CONTENTS

SECTION 1 - OVERVIEW .......................................................................................................................... 3

SECTION 2 – KEY MILESTONES AND TIMELINES ............................................................................. 5
  ▪ Important Note on SDR Implementation Delay .............................................................................. 6

SECTION 3 – THE SETTLEMENT DISCIPLINE REGIME ..................................................................... 7
  i. What is the Context? .......................................................................................................................... 7
  ii. Who is Impacted? ............................................................................................................................. 7
  iii. What is the Scope – Types of Transactions & Instruments? ......................................................... 7

SECTION 4 - HOW WILL SETTLEMENT DISCIPLINE BE ACHIEVED? ............................................ 9
  i. Preventing Fails: Trade Allocation and Confirmation Requirements ............................................. 9
  ii. Preventing Fails: Settlement Processing and Matching Requirements ......................................... 10
  iii. Addressing Fails: Monitoring and Reporting Requirements ......................................................... 10
  iv. Addressing Fails: Cash Penalties .................................................................................................... 11
  v. Addressing Fails: Mandatory Buy-Ins ............................................................................................. 13
    ▪ Financial Implications and Payment Requirements: ................................................................. 14
      ▪ Successful Buy-In ......................................................................................................................... 14
      ▪ Unsuccessful Buy-In ..................................................................................................................... 15
    ▪ Contractual Obligations .................................................................................................................. 16

SECTION 5 - HOW IS STANDARD CHARTERED PREPARING FOR CSDR? ............................. 17
  i. Key Focus Areas .............................................................................................................................. 17
  ii. Market Advocacy ............................................................................................................................ 17

SECTION 6 – WHAT CAN OUR CLIENTS DO? ...................................................................................... 18
SECTION 1 - OVERVIEW

The European Central Securities Depositories Regulation (CSDR) is an EU/EEA regulation that came into effect on 17 September 2014 and aims to increase the safety and efficiency of securities settlement and settlement infrastructures in the EU. The CSD Regulation complements and completes the regulatory framework for securities market infrastructures, alongside European Markets Infrastructure Regulation (EMIR - regulating CCPs) and the Markets in Financial Instruments Directive (MiFID - regulating Trading Venues).

Figure 1: CSDR completes the Regulatory framework for securities markets infrastructures

The CSD Regulation requires that all CSDs are safe and sound and comply with stringent organisational, conduct of business and prudential requirements laid down in the Regulation. It creates, for the first time at European level, a common authorisation, supervision and regulatory framework for CSDs.

To achieve its objectives, CSDR imposes several uniform obligations on CSDs and market participants detailed in the 76 Articles of this EU Regulation. Some of the key obligations include:

- Harmonised shorter settlement cycle of T+2 in the EU
- Requirement for CSDs to be authorised and supervised by their National Competent Authority to provide CSD services
- Requirement for CSDs and the CSD participants to offer a choice of segregated and omnibus accounts to their clients and disclose the associated risks and costs
- EU settlement internalisers required to submit quarterly reports of all EU securities settled outside the securities settlement systems i.e., on their own books
- Introduction of a settlement discipline regime requiring participants to execute settlement by intended settlement date (ISD) or be subject to cash penalties and mandatory buy-ins
ESMA (European Securities and Markets Authority), in close cooperation with the members of the ESCB (European System of Central Banks) has produced regulatory technical standards (RTS) and implementing technical standards (ITS) that have been adopted by the European Commission covering:

- **CSD Authorization**: the authorisation, recognition, supervision of CSDs, organisational and prudential requirements for CSDs, access requirements
- **Internalised settlement** reporting requirements: for securities transactions settled outside a securities settlement system, and
- **Settlement discipline** measures

While the CSD authorization process has taken longer than expected to complete, the internalised settlement reporting has gone live and the first reports were submitted to the NCAs (National Competent Authority) on 14 July 2019.

The focus of this regulation now shifts to its most critical phase, the implementation of the Settlement Discipline Regime (SDR). The intent of SDR is quite simple; improve the efficiency of the EU/EEA securities settlement process by incentivizing the trading parties to meet their obligations under a trade on intended settlement date (ISD). However, the complex nature of the way the markets operate necessitate all parties in the trade and settlement chain to review internal policies and procedures, assess the financial impact of SDR on day-to-day operations and implement a suitable control framework to achieve regulatory compliance.
SECTION 2 – KEY MILESTONES AND TIMELINES

CSDR has been implemented in a phased manner since 2015 and the Settlement Discipline Regime due to go live on 01 February 2021*, is the final step of the implementation process. Refer figure 2 that highlights few of the key past and upcoming milestones.

Figure 2: CSDR – Key Milestones

*On 08 May 2020, the European Commission endorsed ESMA's proposal to delay the implementation date of the settlement discipline regime to 1st February 2021. The delay is now subject to the non-objection of the European Parliament and of the Council.
Important Note on SDR Implementation Delay

The Settlement Discipline Regime was expected to come into force on 14 September 2020. However, following extensive industry advocacy lead by ICMA & AFME\(^1\), on 04 February 2020, ESMA published the final report\(^2\) on CSDR RTS on Settlement Discipline proposing postponement of the date of entry into force until 01 February 2021. The proposed postponement has been endorsed\(^3\) by the European Commission on 08 May 2020 and is now subject to the non-objection of the European Parliament and of the Council.

Rationale of the proposed amendment as stated in ESMA’s final report

“Given the extent and the impact of the settlement discipline regime, which will affect a wide range of market participants (CSDs, CCPs, trading venues, investment firms, credit institutions) and authorities, and having regard to the input from stakeholders and the additional time needed due to new developments, such as the envisaged go live date of the T2S penalty mechanism, the estimated time needed for the necessary IT system changes, for the development and the updating of ISO messages, market testing and adjustments to legal arrangements between the parties concerned, ESMA considers it to be appropriate to provide for more time before the start of the application of the new settlement discipline requirements under the RTS on settlement discipline.”


\(^3\) Source: https://ec.europa.eu/transparency/regdoc/rep/3/2020/EN/C-2020-2842-F1-EN-MAIN-PART-1.PDF
SECTION 3 – THE SETTLEMENT DISCIPLINE REGIME

i. What is the Context?

Chapter III of CSDR or Regulation (EU) No 909/2014\(^4\) lays out details pertaining to the Settlement Discipline Regime which introduces measures to prevent and address settlement fails in CSDs across the European Union (EU) and European Economic Area (EEA). The SDR includes new obligations on CSDs and participants to ensure securities and cash are settled by the intended settlement date (ISD) to avoid undue risk.

The core features of the Settlement Discipline Regime include:

i. Trade Allocation and Confirmation Requirements
ii. Settlement Processing and Matching Requirements
iii. Monitoring and Reporting Requirements
iv. Cash Penalties for trades that fail past Intended Settlement Date (ISD)
v. Mandatory Buy-In Regime

ii. Who is Impacted?

The SDR will impact all market participants that are involved in transactions settling at European and International Central Securities Depositories (ICSDs) such as Clearstream and Euroclear. It is important to note that the geographical location or domicile of the trading parties is irrelevant when determining scope. There is no exemption for non-EU trading parties for transactions settling at an EU CSD, even when the non-EU trading party is an indirect CSD participant.

Participants involved in a transaction for EU issued securities are required to take measures to ensure that they settle securities by the ISD or face penalties from ISD+1 and subsequent mandatory buy-ins or cash compensation where the buy-in is not successful.

iii. What is the Scope – Types of Transactions & Instruments?

The Settlement Discipline Regime will apply to all transactions executed at a trading venue or over-the-counter settling via an EU CSD. The measure will apply to transactions in:

- Transferable Securities
- Money Market Instruments
- Units in Collective Investment Undertakings
- Emission Allowances

The financial instruments in-scope would have been admitted to trading or traded on an EU venue or cleared by an EU CCP and will be subject to the settlement discipline measures regardless of whether they are settled on a Delivery versus Payment (DVP) or Free of Payment (FOP) basis.

All Securities Financing Transactions (SFTs) will also be in scope for cash penalties however, SFTs that meet specific criteria will remain out of scope for the mandatory buy-in regime (see below)

**Out of Scope:**

The below transactions are expected to be out of scope for the mandatory buy-in requirements:

- Securities Financing Transactions with a term of less than 30 business days
- Shares where the primary trading venue is a third-country

Standard Chartered through its participation at various industry trade associations has contributed to the ESMA Q&As and awaits ESMA response to questions that seek clarification of scope for certain transaction types including margin and collateral movements, transfers with no change in beneficial ownership and corporate actions.
SECTION 4 - HOW WILL SETTLEMENT DISCIPLINE BE ACHIEVED?

To achieve the objective of improving the safety and efficiency of securities settlement, in particular for cross-border transactions, the regulation harmonises the timing and framework for securities settlement in the EU. This section will elaborate on the set of measures to PREVENT and ADDRESS failures in the settlement of securities transactions, commonly referred to as settlement discipline measures.

i. Preventing Fails: Trade Allocation and Confirmation Requirements

CSDR Article 6 provides a set of pre-settlement measures to improve Straight-through processing (‘STP’) and limit the number of settlement fails. It requires investment firms to offer their professional clients the possibility of sending confirmations and allocation details electronically and CSDs to use processes designed to work on an automated basis by default. The RTS on Settlement Discipline further elaborates on specific details that must be included as part of the written allocation and confirmation process and sets out timeframes in which the allocation and confirmation process must be completed.

Delegated Regulation (EU) 2018/1229 provides for professional clients of MiFID II Investment firms to send the written allocation and confirmation electronically and to complete the process within set timelines prior to intended settlement date.

- Written allocation and confirmation required on T+0 or latest by 12pm CET on T+1
- Written confirmation to be issued within 2 hours of the written allocation

The allocation must specify:

a) One of the following types of transaction:
   - purchase or sale of securities;
   - collateral management operations;
   - securities lending/borrowing operations;
   - repurchase transactions;
   - other transactions, which can be identified by more granular ISO codes;

b) the International Securities Identification Number (ISIN) of the financial instrument or where the ISIN is not available, some other identifier of the financial instrument;

c) the delivery or the receipt of financial instruments or cash;

d) the nominal value for debt instruments, and the quantity for other financial instruments;

e) the trade date;

f) the trade price of the financial instrument;

g) the currency in which the transaction is expressed;

h) the intended settlement date of the transaction;

i) the total amount of cash that is to be delivered or received;

j) the identifier of the entity where the securities are held;

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k) the identifier of the entity where the cash is held;
l) the names and numbers of the securities or cash accounts to be credited or debited.

The regulation does not provide for any penalties or other incentives to promote adherence; however, it is understood that STP at the trade execution / booking level will set the foundation for timely settlement thereby reducing the risk and exposure to cash penalties and mandatory buy-ins.

ii. Preventing Fails: Settlement Processing and Matching Requirements

Delegated Regulation (EU) 2018/1229 requires CSDs to establish procedures that facilitate the settlement of transactions in financial instruments on the intended settlement date with a minimum exposure of its participants to counterparty and liquidity risks and a low rate of settlement fails.

A suite of CSD facilities are to be made available to ensure timely settlement of trades.

- Matching & population of settlement instruction: CSDs will provide participants with automated, continuous real-time matching throughout the day
- Settlement instruction field requirements: Participants need to provide mandatory matching fields to CSDs in their settlement instructions (Trade Date, Transaction Type, Place of Trade, Place of Clearing)
- Tolerance Levels: CSDs shall set settlement matching tolerances of €2 for settlement amounts of up to €100K and €25 for settlement amounts of more than €100K
- Cancellation Facility: CSDs shall set up a bilateral cancellation facility
- Hold and release mechanism: Ability to put a settlement instruction on hold, and then subsequently release from hold to allow settlement
- Recycling: CSDs shall recycle settlement instructions that have resulted in a settlement fail until they have been settled or bilaterally cancelled
- Partial Settlement: CSDs shall allow for partial settlement of settlement instructions

SWIFT Release 2020 due on 22nd November is expected to introduce changes to the MT Category 5 (Securities Markets) messages, which are required to enable compliance with Central Securities Depository Regulation.

iii. Addressing Fails: Monitoring and Reporting Requirements

CSDs are required to monitor settlement fails and report participants that consistently and systemically fail to their competent authority. CSD shall establish a system that monitors settlement fails and provide regular reports to the competent authority and relevant authorities, as to the number and details of settlement fails and any other relevant information, including the measures envisaged by CSDs and their participants to improve settlement efficiency.

CSDs shall establish working arrangements with the direct participants which have the most significant impact on their securities settlement systems and, where applicable, with relevant CCPs and trading venues to analyse the main reasons for the settlement fails.
A CSD Participant will be deemed to consistently and systemically fail when its settlement efficiency is at least 15% lower than the rate set by the settlement system.

iv. Addressing Fails: Cash Penalties

CSDR Article 7 provides for the application of a daily cash penalty to all transactions that remain failing past the intended settlement date (ISD). Settlement fails penalties shall be calculated for all settlement instructions, free of, against or with payment, that are:

- matched (prior, on or after their Intended Settlement Date (ISD)), and
- failing to settle on and after their ISD

The cash penalties will be calculated and applied by CSDs at the end of each business day from ISD through to actual settlement date. CSDs shall collect penalties from failing CSD participant (at least) monthly for redistribution to the receiving CSD participant. CSDs will not retain any part of the cash penalties but may charge participants separately for the costs of the penalty mechanism.

Two types of penalties will exist, and participants will be notified of penalty details on a daily basis:

1. Late Matching Fail Penalty (LMFP) - to be applied on any instruction which is matched after the relevant cut-off of its intended settlement date
2. Settlement Fail Penalty (SEFP) - to be applied on any matched instruction, which has reached its intended settlement date, and which fails to settle (including when being on hold)

Some exemptions may apply, the industry trade associations and ECSDA are seeking clarifications from ESMA. E.g.: Settlement transactions that do not represent transfer orders, Corporate actions on stocks, T2S automatic realignments.
Figure 3: Penalty rates applicable to settlement fails⁶

<table>
<thead>
<tr>
<th>Type of Fail</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Settlement fail due to a <strong>lack of shares that have a liquid market</strong> within the meaning of point (b) of Article 2(1) (17) of Regulation (EU) No 600/2014, excluding shares referred to in point 3</td>
<td>1,0 basis point</td>
</tr>
<tr>
<td>2. Settlement fail due to a <strong>lack of shares that do not have a liquid market</strong> within the meaning of point (b) of Article 2(1) (17) of Regulation (EU) No 600/2014, excluding shares referred to in point 3</td>
<td>0,5 basis point</td>
</tr>
<tr>
<td>3. Settlement fail due to a <strong>lack of financial instruments traded on SME growth markets</strong>, excluding debt instruments referred to in point 6</td>
<td>0,25 basis point</td>
</tr>
<tr>
<td>4. Settlement fail due to a <strong>lack of debt instruments</strong> issued or guaranteed by: a) a sovereign issuer as defined in Article 4(1) (60) of Directive 2014/65/EU; b) a third country sovereign issuer; c) a local government authority; d) a central bank; e) any multilateral development bank referred to in the second subparagraph of Article 117(1) and in Article 117(2) of Regulation (EU) No 575/2013 of the European Parliament and of the Council; f) the European Financial Stability Facility or the European Stability Mechanism</td>
<td>0,10 basis point</td>
</tr>
<tr>
<td>5. Settlement fail due to a <strong>lack of debt instruments other than</strong> those referred to in points 4 and 6</td>
<td>0,20 basis point</td>
</tr>
<tr>
<td>6. Settlement fail due to a <strong>lack of debt instruments traded on SME growth markets</strong></td>
<td>0,15 basis point</td>
</tr>
<tr>
<td>7. Settlement fail due to a <strong>lack of all other financial instruments</strong> not covered in points 1 to 6</td>
<td>0,5 basis point</td>
</tr>
<tr>
<td>8. Settlement fail due to a <strong>lack of cash</strong></td>
<td>Official interest rate for overnight credit charged by the central bank issuing the settlement currency with a floor of 0</td>
</tr>
</tbody>
</table>

Figure 4: Calculation methods of cash penalties

<table>
<thead>
<tr>
<th>Type of transaction</th>
<th>SEFP</th>
<th>Calculation Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Delivering versus Payment (DVP)</td>
<td>Penalty based on the quantity of securities failed to be delivered and Security penalty rate of the relevant asset type</td>
<td>Security Penalty Rate<em>Reference Price</em>Quantity</td>
</tr>
<tr>
<td>- Delivering Free of Payment (DFP)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Receiving Free of Payment (RFP)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Receiving versus Payment (RVP)</td>
<td>Penalty based on the quantity of securities failed to be delivered and the discount rate of the relevant currency.</td>
<td>Cash Discount Penalty Rate<em>Reference Price</em>Quantity</td>
</tr>
<tr>
<td>- Debiting Payment Free of Delivery (DPFOD)</td>
<td>Penalty based on the amount of cash failed to be delivered and the discount rate of the relevant currency.</td>
<td>Cash Discount Penalty Rate*Amount</td>
</tr>
<tr>
<td>- Crediting Payment Free of Delivery (CPFOD)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Delivering with Payment (DWP)</td>
<td>Penalty will be the sum of:</td>
<td>Security Penalty Rate<em>Reference Price</em>Quantity + Cash Discount Penalty Rate*Amount</td>
</tr>
<tr>
<td>- Receiving with Payment (RWP)</td>
<td>- Penalty based on the quantity of securities failed to be delivered and Security penalty rate of the relevant asset type; and - Penalty based on the amount of cash failed to be delivered and the discount rate of the currency.</td>
<td></td>
</tr>
</tbody>
</table>

Note: For settlement instructions that are matched in the CSD system only after the relevant cut-off of their Intended Settlement Date (ISD), penalties shall be calculated only once (i.e. on the business day when they are matched) but considering all the previous business days where the instruction failed to settle due to the late matching. Settlement Fail Penalties (SEFP) and Late Matching Fail Penalties (LMFP) shall follow the same principles for their computation.

ECSDA’s CSDR Settlement Fails Penalties Framework is the effort of compliance with the Regulation and harmonisation of settlement penalties mechanisms across CSDs subject to CSDR or regulation alike and constitutes a market practice for the CSDs that fall in scope of this EU regulation.

v. Addressing Fails: Mandatory Buy-Ins

CSDR Article 7 provides for the introduction of a mandatory buy-in process where a failing participant does not deliver the financial instruments to the receiving participant within 4 business days after the intended settlement date (‘extension period’). Where the transaction relates to a financial instrument traded on an SME growth market the extension period shall be 15 days unless the SME growth market decides to apply a shorter period.

9 SME stands for Small and Medium-sized Enterprises
There are exemptions:

(a) Based on asset type and liquidity of the financial instruments concerned, the extension period may be increased from four business days up to a maximum of seven business days.

(b) For operations composed of several transactions, including securities repurchase or lending agreements, the buy-in process shall not apply if the intended settlement date (ISD) of the second transaction is set within 30 business days after the ISD of the first transaction.

The exemptions shall not apply to transactions for shares cleared by a CCP.

The Buy-In shall be initiated by the concerned receiving participant depending on the type of transaction:

- For cleared activity, the buy-in will be initiated and managed by the CCP.
- For non-cleared activity, the buy-in will be initiated and managed by the receiving trading venue member or the receiving trading party for off-exchange transactions.

Figure 5: Timeframe for Buy-In Process

<table>
<thead>
<tr>
<th>Financial Instruments / Market</th>
<th>Settlement Cycle</th>
<th>Extension Period</th>
<th>Buy-In Period</th>
<th>Deferral Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquid Shares</td>
<td>TD+2</td>
<td>4 Business Days after ISD</td>
<td>4 Business Days after Extension Period</td>
<td>4 Business Days after Buy-in period</td>
</tr>
<tr>
<td>Other Securities inc. Debt</td>
<td>TD+2</td>
<td>7 Business Days after ISD</td>
<td>7 Business Days after Extension Period</td>
<td>7 Business Days after Buy-in period</td>
</tr>
</tbody>
</table>

### Financial Implications and Payment Requirements:

The success or failure of the buy-in process will result in payments: Buy-in costs where a buy-in gets completed successfully or Cash Compensation in the event a buy-in cannot be completed.

#### Successful Buy-In

The trading party that fails to deliver the securities will be liable for payment of all buy-in costs. The 2 key components are:

- **Price Difference:**
  Where the price of the shares agreed at the time of the trade is higher than the price paid for the execution of the buy-in, the corresponding difference shall be paid to the receiving participant by

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the failing participant no later than on the second business day after the financial instruments have been delivered following the buy-in.

The regulation also makes a provision for any price difference in favour of the failing party to be ‘deemed paid’ creating an ‘asymmetry’ which has been widely debated by the industry trade associations led by ICMA and has made it to ESMA’s list of pending regulatory clarifications.

- **Fees / Other Costs**
  The trading party that fails to deliver the securities will need to reimburse any execution fees resulting from the buy-in to the entity that executes the buy-in. Any such fees shall be clearly disclosed to the participants.

  ▪ **Unsuccessful Buy-In**

  If a buy-in is unsuccessful for any reason during the ‘extension period’ or the ‘deferral period’, cash compensation is to be paid to the receiving party by the failing party no later than on the second business day after the end of the buy-in process.

**Cash Compensation – Calculation Methodology**\(^\text{11}\)

- **DVP / RVP**: The difference between the market value of the relevant financial instruments on the business day before the payment of the cash compensation and the settlement amount included in the failed settlement instruction where that settlement amount is lower than that market value;
- **FOP**: The difference between the market value of the relevant financial instruments on the business day before the payment of the cash compensation and the market value of those financial instruments on the day of their trade, where the market value of those financial instruments on the day of their trade is lower than on the business day before the payment of the cash compensation.

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- Contractual Obligations

Article 25 of the Delegated Regulation 2018/1229 requires parties in the settlement chain to establish contractual arrangements with their relevant counterparties that incorporate the buy-in process requirements set out in Article 7 of CSDR\(^\text{12}\) and the RTS on Settlement Discipline. Parties are required to ensure these contractual arrangements are enforceable in all jurisdictions to which parties in the settlement chain belong.

It is of vital importance that steps be taken to inform clients and counterparties that are not based in Europe but, settle transactions in EU CSDs are informed and educated about this EU legislation and the obligations it creates on these parties.

Standard Chartered is currently reviewing its contractual provisions to comply with this regulatory requirement and is working with the industry trade associations who are developing standardized settlement discipline annexes that could potentially be incorporated into the existing custody and master trading agreements with clients and counterparties. Our team of legal experts will soon be in touch with additional information on this matter and to complete the necessary legal and contractual repapering. If you have any specific questions on this legal requirement or would like to discuss in further detail, you can reach our dedicated legal team directly at CSDR.repapering@sc.com

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SECTION 5 - HOW IS STANDARD CHARTERED PREPARING FOR CSDR?

Standard Chartered recognises the importance of this regulation to harmonise securities settlement processes in the EU (including cross border transactions) and the impact it will have on our clients and industry in general if not implemented in a streamlined manner. Accordingly, the Bank has established a central CSDR Programme to ensure we are ready to comply with the complex regulatory requirements and assist our clients through this landmark change.

The Settlement Discipline Regime will require significant changes to the way we currently manage our front, back and middle office functions. Several internal workstreams have been kicked off under the central programme to ensure all aspects of the regulatory requirements are addressed ahead of the implementation date.

i. **Key Focus Areas**

- Reviewing end-to-end trade execution, booking and settlement process to identify inefficiencies and remediate ahead of implementation date
- Reviewing and enhancing current processes to monitor, report and mitigate settlement fails
- Reviewing our technology infrastructure to pro-actively identify trades at risk of cash penalties and buy-ins
- Upgrading our technology infrastructure to consume and process cash penalties against each failing securities transaction
- Completing internal work required to process new MT Category 5 messages due to be released by SWIFT in November 2020
- Identifying and appointing a buy-in agent and building a front-to-back buy-in management workflow
- Seeking legal advice on amendments required to trading, broker or custody agreements to ensure contractual arrangements incorporate the buy-in process requirements and are enforceable in all relevant jurisdictions
- Targeted client outreach to review current settlement efficiency levels and remedy root cause issues causing settlement failures.

ii. **Market Advocacy**

Standard Chartered actively participates at all major trade associations and industry working groups focusing on CSDR and is keen to collaborate with other market participants to prevent unintended consequences of the regulation. We have been actively contributing to industry guidelines developed by trade associations such as AFME, ICMA, ISLA and AGC. There are still several clarifications that are needed ahead of implementation and Standard Chartered looks forward to playing its part in ensuring a streamlined implementation of this pivotal securities market regulation.
SECTION 6 – WHAT CAN OUR CLIENTS DO?

While there remain a number of uncertainties, Standard Chartered strongly recommends that clients commence performing their own assessment of the impact this regulation might have on their current business strategies and evaluate the efficiency of their trade booking, pre-matching and settlement operating models. We also recommend that clients stay tuned into industry developments on implementation of the settlement discipline regime and periodic updates from ESMA on clarifications pertaining to the regulatory technical standards.

Clients can contact Standard Chartered to discuss CSDR at any time. Please contact your Relationship Manager for any CSDR related queries.