FRENCH PROPOSAL FOR THE SETTLEMENT PENALTY REGIME

Our proposal is to leverage out of the current penalty regime of Euroclear France (as described below). due to the short timeframe of the consultation these are only initial thoughts that could be elaborated/amended in a 2nd step.

A. BASE OF THE REGIME: NET POSITION / PER TRANSACTION, SOME POINTS TO BE RECALLED

Details on a net position principle

The net position for a participant is obtained by taking into account all the instructions to receive and to deliver that are matched but failed to settled and the position held by the participant. . This could be done since the **irrevocability** of the settlement is certified by the CSD (done on a real time basis).

The result which is a **theoretical net position** may be negative (in this case penalties are to applied) or equal to 0 or positive then no fines to be charged.

In no case an instruction, which is not matched, could be included in the calculation.
At the opposite according to AFTI on hold transaction should **always** be taken in account in the net position in order to avoid participants using this functionality not to be fined if the instruction has not be release on Intended Settlement Day as it should be.

This method is actually the one used for almost 30 years by EOC France.

For example:

a participant has to receive 1000 from A and 200 from B and has to deliver those 1200 to C and actually it received only 200 from B so that it is not able to deliver the 1200 to C

*Its **net theoretical position** will be: - 1200 (failed delivery) + 1000 (failed receipt) + 200 (stock) = 0*
Thus it would not be charged.

Requirement in case of penalty on "a per transaction" basis

To be fair the regime must penalize the real defaulter (the one who sold the securities and had to made them available for the settlement in time).

Applying fines to each transaction without any other consideration supposes, to be valid, that each transaction is completely independent from the others, in other words, that for each "on-exchange or off-exchange trade" done between two parties there are only one settlement. Actually this not the case since there is a one to many relationship between trades and their related settlement instructions.

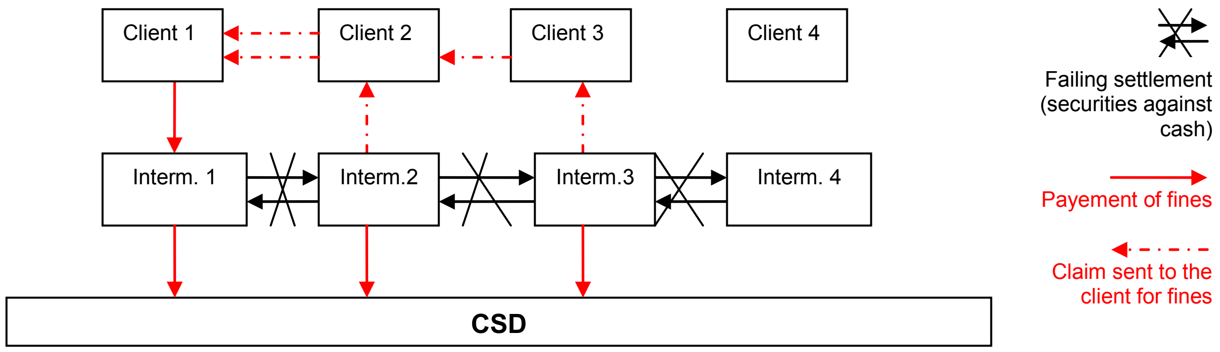
Therefore due to settlement chains with several intermediaries between the custodian of the seller and the custodian of the buyer, having a regime where each entity is charged for failing settlement implies **that each entity is also indemnified for the stock it didn't receive**.

If not the regime will multiple the fines for the same lack of stock and thus penalize intermediaries. Indeed each participant to the CSD (assuming it is not about proprietary trading) has been instructed by one of its clients. This chain of clients may be considered as the trading chain.

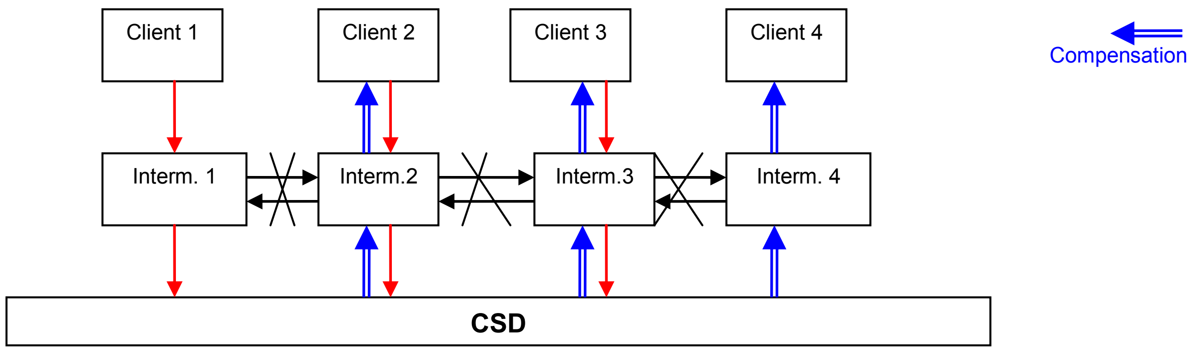
If fines are not credited to the next intermediary in the chain at the CSD level then some intermediaries will face difficulties since only the first intermediary can easily pass on the penalty to its client (as it should be done). For the others it will be more difficult as logically they all will try to pass on the penalty indirectly to the final seller when the latter would never accept to be charged more than once (by its custodian). Moreover those claims are managed out of the CSD system.

See below.

With the current proposal, the client 1 will pay the fines to its intermediary (n°1) and be claimed twice to reimburse the fines paid by intermediaries 2 and 3 to the CSD.



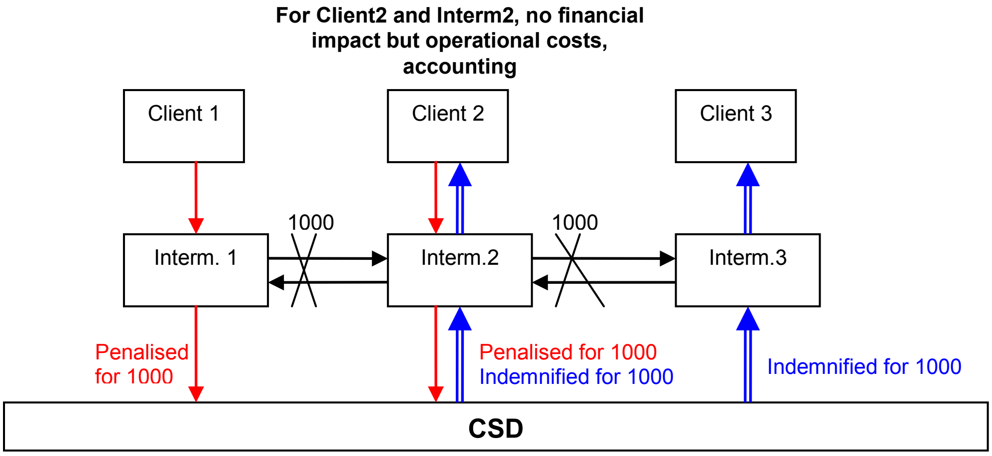
Instead we should have this



<u>Why this "per transaction based regime" is not easily applicable and is unfair?</u>

- **Because participants will incur undue costs**

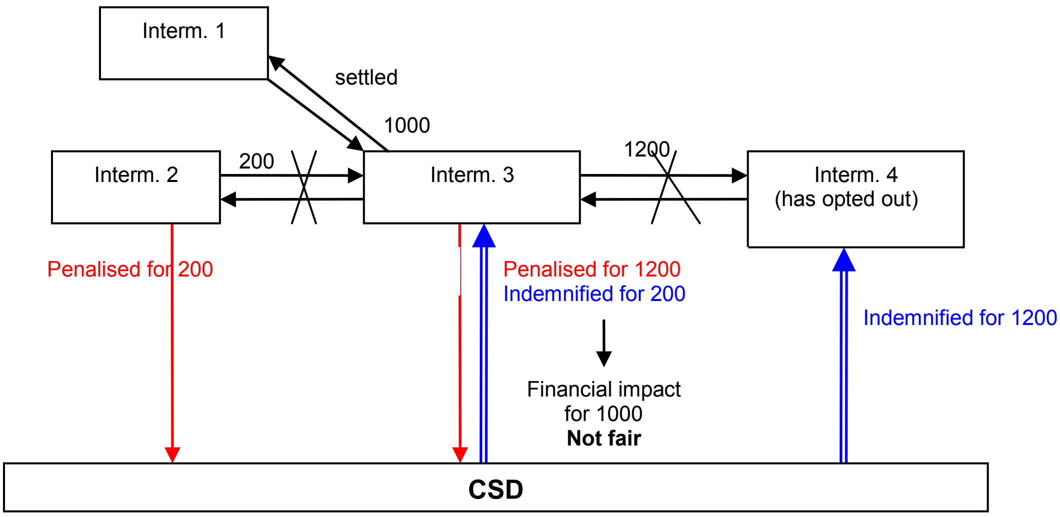
  Even taking the example of a theoretical / ideal case of a settlement chain where each party just has to deliver the same quantity as the one it should receive we will have a fine applied on each outstanding settlement which will lead each intermediary to pay fines on one hand and be indemnified on the other hand.



Of course in this case there will be globally no financial impact for Intermediary 2 (since it will be credited and debited for the same amount) but it will be obliged to manage those cash amounts to the extent of their accounting.

- **Because of the opt-out option for partial delivery**

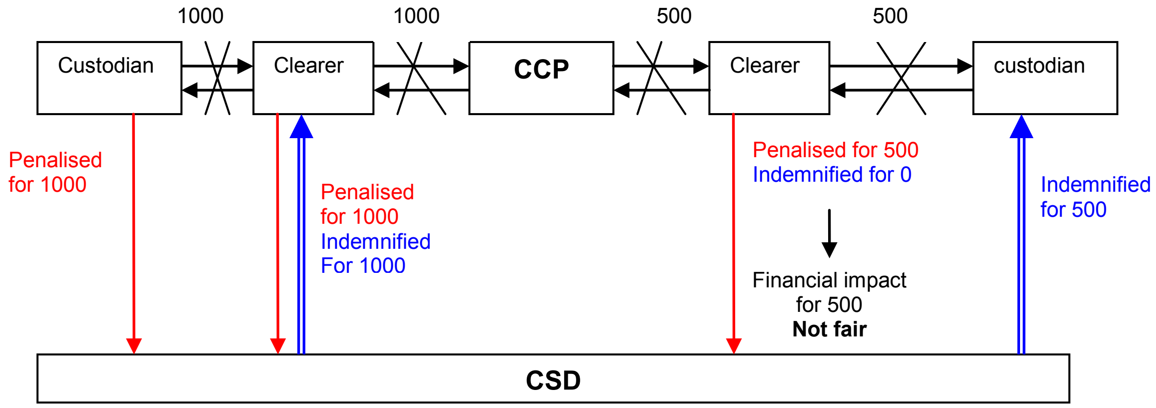
Even if the settlement system promotes the use of partial settlement (whatever the mean to do it) - and that is the case for T2S where partial settlement is per default -, this could not be mandatory and the option to opt out should be offered thus leading for such situation (see below).



Important: when the buy-in process is triggered there should be no longer any opt-out option

- **Because CCPs are exempted of any fines**

A regime where the fine is passed on from intermediary to intermediary only works if all the intermediaries are under the same rules; since CCPs are exempted each time they are part of a settlement chain there will be a breach. The first intermediary after the CCP will be charged but will not receive any indemnity


1000
1000
500
500
Custodian
Clearer
CCP
Clearer
custodian
Penalised for 1000
Penalised for 1000
Indemnified For 1000
Penalised for 500
Indemnified for 0
Financial impact for 500
Not fair
Indemnified for 500
CSD

The French proposal

The French market is in favour of a regime**:**

- **based on a net position** taking into account failing deliveries and receipts but **also** the stock on the account

Of course it will lessen the amount of the penalty but one may keep in mind that the stock the participant holds on its account has been paid and this amount has to be seen as a part of the financial impact incurred by the participant.

It must also be noted that stock is rarely sold for free (at the trading level there are most of the time a cash leg to the transaction). This is important when regarding FOP transaction (only shares, no cash) since **it mostly goes with financial movements done from bank to bank outside the SSS** for normal reason such as a currency not admitted by the CSD.

Finally one should note that the participant which has opted out has also kept the whole amount it should pay for the whole quantity.

- it should also take into account **instructions put on hold by** the participant

Thus there will no misuse of the stock remaining on the account of the participant. If a participant has stock under custody on the same account it will protect it by using the hold and release function (where the function is available).
Then if the delivery instruction is on hold it means that stock available on the account could not be used for its settlement.

B. LEVEL OF FINES

To be disincentive the amount of the penalty should be high enough so a fixed amount may not be enough when applied to a net position per day. Thus an **ad-valorem** principle should be introduced.

The French proposal

A mix of both fixed and ad valorem fines is the right set-up:
- a flat fee which should help cover the costs of maintaining this regime at the CSD level
- an ad valorem component

Since the regime is based on a **net theoretical position** an **ad valorem** principle will need to use prices in order to determine the amount on which the fine will be applied. For such calculation the penalty regime should use prices coming from the market of reference of the underlying security.

Finally a sliding scale must be introduced which will depend upon asset classes. Indeed the ad valorem part should be carefully designed when being applied to bonds transactions as their amounts are quite significant.