closed, even if the ETF's listing market is open.

In the experience of one of our members – around 20% of the equity ETF sales to clients would be impossible to cover via the primary market for T+2 standard settlement due to such reasons.

Because of these structural factors, most fines that we observe are unavoidable. These issues are exacerbated by the fact that the borrow market for ETFs is much less established and less liquid than the borrow market for Equities. In addition, due to ETFs often having multi-listings across different CSDs uncertainty over place of settlement between two counterparties can delay matching and therefore settlement. For ETFs, these structural reasons mean that larger penalties may not be able to facilitate faster settlement, as they are not "actionable", but instead risk increasing costs to investors.

It is also the experience of our members that fails in ETFs are almost always due to the selling party, rather than the buyer. It is worth noting, the seller already has a strong incentive to settle on time, namely the interest income they would gain from holding the cash deliverable by the buyer.

If the seller fails to settle, they are missing out on the interest which is an opportunity cost to them. With interest rates at current levels, this is a strong incentive and higher settlement fail rates are in spite of this – highlighting the structural factors at play. In this regard, ESMA may benefit from conducting further analysis of settlement fail rates over a longer period of time since higher interest rates have been in effect so this behavioural incentive is likely to be more evident in the data. Liquidity providers are already strongly incentivized to settle on time, even without CSDR penalties. In addition, counterparties/clients may choose to trade with alternative liquidity providers if settlement cannot occur in an acceptable timeframe or the liquidity provider has a history/pattern of failing to settle on time.

Another contributing factor for ETFs is the highly fragmented listing environment. One ETF may be listed many times across Europe to suit local investor preferences and allow for listings in different currency lines. In general, the same ETF (by ISIN) will have multiple lines listed in Europe (often 3 or more), a UK line and a Swiss line. These trading lines may settle into many different locations, including ICSDs or local depositories. These aspects are not true for other asset classes such as cash equities and make the ETF post trade settlement process somewhat uniquely complex. Given this fragmentation is unlikely to change (or need to change) for CSDR, it is a factor that regulators should take into account when designing penalties for late settlement, and taking account of the more complex workflows which apply to ETFs.

The addition of CSDR penalties, on top of missed interest, makes the overall cost larger, but does not solve the underlying problems or provide a benefit to end investors. Indeed – for market makers providing liquidity in these products where structural problems may arise – they will be able to anticipate the additional cost and widen out their spreads to take account of them. This would not be a case of a pass-through of fees to underlying investors, but it is an outcome of structural issues making delayed settlement inevitable. Market makers may therefore be net-flat in terms of the wider spreads offsetting the higher costs. Equally end clients may also be net flat as while they pay wider spreads, they would collect the CSDR penalties. The main impact would be to the wider market's perception (including retail investors) who would simply see the wider spreads but the factors driving those spreads would not be transparent to them, making the European ETF market look more expensive and illiquid.

As UCITS ETFs are a wrapper which can reference global underlying assets (and are a product which has proved globally popular), they require flexibility in settlement outside of standard T+2 cycles to facilitate their reference to underlying markets outside of the European time zone. That is a feature of the product, not a flaw, and ETFs should be treated specially and specifically to recognize this fact.

Measures the regulators may look to review to encourage more timely settlement would include:

- Reduced fragmentation and increased interoperability of European post trade processes – many late settlements may originate from uncertainty stemming from the many places ETFs may settle
- Initiatives to improve ETF borrow markets – which are underdeveloped versus cash equities and potentially harmed further by large increases to CSDR penalties
- Smaller creation unit sizes
- Recognition of the unique role of market makers – given ETFs are a highly fragmented product, the market relies on market makers to intermediate liquidity. Further flexibility should be afforded them to ensure they can stitch together various fragmented liquidity demands without the threat of costs that would harm their ability to perform this important function.

Q16: In your view, is the current CSDR penalty mechanism deterrent and proportionate? Does it effectively discourage settlement fails and incentivise their rapid resolution? Please provide data and arguments to justify your answer.

As mentioned above, FIA EPTA member do not observe the current CSDR penalty mechanism as acting as a deterrent because it is not targeted at actionably avoidable settlement failures whereas many of the settlement fails we observe are caused by structural factors. These underlying root causes should be remediated rather than resulting in additional costs which increase the overall cost of trading in European markets, ultimately undermining European competitiveness compared to markets which facilitate trading the same or equivalent instruments but do not have penalty regimes.

Q17: What are the main reasons for settlement fails, going beyond the high level categories: "fail to deliver securities", "fail to deliver cash" or "settlement instructions on hold"? Please provide examples and data, as well as arguments to justify your answer

While the objective of the proposed steps is to ensure market participants' rational economic choice is to settle on time where possible, the consultation and proposed amendments do not recognise situations where participants are unable to settle in standard settlement windows due to the structural nature of a product. ETFs provide examples of where this can be true and also a specific case where settlement flexibility is helpful.

Sourcing ETF shares on-exchange may not be possible due to thin liquidity, the structurally fragmented nature of EU capital markets, or be significantly more expensive for clients than where liquidity providers create ETF units in the primary market, including for the reasons mentioned above in our response to question 15.

Changes to the CSDR penalty regime would not change the fact that ETF liquidity providers may still need to source liquidity in the primary market to satisfy investor demand. However, in the future, the cost incurred by liquidity providers for failing to settle the ETF with the client by ISD would be significantly larger. That cost would have to be reflected in the quotes provided, significantly widening spreads and increasing the cost of trading for the end investor. This cost impact would be particularly acute for retail investors given their overall cost sensitivity and the assessment of best execution being in relation to overall cost. It may therefore act as a disincentive for them to invest in ETFs or to prefer to invest in ETFs outside of Europe in jurisdictions where there is no late settlement penalty regime where they may be comparatively cheaper and more attractive from a best execution perspective.

Q18: What tools should be used in order to improve settlement efficiency? Please provide examples and data, as well as arguments to justify your answer.

The potential areas listed below may not be in the powers of regulators directly, often requiring industry wide efforts, but are examples of areas that may help to improve overall ETF settlement efficiency and effectiveness:

- **Improving the borrow market in ETFs.** This is relatively limited today, but industry initiatives to make borrows in ETF more reliable, available and cheaper would aid ETF liquidity, pricing and settlement.
- **Expanding creation access in ETFs.** Industry initiatives (across issuers, custodians, market makers etc) to look into areas such as later cutoffs, smaller creation units, more open access when underliers are closed and T+2 settlement even for funds including Asian constituents could all help align primary market access with the local ETF trading calendar.
- **Encouraging interoperability and adoption of pan-European post-trade infrastructures.** European ETFs can have many potential settlement locations. Use of ICSDs and strategic settlement models like T2S can help the efficiency of the ETF settlement. CCP interoperability can provide similar benefits through simplifying and improving post trade workflows.

In addition to looking to improve settlement efficiency, the policies and models used should also recognize the potential limits of their impact and upper bounds of success. While overall statistics for ETF settlement may be lower than for other assets such as cash equities, the upper bound possible for ETFs may itself be lower due to the structural reasons. One of EPTA's members estimates that around 20% of their ETF sales would be impossible to cover using the primary market due to these structural reasons previously detailed.

Q19: What are your views on the appropriate level(s) of settlement efficiency at CSD/SSS level, as well as by asset type? Please provide data and arguments to justify your answer.

Aside from the primary market examples previously mentioned, there are also examples of where a liquidity provider may determine they would be able to quote tighter where they source liquidity in the secondary market (e.g. on exchange) to satisfy the demand. This is more likely for the subset of European ETFs with relatively liquid secondary market trading.

Today, this anticipated improvement in hedging costs would result in tighter spreads for the client. However, sourcing the ETF shares in the market may take time and potentially delay the settlement of the trade with the client until the liquidity provider has sufficient inventory. While the client's settlement may be delayed, it is ultimately a choice clients may, and in practice do, wish to make with respect to their own best execution obligations.

Higher CSDR penalties would make this kind of workflow more costly, meaning liquidity providers would be more certain to have to create in the primary market, even where this is at a higher cost to clients, including because of minimum basket sizes. This may cut across other broader policy objectives regarding incentivizing retail investment in EU capital markets and growing European ETF markets.

Q20: Do you think the penalty rates by asset type as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389 are proportionate? Please provide data and arguments to justify your answer.

It is unclear to FIA EPTA members how ESMA has determined these stricter proposals are necessary. Current Settlement discipline rates over the timeframe analysed by ESMA might not be at a level that ESMA considers optimal, but there is very limited data as of yet to determine whether the current regime has been effective or not. For instance, our members have experienced a decrease in settlement fails, especially in H2 2023, rather than an increase or continuation of status quo.

We do not believe the proposed penalty rates for ETFs are proportionate. This is because they do not recognise that ETFs have a structure where fails are not always "actionably avoidable". Specifically, this would include where liquidity providers need to create new ETF shares in the primary market to satisfy client demand, but the primary market is closed or operating on a longer settlement period, driven by the ETF's underlying assets and markets.

The regulation should recognise this key difference for ETFs as well as the role market makers play in the market, taking inspiration from other markets such as the US where market makers are provided with additional flexibility, recognising the key role they play in the markets intermediating risk transfer and structural factors impeding settlement efficiency particularly for market makers in ETF markets. For further detail on this point, please see our response to question 26, below.

We further believe that when considering proportionality, ESMA should also have regard to the timing of these proposals. As raised in our executive summary, FIA EPTA members believe that there has been insufficient time to gather data giving a truly representative sample of settlement failure rates since introduction of the CSDR cash penalties regime. Further time is needed to assess the impact of these and the effect of higher interest rates on settlement failure rates to assess whether such a dramatic change to the design of the penalty regime is justified by the proportion of actionably avoidable fails.

Q21: Regarding the proportionality of the penalty rates by asset type as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389, ESMA does not have data on the breakdown of cash penalties (by number and value) applied by CSDs by asset type. Therefore, ESMA would like to use this CP to ask for data from all EEA CSDs on this breakdown, including on the duration of settlement fails by asset type.

No comment

Q22: In your view, would progressive penalty rates that increase with the length of the settlement fail be justified? Please provide examples and data, as well as arguments to justify your answer.

We make the following comments on the impact of progressive penalty rates on ETF markets:

- **ETFs can have structural mechanics that require settlement flexibility**

While the objective of the proposed steps is to ensure market participants' rational economic choice is to settle on time where possible, the consultation and proposed amendments do not recognise situations where participants are unable to settle in standard settlement windows

due to the structural nature of a product. ETFs provide examples of where this can be true and also where settlement flexibility is helpful.
Sourcing ETF shares on-exchange may not be possible due to thin liquidity, the structurally fragmented nature of EU capital markets, or be significantly more expensive for clients than where liquidity providers create ETF units in the primary market. Where doing so, timely settlement would not be possible where:

- The fund's standard creation settlement timeline is longer than T+2
    - This is often the case for ETFs with a large portion of Asian market underlyings due to the differing time zone of such underlyings.
- The sale occurs after the fund's primary market has closed.
    - ETF creation cut-off times are often earlier than exchange closing times meaning trading may still occur after this point
- There is a fund holiday.
    - These are situations where the home markets of a significant portion of an ETF's underlying assets are closed, and accordingly the ETF's primary market is closed, even if the ETF's listing market is open

Changes to the CSDR penalty regime would not change the fact that ETF liquidity providers may still need to source liquidity in the primary market to satisfy investor demand. However, in the future, the cost incurred by liquidity providers for failing to settle the ETF with the client by ISD would be significantly higher. That cost would have to be reflected in the quotes provided, significantly widening spreads.

- **All-in trading costs will be potentially higher and more opaque, threatening the EU's competitiveness vis-a-vis other regions**

Counterintuitively, clients themselves may not always be worse off on a net basis from the changes. The increased spreads could (but not always) be offset by the CSDR penalties sourced by the CSD from the liquidity provider and credited to the client. However this will not be clear to the client at the point of trade, and the cost of trading may be unclear to them (i.e. are they paying the full spread, or likely to recoup some through CSDR penalty reimbursements).

In addition, any reimbursements would be invisible to the wider market, who would only see the increased costs from the spread. This could impact the attractiveness of European ETFs, versus other regions, and act against the wider strategic objectives of European policymakers. This may be especially true for retail investors, disincentivising a key market segment.

ETF listings are a somewhat unique competitive environment in that the same exposures can be offered via products listed in different regions, globally. This point is also true locally in Europe with listings across the UK and EU. As the UK decided not to proceed with CSDR's penalty regime after Brexit, higher penalties in the EU may give rise to large differences in trading costs, causing issuers and investors to focus more on UK products which may exhibit tighter spreads.

- **Settlement flexibility in ETFs can mean end-investors get better pricing**

Aside from the primary market examples previously mentioned, there are also examples of where a liquidity provider may determine they would be able to quote tighter where they source liquidity in the secondary market (e.g. on exchange) to satisfy the demand, including because primary creation may entail minimum basket sizes. This is more likely for the subset of European ETFs with relatively liquid secondary market trading.

Today, this anticipated improvement in hedging costs would result in tighter spreads for the client. However, sourcing the ETF shares in the market may take time and potentially delay the settlement of the trade with the client until the liquidity provider has sufficient inventory. While the client's settlement may be delayed, it is ultimately a choice clients may, and in practice do, wish to make with respect to their own best execution obligations.

Higher CSDR penalties would make this kind of workflow more costly, meaning liquidity providers would be more certain to have to create in the primary market, even where this is at a higher cost to clients.

- **Higher CSDR fees may make the ETF market less competitive**

Investors may have a choice of ETFs to achieve their target exposure, i.e. different issuers may list competing products targeting similar / the same benchmarks. Where there is a more established product or ETF with higher AUM, it may also have a more active borrow market, enabling liquidity providers to borrow the units where required and avoid CSDR penalties. For the ETFs which have less AUM or are less established, that may not be possible.

This means liquidity providers may have to quote wider for less actively traded products, acting as a barrier to ETFs issuers' ability to innovate and bring new offerings to the market.

Q23: What are your views regarding the introduction of convexity in penalty rates as per the ESMA proposed Option 2 (settlement fails caused by a lack of liquid financial instruments)? Please justify your answer by providing quantitative examples and data if possible.

No comment

Q24: Would it be appropriate to apply the convexity criterion to settlement fails due to a lack of illiquid financial instruments as well? Please justify your answer by providing quantitative examples and data if possible.

Progressive penalty rates, even with an element of convexity, are inappropriate for financial instruments structurally complex settlement arrangements, such as ETFs. Instead, steps should be taken to address structural issues driving settlement failures in these markets with a view to improving overall post-trade efficiency in Europe.

Should ESMA decide that it has no choice but to apply progressive penalty rates, FIA EPTA members strongly recommend in relation to ETFs:

- There should be an exemption for bona fide market making activity to recognize the particular risks and function of market makers; and

- A single flat penalty rate be applied to other market participants rather than progressive penalty rates. Whilst it is not possible to definitively identify a single rate or benchmark against which to set a rate that appropriately disincentivizes actionably avoidable settlement failures, the funding rate may be a reasonable starting point for assessment. Alternatively, a flat rate of approximately 1-1.5bps may be an appropriate starting point, with the penalty rate subject to review by ESMA on a periodic basis, having reference to a range of factors including the prevailing interest rate., We recommend this rate and the factors to be considered in its review be formulated in further consultation with industry with the objective of tailoring it to address the particular characteristics of European ETF markets.

Q25: What are your views regarding the level of progressive penalty rates: a) as proposed under Option 1? b) as proposed under Option 2?

As per our response to Question 20, we do not believe the proposed penalty rates for ETFs are proportionate. This is because they do not recognise that ETFs have a structure where fails are not always "actionably avoidable". Specifically, this would include where liquidity providers need to create new ETF shares in the primary market to satisfy client demand, but the primary market is closed or operating on a longer settlement period, driven by the ETF's underlying assets and markets. The regulation should recognise this key difference for ETFs as well as the role market makers play in the market, taking inspiration from other markets such as the US where market makers are provided with additional flexibility, recognising the key role they play in the markets intermediating risk transfer.

For these situations, where fails are not actionably avoidable, liquidity providers in ETFs would need to add these costs to prices offered to client, widening spreads.

Counterintuitively, clients themselves may not always be worse off on a net basis from the changes. The increased spreads could (but not always) be offset by the CSDR penalties sourced by the CSD from the liquidity provider and credited to the client. However, this will not be clear to the client at the point of trade, and the true cost of trading may be unclear to them (i.e., are they paying the full spread, or likely to recoup some through CSDR penalty reimbursements).

In addition, any reimbursements would be invisible to the wider market, who would only see the increased costs from the spread. This could impact the attractiveness of European ETFs, versus other regions, and act against the wider strategic objectives of European policymakers. This may be especially true for retail investors, disincentivising a key market segment.

ETF listings are a somewhat unique competitive environment in that the same exposures can be offered via products listed in different regions, globally. This point is also true locally in Europe with listings across the UK and EU. As the UK decided not to proceed with CSDR's penalty regime after Brexit, higher penalties in the EU may give rise to large differences in trading costs, causing issuers and investors to focus more on UK products which may exhibit tighter spreads.

Q26: If you disagree with ESMA's proposal regarding the penalty rates, please specify which rates you believe would be more appropriate (i.e. deterrent and proportionate, with the potential to effectively discourage settlement fails, incentivise their rapid resolution and improve settlement efficiency). Please provide examples and data, as well as arguments to justify your answer. If

relevant, please provide an indication of further proportionality considerations, detailed justifications and alternative proposals as needed.

Commenting specifically on ESMA's proposals and how they may be improved;

The penalty regime should recognise that many ETF fails around ISD are not by choice (as highlighted in previous examples) and focus on penalising "actionably avoidable" fails. This approach would target cases where settlement fails are a result of behavioural factors rather than structural complexity and therefore operate as an incentive to improve settlement efficiency rather than simply adding to the overall cost of trading. Splitting out ETFs as a distinct asset class, as suggested in ESMA's "Option 1", is likely a positive step towards this.

Looking globally, similar regulations in other jurisdictions provide separate treatment for principal liquidity. Reg SHO in the US allows firms engaged in "bona fide market making" additional time to settle without penalty - recognising the additional settlement complexities market makers may face due to structural factors impacting their ability to source liquidity. Market making should be viewed here in the broad sense under MiFID II, dealing on own account across all venues and protocols, not just for on-exchange trading. A similar exemption is provided for market makers under the EU Short Selling Regulation in recognition of particularly important function played by market makers particularly in a fast-moving market. The US Securities and Exchange Commission observe in describing the exemption for market makers under Reg SHO that market makers may have to buy financial instruments without having time to arrange cover due to their commitments to counterparties and trading venues in undertaking to act as market makers. This is particularly the case in thinly traded and illiquid instruments. See: [Key Points About Regulation SHO (sec.gov)]

This type of approach may be especially important in times of market stress when concurrently overall levels of settlement fails can increase. High penalties with significant scaling rates for longer fails, as proposed by ESMA, may act as an additional barrier to market makers from providing liquidity and supporting the market during these periods, given the potential settlement penalties they may incur.

Taking a similar approach to the US by introducing a longer gap until penalties applied, potentially until ISD+2 for ETFs, would help provide time for many of these structural reasons behind late settlement to be worked through – and so "solve" the problem for most instances. However, edge cases would remain, for example, European listed ETFs with Chinese exposure may have their primary markets closed for long periods due to holidays such as Chinese Lunar New Year. Also having a market maker exemption would help provide a solution for these.

A more specific solution targeting particular ETFs would not be practical due to the rapidly changing listings environment, holdings of underlying indices and lack of data to target such ETFs. A principles-based approach would lead to better outcomes recognizing the role played by market makers intermediating these markets.

However, broadly speaking, the EU may wish to consider whether market makers, a group already recognised under European regulations such as MiFID and the Short Selling Regulation, should qualify for different treatment under the CSDR rules, as in the US. This may be especially important for European ETFs, which is a market mostly facilitated by market makers and risk liquidity.

In relation to ETFs, if ESMA believes that it is necessary to increase penalty rates, FIA EPTA members strongly support an exemption for market makers with other market participants to be subject to an increase in penalties levied at a flat rate of 1-1.5bps, subject to periodic review by ESMA (as outlined above in our response to question 24), which may act as an appropriate disincentive to failed trades if evidence establishes that such failures are driven by behavioural factors. However, we note that there is no clear ideal number or reference rate to determine the point at which such behaviour is appropriately disincentivized. In formulating this approach, we believe ESMA would benefit from further consultation with the industry to develop a solution suitable to cater for the unique characteristics of ETF markets.

In any event, a single flat fee is far more appropriate for ETFs than progressive rates given the structural complexities of the ETF post-trade environment. We strongly recommend that ESMA does not implement progressive penalty rates due to the likely detrimental impact on liquidity and costs in European ETF markets.

However, generally, FIA EPTA members believe that merely increasing settlement penalties will not materially reduce settlement failure rates as a large proportion are caused by structural issues. In order to address failure rates more broadly, these structural issues should be addressed directly to improve overall post-trade efficiency across Europe. Some measures in this regard include mandating consent for partial settlement and providing a regulatory environment that incentivizes lower cost ICSD(s) (for further detail, please see our response to questions 6, 15 and 18). These measures are particularly important in the context of discussing potentially shortening settlement cycles in Europe and in the view of FIA EPTA members, are a necessary precursor to successfully implementing a shorter settlement cycle.

It should also be noted that the listing and trading of ETFs is a globally competitive market, in that ETFs with the same exposures can be listed in different locations. Should the EU introduce unnecessary costs into the trading of EU listed ETFs, liquidity may move to ETFs listed in other locations where these costs do not apply (noting the UK has not applied an equivalent regime) and hence have tighter spreads and lower trading costs.

Q27: What are your views regarding the categorisation of types of fails: a) as proposed under Option 1? b) as proposed under Option 2? Do you believe that less/further granularity is needed in terms of the types of fails (asset classes) subject to cash penalties? Please justify your answer by providing quantitative examples and data if possible.

No comment

Q28: What costs and benefits do you envisage related to the implementation of progressive penalty rates by asset type (according to ESMA's proposed Options 1 and 2)? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Due to structural post-trade complexity in Europe, particularly in ETF markets, ESMA's proposals are likely to result in far higher costs of trading, most likely in the form of wider spreads which will be passed on to end investors and most acutely impacting retail investors, contrary to broader EU policy objectives aimed at stimulating retail participation in EU capital markets. Penalty rates are unlikely to materially improve fail rates in ETF markets as they are caused by structural issues, not behavioural issues.

As discussed above in our response to question 24, progressive penalty rates are inappropriate for financial instruments traded in a structurally complex environment, such as ETFs. Instead, steps should be taken to address structural issues driving settlement failures in these markets with a view to improving overall post-trade efficiency in Europe.

If ESMA decides that it has no choice but to apply progressive penalty rates, FIA EPTA members strongly recommend that in relation to ETFs:

- There be an exemption for market making activity to recognize the particular risks and function of market makers; and
- A single flat penalty rate be applied to other market participants. For further detail on this proposal, please see our response to question 24.

Below we provide a worked example illustrating potential cost on an ETF referencing a global basket including Asian financial instruments, in the event that progressive penalty rates as proposed by ESMA apply to ETFs. During Lunar New Year the Asian market is (partly) closed. As you can see from the example, the cost impact is profound. This year it also coincides with President's Day in the US, making alignment of settlement timetables more complex. Interest costs have been left out of the calculation, so it does not include weekends.

- Table 1 shows the impact in basis points on a normal trade done on the day before Lunar New Year/President's Day with the **current flat rate of 0.5 bp**. For a *pure* Taiwan ETF this will cost 3.5 bps and for a mixed Asia/US ETF this will cost 5 bps, so respectively 3.5 and 5 cents on 100 euros.

Table 1

5-Feb	6-Feb	7-Feb	8-Feb	9-Feb	12-Feb	13-Feb	14-Feb	15-Feb	16-Feb	19-Feb	20-Feb	21-Feb	Total Non-Settlement Cost
Taiwan Closes	Closed	Closed	Closed	Closed	Closed	Closed	Closed	Open	Open				
Sell ITWN NA (100% Taiwan)		Settlement day						First creation date	First settlement date				
CSDR (in basispoints)		0.5	0.5	0.5	0.5	0.5	0.5	0.5					3.5
Last fund creation date	Fund closes	Fund closed	Fund closed	Fund closed	Fund closed	Fund closed	Fund closed	Fund closed	Fund closed	Fund closed	Open	Open	
Sell XMAS GY (MSCI EM Asia ESG)		Settlement day									First creation date	First settlement date	
CSDR (in basispoints)		0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5		5
Fund day multiplier		1	1	1	1	1	1	1	1	1	1		

- Table 2 shows the impact in bps on the same trade but with the progressive rate proposed in ESMA's CP (see bottom row). For the *pure* Taiwan ETF the CSDR costs will then total 54,5 bps and for the Asia/US ETF the costs will be 92 bps, so respectively 54,5 and 92 cents on 100 euros.

Table 2

5-Feb	6-Feb	7-Feb	8-Feb	9-Feb	12-Feb	13-Feb	14-Feb	15-Feb	16-Feb	19-Feb	20-Feb	21-Feb	Total Non-Settlement Cost
Taiwan Closes	Closed	Closed	Closed	Closed	Closed	Closed	Closed	Open	Open				
Sell ITWN NA (100% Taiwan)		Settlement day						First creation date	First settlement date				
CSDR (in basispoints)		3	4	5	7.5	10	12.5	12.5					54.5
Last fund creation date	Fund closes	Fund closed	Fund closed	Fund closed	Fund closed	Fund closed	Fund closed	Fund closed	Fund closed	Fund closed	Open	Open	
Sell XMAS GY (MSCI EM Asia ESG)		Settlement day									First creation date	First settlement date	
CSDR (in basispoints)		3	4	5	7.5	10	12.5	12.5	12.5	12.5	12.5		92
Fund day multiplier		6	8	10	15	20	25	25	25	25	25		

Q29: Alternatively, do you think that progressive cash penalties rates should take into account a different breakdown than the one included in ESMA's proposal above for any or all of the following categories: (a) asset type; (b) liquidity of the financial instrument; (c) type of transaction; (d) duration

of the settlement fail. If you have answered yes to the question above, what costs and benefits do you envisage related to the implementation of progressive penalty rates according to your proposal? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Commenting specifically on ESMA's proposals and how they may be improved; the penalty regime should recognise that many ETF fails around ISD are not by choice (as highlighted in previous examples) and focus on penalising "actionably avoidable" fails. Splitting out ETFs as a distinct asset class, as suggested in ESMA's "Option 1", is likely a positive step towards this.

We would encourage viewing ETFs as a whole and not splitting out further. Due to their nature and ability to source liquidity in their underlying assets as well as the global scope their underlyings may have, further categorization is likely not possible or helpful.

Looking globally, similar regulations in other jurisdictions provide separate treatment for principal liquidity. Reg SHO in the US allows firms engaged in "bona fide market making" additional time to settle without penalty - recognising the additional settlement complexities market makers may face versus agency brokers

This type of approach may be especially important in times of market stress when concurrently overall levels of settlement fails can increase. High penalties with significant scaling rates for longer fails, as proposed by ESMA, may act as an additional barrier to market makers from providing liquidity and supporting the market during these periods, given the potential settlement penalties they may incur.

Taking a similar approach to the US by introducing a longer gap until ETF penalties applied would help for many issues but would not solve for all, for example, European listed ETFs with Chinese exposure may have their primary markets closed for long periods due to holidays such as Chinese Lunar New Year. We suggest allowing a period of ISD+2 as a reasonable starting point given time differences in global markets, but recommend consideration of ISD+3 in the event that material steps are taken towards shortening European settlement cycles to a T+1 timetable.

Broadly speaking, the EU may wish to consider whether market makers, a group already recognised under European regulations such as MiFID, should qualify for different treatment under the CSDR rules, as in the US. This may be especially important for European ETFs, which is a market mostly facilitated by market makers and risk liquidity.

Providing an exemption for market making in ETFs as discussed above in our response to question 26 would support liquidity and efficiency in ETF markets and would appropriately incentivise market making in particularly illiquid instruments. It's not possible to quantify this benefit in the abstract but it would support the growth of ETF markets through enhancing liquidity, improving competition and reducing the cost of trading in the form of tighter spreads, in line with broader EU policy objectives.

Addressing structural inefficiencies and complexity in the EU post-trade environment would improve settlement efficiency and support a transition to a shorter settlement cycle as well as reducing the overall cost of trading in Europe. Some means of achieving this are outlined in our response to questions 15 and 18.

In relation to ETFs, if ESMA believe that it is necessary to increase penalty rates, FIA EPTA members strongly support an exemption for market makers with other market participants to be subject to an increase in penalties aligned with the rate of funding, which may act as an appropriate disincentive to failed trades if evidence establishes that such failures are driven by behavioural factors. However, we note that there is no clear ideal number or reference rate to determine the point at which such behaviour is appropriately disincentivized. In any event, a single flat fee is far more appropriate for ETFs than progressive rates given the structural complexities of the ETF post-trade environment.

Q31: Besides the criteria already listed, i.e. type of asset, liquidity of the financial instruments, duration and value of the settlement fail, what additional criteria should be considered when setting proportionate and effective cash penalty rates? Please provide examples and justify your answer.

As discussed above, the penalty regime should recognise that many ETF fails around ISD are not by choice (as highlighted in the examples referred to in our response to question 6) and focus on penalising "actionably avoidable" fails. Splitting out ETFs as a distinct asset class, as suggested in ESMA's "Option 1", is likely a positive step towards this. This approach would target cases where settlement fails are a result of behavioural factors rather than structural complexity and therefore operate as an incentive to improve settlement efficiency rather than simply adding to the overall cost of trading.

Q32: Would you be in favour of the use of the market value of the financial instruments on the first day of the settlement fail as a basis for the calculation of penalties for the entire duration of the fail? ESMA would like to ask for the stakeholders' views on the costs and benefits of such a measure. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

We do not agree with this approach as it is too dependent on the liquidity of a particular ETF. It would be costly to administer and would result in imposition of differential penalties that do not necessarily correspond to any relevant behavioural incentive.

Q33: How should free of payment (FoP) instructions be valued for the purpose of the application of cash penalties? Please justify your answer and provide examples and data where available.

No comment

Q34: Do you think there is a risk that higher penalty rates may lead to participants using less DvP and more FoP settlement instructions? Please justify your answer and provide examples and data where available.

No comment

Q35: ESMA is considering the feasibility of identifying another asset class subject to lower penalty rates: "bonds for which there is not a liquid market in accordance with the methodology specified in Article 13(1), point (b) of Commission Delegated Regulation (EU) 2017/583 (RTS 2)". The information on the assessment of bonds' liquidity is published by ESMA on a quarterly basis and further updated on FITRS. However, ESMA is also aware that this may add to the operational burden for CSDs that would need to check the liquidity of bonds before applying cash penalties. As such, ESMA would like to ask for the stakeholders' views on the costs and benefits of such a measure. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

No comment

Q36: Do you have other suggestions for further flexibility with regards to penalties for settlement fails imposed on illiquid financial instruments? Please justify your answer and provide examples and data where available.

ETFs are an example of an asset class that can have a wide range of liquidity. In Europe, liquidity must often be sourced in the primary market to satisfy demand. Blackrock estimate the primary market is around a third of all activity in ETFs in Europe, making it a significant source of liquidity.

ETF primary markets often have different operating times and calendars to the secondary market as they rely on access to the markets of the ETFs underlying assets, which are often global. In addition, ETF borrow markets are relatively underdeveloped meaning liquidity providers may be unable to borrow ETFs to ensure they can settle on time.

This is a feature that the CSDR should recognise through additional flexibility specifically for ETFs.

The ETF market is facilitated by market makers and capital commitment, with agency trading being relatively small. Given the above points the regulation should allow for greater flexibility for market makers specifically given their role in intermediating risk transfer and the value of flexibility in promoting liquidity.

Equally, regulators may wish to allow for a delay (for example ISD+2 or possibly ISD+3 in the event Europe moves to a T+1 settlement cycle) until penalty rates for ETFs apply. This would provide further time for participants to manage the structural factors and additional complexity ETFs pose post-trade given they can also settle in many different locations (unlike other assets).

Blackrock iShares, Global ETF Market Facts: three things to know from Q2 2023, July 2023 available at: https://www.ishares.com/us/insights/global-etf-facts

Q37: How likely is it that underlying parties that end up with "net long" cash payments may not have incentives to manage their fails or bilaterally cancel failing instructions as they may "earn" cash from penalties? How could this risk be addressed? Please justify your answer and provide examples and data where available.

Firms that "earn" cash from penalties are not incentivized to implement broader structural changes contributing to post-trade efficiency, such as resolving through partial settlement. Implementing broader post-trade reforms to improve efficiency, such as mandating consent to partial settlement, would have broader and more substantial benefits for improving settlement discipline and overall post-trade efficiency, which is particularly important in light of discussions regarding reducing settlement cycles in Europe.

Q38: How could the parameters for the calculation of cash penalties take into account the effect that low or negative interest rates could have on the incentives of counterparties and on settlement fails? Please provide examples and data, as well as arguments to justify your answer.

It should be recognized that in today's high interest environment, firms who are selling are strongly incentivized to settle due to the opportunity costs of not receiving the cash and missing interest on it. Given ETF settlement fails, in our experience, are mainly due caused by sellers, this shows how the settlement fails are in spite of the strong incentives from both interest and the CSDR penalties.

Q39: To ensure a proportionate approach, do you think the penalty mechanism should be applied only at the level of those CSDs with higher settlement fail rates? Please provide examples and data, as well as arguments to justify your answer. If your answer is yes, please specify where the threshold should be set and if it should take into account the settlement efficiency at: a) CSD/SSS level (please specify the settlement efficiency target); b) at asset type level (please specify the settlement efficiency target); or c) other (please specify, including the settlement efficiency target).

We agree with ESMA that applying the penalty mechanism at an individual CSD level (based on the CSD settlement fail rates), i.e., only to those CSDs with higher settlement fail rates, would not be appropriate as it would lead to an unlevel playing field across CSDs and could result in market participants preferencing one CSD over another based on the penalty regime rather than settlement location.

If such an approach is to be taken, we recommend this assessment being made in relation to actionably avoidable fails with thresholds taking into account structural complexities. On this basis, asset type level thresholds would be pragmatic, with ETFs being split out as a separate asset class for this purpose due to the structural issues impacting settlement times specific to markets for these assets.

Q40: Please specify what costs and benefits you envisage regarding the application of the penalty mechanism only at the level of the CSDs with higher settlement fail rates. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

No comment

Q41: Do you think penalty rates should vary according to the transaction type? If yes, please specify the transaction types and include proposals regarding the related penalty rates. Please justify your answer and provide examples and data where available. Please specify what costs and benefits you envisage related to the implementation of your proposal. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Providing an exemption for market making in ETFs as discussed above in our response to question 26 would support liquidity and efficiency in ETF markets and would appropriately incentivise market making in particularly illiquid instruments. Looking globally, similar regulations in other jurisdictions provide separate treatment for principal liquidity. Reg SHO in the US allows firms engaged in “bona fide market making” additional time to settle without penalty - recognising the additional settlement complexities market makers may face versus agency brokers.

This type of approach may be especially important in times of market stress when concurrently overall levels of settlement fails can increase. High penalties with significant scaling rates for longer fails, as proposed by ESMA, may act as an additional barrier to market makers from providing liquidity and supporting the market during these periods, given the potential settlement penalties they may incur.

Taking a similar approach to the US by introducing a longer gap until ETF penalties applied would help for many issues but would not solve for all, for example, European listed ETFs with Chinese exposure may have their primary markets closed for long periods due to holidays such as Chinese Lunar New Year.

However, broadly speaking, the EU may wish to consider whether market makers, a group already recognised under European regulations such as MiFID, should qualify for different treatment under the CSDR rules, as in the US. This may be especially important for European ETFs, which is a market mostly facilitated by market makers and risk liquidity.

Q42: Do you think that penalty rates should depend on stock borrowing fees? If yes, do you believe that the data provided by data vendors is of sufficient good quality that it can be relied upon? Please provide the average borrowing fees for the 8 categories of financial instruments depicted in Option 1 (i.e. liquid shares, illiquid shares, SME shares, ETFs, sovereign bonds, SME bonds, other corporate bonds, other financial instruments).

The regulation should have reference to the availability of stock borrow. However, the limitations should also be recognized.

ETFs are examples of assets with underdeveloped borrow markets, where liquidity providers may not be able to borrow ETFs. There are likely ETFs where there has never been a borrow available or undertaken in the market. This is a contributor to the fact that there are often examples where ETF fails are not actionably avoidable and the asset class should be treated differently.

If the penalty rates were dependent on stock borrowing fees this would add a competitive disadvantage to less liquid ETFs that would have significantly higher borrow fees (where borrows were available). It would discourage liquidity provision in these less liquid names and drive the price of these ETFs up in comparison with competing ETFs that are more established and liquid.

The potential areas listed below may not be in the powers of regulators directly, often requiring industry wide efforts, but are examples of areas that may help to improve overall ETF settlement efficiency and effectiveness:

- **Improving the borrow market in ETFs.** This is relatively limited today, but industry initiatives to make borrows in ETF more reliable, available and cheaper would aid ETF liquidity, pricing and settlement
- **Expanding creation access in ETFs.** Industry initiatives (across issuers, custodians, market makers etc) to look into areas such as later cutoffs, smaller creation units, more open access when underliers are closed and T+2 settlement even for funds including Asian constituents could all help align primary market access with the local ETF trading calendar
- **Encouraging interoperability and adoption of pan-European post-trade infrastructures.** European ETFs can have many potential settlement locations. Use of ICSDs and strategic settlement models like T2S can help the efficiency of the ETF settlement. CCP interoperability can provide similar benefits through simplifying and improving post trade workflows

For ETFs further thought may be beneficial in order to protect end-investors' outcomes and ensure the region's ongoing competitiveness. This could involve further data-driven analysis on the root-cause issues for fails as well as investigating specific new rules for ETFs, the role of market makers or potentially even maintaining the current status quo.

Q43: Do you have other suggestions to simplify the cash penalty mechanism, while ensuring it is deterrent and proportionate, and effectively discourages settlement fails, incentivises their rapid resolution and improves settlement efficiency? Please justify your answer and provide examples

and data where available. Please specify what costs and benefits you envisage related to the implementation of your proposal. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

Incorporating recognition of the specific challenges posed by ETF markets and the additional settlement complexities market makers face would aid in making the penalty mechanism pragmatic and proportionate. Imposing penalties for fails resulting from structural complexities does not act as a deterrent, it simply makes the impacted markets or asset classes more expensive and less attractive to investors. Broader structural solutions are required to address these issues, as discussed above.

Accordingly, we recommend:

- Providing separate treatment for principal liquidity, such as is provided under Reg SHO in the US which allows firms engaged in "bona fide market making" additional time to settle without penalty - recognising the additional settlement complexities market makers may face versus agency brokers. and ETF markets are mostly facilitated by market makers and risk liquidity;
- Introducing a longer gap until ETF penalties apply (eg ISD+2) would help for many issues. However we note this would not solve for all issues, for example, European listed ETFs with Chinese exposure may have their primary markets closed for long periods due to holidays such as Chinese Lunar New Year; and
- Applying a single flat rate penalty to disincentivize "actionably avoidable" fails. For further detail on this proposal, please see our response to question 24.

However, as discussed above, FIA EPTA members believe the majority of settlement failures in Europe are caused by structural issues rather than behavioural issues and therefore ESMA's proposals should focus on addressing actionably avoidable fails. This is particularly the case in ETF markets where structural complexity concerning settlement including that there is no one single centralized place of settlement and that primary creation of ETFs by liquidity providers to meet customer demand results in complex settlement requirements in relation to the instruments underlying the ETF, particularly for ETFs referencing global instruments. For more information, please see our response to question 42.

Q44: Based on your experience, are settlement fails lower in other markets (i.e USA, UK)? If so, which are in your opinion the main reasons for that? Please also specify the scope and methodology used for measuring settlement efficiency in the respective third-country jurisdictions.

The US model's allowance for further flexibility for market making activities is a valuable addition, recognizing the unique role market makers play in intermediating the market. This would be even more important for European ETFs given the highly intermediated nature of the market and underlying post-trade complexity due to the fragmentation of ETF listings and CSDs.

Settlement fails may be lower in the USA and UK, but this is due to a lack of fragmentation where the place of settlement is a fixed location and inventory resides in the same location thereby ensuring a high level of settlement efficiency. Therefore, a like-for-like comparison cannot be made between settlement rates in the EU versus other such markets.

Q45: Do CSD participants pass on the penalties to their clients? Please provide information about the current market practices as well as data, examples and reasons, if any, which may impede the passing on of penalties to clients.

No comment

Q46: Do you consider that introducing a minimum penalty across all types of fails would improve settlement efficiency? Is yes, what would be the amount of this minimum penalty and how should it apply? Please provide examples and data, as well as arguments to justify your answer.

FIA EPTA members do not believe that a minimum penalty fee should be introduced. This would result in small value trades incurring this minimum fee and discourage retail investors for trading EU markets as they would primarily be the investors trading in such small size. De minimis penalties should be written off and not rounded up to avoid additional operational work/complexity, and to avoid disincentivising liquidity provision in thinly traded ETFs.

Q47: What would be the time needed for CSDs and market participants to implement changes to the penalty mechanism (depending on the extent of the changes)? Please provide arguments to justify your answer.

No comment

Q48: Since the application of the RTS on Settlement Discipline, how many participants have been detected as failing consistently and systematically within the meaning of Article 7(9) of CSDR? How many of them, if any, have been suspended pursuant to same Article?

No comment

Q49: In your view, would special penalties (either additional penalties or more severe penalty rates) applied to participants with high settlement fail rates be justified? Should such participants be identified using the same thresholds as in Article 39 of the RTS on Settlement Discipline, but within a shorter timeframe (e.g. 2 months instead of 12 months)? If not, what criteria/methodology should be used for defining participants with high settlement fail rates? Please provide examples and data, as well as arguments to justify your answer.

No comment

Q50: How have CSDs implemented working arrangements with participants in accordance with article 13(2) of the RTS on Settlement Discipline? How many participants have been targeted?

No comment

Q51: Should the topic of settlement efficiency be discussed at the CSDs' User Committees to better identify any market circumstances and particular context of participant(s) explaining an increase or decrease of the fail rates? Please justify your answer.

No comment