German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

on ESMA´s discussion paper "Draft Technical Standards for the Regulation on improving securities settlement in the European Union and on central securities depositories (CSD)"

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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GBIC's comments on ESMA´s discussion paper "Draft Technical Standards for the Regulation on improving securities settlement in the European Union and on central securities depositories (CSD)"

I. General Remarks

As participants and users of CSDs, we are very interested in both their regulation and improving securities settlement in the EU in order to guarantee the safe, effective, cost-efficient and reliable functioning of one of our core service providers.

Please note that there is, in addition, a response of the Association of German Banks (Bundesverband deutscher Banken (BdB)) which is the voice of the private banks in Germany and a member of the German Banking Industry Committee to ESMA's discussion paper. The response of the Association of German Banks elaborates some aspects further and in-depth. Therefore, please read the following remarks in conjunction with the statements by the Association of German Banks.

1. Adequate regulation

Given the unique role of CSDs, their regulation should be tailored for them or at least accommodate their role, risk profile and services adequately. Although we believe that it can be beneficial to adapt certain definitions or provisions from other pieces of legislation and regulation in order to ensure consistency, we also clearly see a **danger of blueprinting** complete systems or mechanisms that do not take into account the specificities of CSDs and will therefore lead to adverse results.

The Regulation (EU) No 648/2012 on OTC derivatives, central counterparties (CCPs) and trade repositories (TRs) EMIR, for instance, considers the role, services and mechanisms of CCPs[1] against a derivatives background which are, if at all, comparable with CSDs only in a very limited way.

For the benefit of our clients and customers and also for the sake of our own assets, any custodian, and particularly the CSD, has to work as a safe and reliable depository which not only safeguards but also administers the securities that it is entrusted with. Those assets must hence be unequivocally insolvency-remote in case of a problem of the custodian. On the other hand, markets are dependent on the quick functioning of settlement instructions in order to fulfil contractual obligations.

Therefore, in many member states, including Germany, the system of omnibus account holding has been established. It guarantees (at least this is the case in Germany) the insolvency-remoteness of all assets the custodian holds for its clients while allowing the quick, safe and reliable transfer of securities including the netting or offsetting of settlement instructions even through long chains of sub-custodians. The collective safe custody of securities in omnibus account structures was created in order to serve the needs of high-volume business and to simplify securities safekeeping in general without compromising any legal aspects. Any additional segregation of securities at the level of each (sub-)custodian and at the level of the CSD will, however, lead to a multiplication and complexity of securities accounts. This would make account reconciliation and the bookkeeping process more complicated and time-consuming, while fewer transactions can be netted, and could give rise to a greater likelihood of incorrect book entries and, therefore, to actual or legal disadvantages for clients.

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[1] We use the same abbreviations like in the discussion paper "Draft Technical Standards for the Regulation on improving securities settlement in the European Union and on central securities depositories (CSD)" of March 20, 2014.

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What is important from the client´s perspective is not the multiplication of individual accounts but that custodians segregate their own assets from those belonging to other parties. In fact, access to assets held in collective safe custody in omnibus accounts does not require individual segregation. It is also unclear – especially in the case of cross-border chains of custodians – how the relevant accounting chain is supposed to be maintained. Moreover, this complex form of account-keeping may well be more prone to errors.

We recognized with some surprise that namely the account segregation in Article 38 CSDR lead to a comparison of apples and oranges. We would, therefore, like to take this as an example that EMIR and other legislation, f. e. the Regulation (EU) 236/2012 on short selling and certain aspects of credit default swaps SSR or the Alternative Investment Fund Managers Directive 2011/61/EU AIFMD, cannot be the model for the CSDR – neither for level 1 nor for level 2.

In contrast to Article 39 EMIR, where the segregation of contractual obligations of a customer with regard to a CCP leads to the advantage of insolvency-remoteness of these obligations, and therefore to more security, Article 38 CSDR may well lead to the opposite result when clients of a CSD-participant opt for the segregation of their assets. We would like to point out that securities are not contractual claims that can simply be eliminated by, for example, being netted. Even if a CSD participant becomes insolvent, its client is not adversely affected – unlike the client of a CCP – because its ownership rights to its securities are not impaired, whereas the claims of a CCP clearing member's client under the law of obligation are converted into insolvency claims. The relationship between a CSD participant and its client is, from a legal and economic perspective, quite different from the relationship between a CCP clearing member and its client.

This example shows that the adaption of provisions that are reasonable in respect of a certain market participant or financial market infrastructure onto another does not necessarily enhance transparency and certainly does not improve security – if anything, the opposite is the case.

Although ESMA is not called upon to draft technical standards on the issue of account segregation, we would nevertheless like to express our concern that undesirable results can be created if inappropriate provisions – EMIR in this case – serve as the model for an FMI (CSD in this case) that is not comparable with the FMI for which the provisions were originally developed (CCP in this case). We are confident that ESMA will acknowledge the specificities and distinctiveness of the CSDs as well as their important role when drafting the technical standards.

We miss, on the other hand, the use of or reference to pieces of legislation or global principles that have been created/implemented especially for CSDs.

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II. Settlement discipline

Timing will be of the essence with respect to the parallel implementation of t+2, T2S and new provisions on a harmonised settlement discipline regime. Against this background, please take note that the European wide development and synchronized implementation of the new settlement discipline regime is a common task for market infrastructures, market participants and supervisors to consult on meaning a process which will be, from our point of view, by no means terminated before spring 2017. See the enclosed multi-associations letter of EBF, ECSDA, ICMA etc. in which the challenges of these new tasks and proceedings are laid out. Regarding the buy-in procedure we would like to point to the difficulties of the creation of a standard procedure for CSDs and trading venues as well as its timely implementation. In view of the fact that no established standards exist as of today that can stand as a model for a new buy-in regime, we see the need for an **in-depth discussion** among market participants about the details of possible future models and different solutions. We would like to invite ESMA to facilitate such discussion and make use of **phase-in periods** to ensure a smooth implementation and application of new standards.

We will gladly contribute more details regarding the efforts when introducing a new settlement landscape [see also Q 14 and II. below].

With regard to the method for the execution of the buy-in, our suggestion therefore is to

- keep the established buy-in procedures of CCPs and trading venues according to Article 15 Short Selling Regulation (SSR). Article 7 para 10 a) and b) CSDR already takes this into account. For Germany this would mean an auction process by the CCP – other markets may want to implement a similar mechanism or keep any other mechanism that proved to be efficient (see also Q 14).
- take a cautious approach for the buy-in procedure of bilateral transactions. The CSD is to include in its internal rules an obligation for its participants to be subject to buy-in measures. However, the CSD receives settlement instructions from its participants without knowing any details of the trade including the identity of the parties. In order to initiate a buy-in procedure, the CSD needs to be provided with the necessary buy-in information. As of today, it is up to the buyer to initiate the buy-in procedure, which will usually take place by way of a buy-in agent if at all. Implementing the same mechanism for such transactions (and forcing the CSD who is in charge to organise/facilitate a buy-in according to Article 7 para 2CSDR) would mean that the specific risk of a bilateral trade is spilled into another infrastructure or into the market. It seems more justified to also keep the established buy-in procedures as of today, with the obligation to execute it as it is newly introduced by Article 7 CSDR as a compulsory remedy for the settlement fail of bilateral trades except where the buy-in is not possible or ineffective (see Q 15 and 16). Today, the buyer is responsible for the buy-in, however no legal provisions in respect to their execution exist. In the future, it should still be the buyer who will bear the risk for executing the buy-in. It should, however, be a buy-in agent with a wide range of potential sellers, like a CCP. We thereforestrongly support ESMA´s proposed procedures handled at CSD level according to Article 7 para 10 c) CSDR and described in para 54 of the discussion paper.

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Settlement fails can typically occur for the following reasons, most of which are of technical nature:

- Client changes trading or settlement partner
  Whenever a client decides to change to a new trading or settlement partner, for instance a new custodian or a new broker, the current securities settlement instructions (SSIs) need to be adjusted and reconciled at the level of the new trading or settlement partner and other involved parties. Depending on the remaining time for the settlement of a certain transaction, the general and specific requirements cannot always be installed in time. A settlement fail can occur when the time for adjustment is too short. The settlement will take place as soon as the instructions are in place among the involved parties.

- Differences in time zones and business days
  Trading or settlement partners can be located in different time zones and countries with different business days. Time zones in Asia or America can diminish the time necessary for the reconciliation of settlement instructions. This is even more the case for (cross border) settlement than for trading. Additionally, different working days and holidays lead to different business days when settlement can take place.

- Difficulties in the reconcilement of settlement instructions
  In markets without fixed rules for settlement, details for the settlement instructions need to be agreed upon among the involved parties; this can take some time. Additionally, the longer the chain of involved parties for a settlement is, the more time will be consumed. An example: an asset manager sends his settlement instruction to the investment company which forwards it to the depositary bank which forwards it to its global custodian which forwards it to its sub-custodian and so on.

- Cross border settlement, unequal settlement batches
  The failing participant needs to deliver product A on the intended settlement date. The failing participant wants to deliver product A from another transaction that is also due on the same intended settlement date. The failing participant is expecting product A from his counterparty who delivers in a late batch on the intended settlement date. However, although the settlement of product A takes place in time, the delivery is too late for the last batch in order to forward product A to the receiving participant for settlement. A settlement fail occurs. The settlement can take place on the next business day.

- Different settlement cycles
  Failing participant is obliged to deliver product A within t+2. However, on the trade date he has bought product A in a market with a longer settlement cycle, for example t+3 or more. Markets outside the EU will continue to have other settlement cycles than in the CSDR. The same applies to transactions within the EU which are not executed on a trading venue (Article 5 para 2 CSDR). In order to ensure a timely settlement, failing participant will borrow product A under securities borrowing/lending agreement from another party. If settlement under this agreement does not take place in time, obligation for delivery is cancelled (or rolled over) according to securities borrowing/lending agreement, settlement can take place with either original securities from longer settlement cycle or other (newly) borrowed or rolled over securities.

- Chain fails:
  Receiving participant in all above-mentioned transactions expects delivery of product A and wants to use it in order to settle a delivery obligation of its own. Since delivery by the failing participant is late, the receiving participant cannot settle in time either. A settlement fail occurs. Every other party in a chain with the same intended settlement date regarding product A will also not be in a position to deliver in time and produce more settlement fails. A chain fail can also occur as a result to a short sale.

A considerable amount of the above mentioned technical problems should be eliminated once the harmonisation of the settlement cycle t+2 according to Article 5 para 2 CSDR is in place. Therefore, we are expecting the effect of enhanced settlement efficiency within the EU just by harmonisation of the settlement cycle. It should be respected, nevertheless, that the implementation of t+2 in many of the markets at the same time and the migration onto T2S can be onerous with the effect that as long as the changes are taking place, mistakes and problems can additionally arise and settlement efficiency could thus be negatively affected for a certain time. As mentioned above, a phase-in period regarding the implementation of a new settlement discipline could be needed to avoid more interference with the change towards t+2 and the migration on T2S. For this reason, we would like to ask ESMA to consider the monitoring of all the effects of t+2 and T2S after they have been finished/concluded. Furthermore, ESMA should evaluate the settlement efficiency and, thereafter, set those rules on settlement discipline into force which ESMA then deems necessary for a further enhancement of the settlement efficiency. Otherwise, the rules that ESMA is envisaging today may turn out to be an obstacle rather than an appropriate means for improvement.

The same applies to the period in which Article 15 SSR is deleted by Article 7 CSDR but the technical standards for the settlement discipline regime have not come into force yet. We deem this period a good opportunity to observe the effects of the buy-in procedures from Article 15 SSR as we are convinced that these will not change just because no legal provision is in force for a certain time. The positive effects as well as the difficulties created by Article 15 SSR can be considered and corrected in connection with the implementation of the technical standards under Article 7 CSDR.

Please find our further comments directly to ESMA´s questions below:

Q1: Which elements would you propose ESMA to take into account / to form the technical standards on confirmation and allocation between investment firms and their professional clients?

We support ESMA's approach to enhance settlement efficiency. Precondition is that trades are confirmed and allocated. ESMA should therefore develop **minimum** standards for confirmation and allocation.

Elements ESMA should take into account: the mandatory matching fields should be included in the confirmation, the SWIFT MT 515 should give the right orientation as well as the matching rules developed within T2S, the latter as minimum requirements. Today the mandatory matching fields vary slightly between the (local) markets, which reflect the needs of the specific markets. This should be taken into account when defining the necessary common elements; differences between local markets shall not automatically be mistaken as a barrier for an integrated European market.

Moreover we recommend that confirmation and allocation take place at the same time. This is a precondition especially for the efficient settlement of block trades.

Electronic communication is preferred for the communication between the investment firms and their clients, although other options should not be excluded.

Q2: In your opinion, are there any exceptions that should be allowed to the rule that no manual intervention occurs in the processing of settlement instructions? If so please highlight them together with an indication of the cost involved if these exceptions are not considered.

We absolutely support ESMA's view, that automated procedures should be the rule for the settlement instructions on CSD level. Nevertheless manual intervention is nowadays a well-known tool to actually enhance settlement efficiency. This is just to correct little mistakes within the instructions like the wrong currency. This should be considered when setting the standards. Moreover it could be considered as an alternative communication channel in case of any communication disruptions (Fall Back Scenario).

Q3: ESMA welcomes concrete proposals on how the relevant communication procedures and standards could be further defined to ensure STP.

We support the ISO format, but do not see the need to set this as a standard for the whole market. A consideration for the CSD level (between CSDs and their clients) can be supported. T2S rules for example acknowledge current market practice and allow coexistence of specific ISO standards - ISO 20022 for communication between T2S and CSDs, ISO 15022 for the communication between T2S (via CSDs) and CSD participants. An ESMA standard for the CSD level (between CSDs and their clients) can be supported, but should be flexible enough to allow current wide market practice without limiting future develpments. We therefore recommend not to refer to a specific ISO number (like 15022/20022).
The German market has agreed with its CSD (CBF) that, for the time being, communication between market participants and CBF will continue to be based on ISO 15022. Only CBF participants that send their instruction directly to the T2S platform (DCPs) will use ISO 20022. For all other market participants, shifting to ISO 20022 will entail very significant complexity and costs with no apparent benefits in terms of STP or efficiency. Considering the overarching aim of the consultation to balance the costs and benefits potential technical standards would imply any harmonization of communication standards below the T2S level should only be a long term goal. The intended increase in the efficiency of cross-border settlements is largely achieved by the use of ISO 20022 at the T2S level.

Q4: Do you share ESMA's view that matching should be compulsory and fields standardised as proposed? If not, please justify your answer and indicate any envisaged exception to this rule. Are there any additional fields that you would suggest ESMA to consider? How should clients' codes be considered?

We again share ESMA's view that matching is a precondition to gain high settlement efficiency. Nevertheless for specific reasons settlement should also be possible without matching (in the settlement system):

(a) when instructions have already been matched by a trading venue or a CCP and are received by the CSD via a trade feed;

(b) in case of corporate actions processing;
(c) for other (exceptional) transfers such as transfers between custodians.
ESMA should be aware that the settlement system is not the only place where matching can take place and the settlement of instructions – like the transfers between custodians – can already have been matched elsewhere. We therefore suggest that exemptions from matching should also be possible for the different markets where it is needed, without assuming a market failure.We therefore suggest that exemptions from matching should also be possible for the different markets where it is needed, without assuming a market failure.

Para 16 seems to be very specifically asking for matching „continuously throughout the day". While drafting the standards we would recommend a little bit wider approach that considers matching in near time (batches), too for cost reasons. This standard works in Germany very well and leads to high settlement efficiency without too emphasized costly rules, since it almost appears to be real time. Therefore we do not see the need for a European standard to go beyond.

To include client codes only optionally is sufficient in our view.

In addition, we refer to the draft reply by the T2S AG: The specific matching fields should better be agreed upon by an industry body, such as the T2S AG, in order to allow for relatively swift enhancements of the matching methodology if and where necessary.

Q5: Do you agree with the above proposals? What kind of disincentives (other than monetary incentives such as discounts on matching fees) might be envisaged and under which product scope?

We would like to point out that different matching systems and mechanisms are in place today. Para 23 of the discussion paper seems to take a look merely from the view of a CSD. We would like to call the model described in para 23 "Trade Date Netting" (TDN) as it is built on the idea that the settlement instructions are submitted to the CSD on the trade – here ISD-2. At the end of that date all instructions will be netted with instructions with the same ISD. In the case of open settlement instructions for a certain ISD, they can only be netted on the following business day with settlement instructions which have the same delivery date. A deletion of such instructions is only possible in mutual agreement of the CSD participants.

The TDN model may work well for bilateral transactions. However, the matching and netting system at CCP level works differently: In the so called "Actual settlement date netting"-system (ASDN) of the German CCP, Eurex Clearing, all open settlement instructions can be cancelled at CSD level at the end of the business day of the CCP before settlement takes place at the CSD. These open (and cancelled) settlement instructions can be netted with new instructions that come in at the CCP the next business day. This mechanism was invented in 2003 and has been working successfully ever since. The same applies under the so called "Continuous Settlement Netting"-system (CSN) of the French CCP, LCH Clearnet S.A. The advantage of these systems is that matching and netting of the settlement instructions can take place continuously without leaving behind open settlement instructions at the level of the CSD. Especially for low liquid or illiquid products the procedure described in para 23 of the discussion paper will lead to settlement fails which do not necessarily exist in reality. If the current ASDN- or CSD-procedures were to be altered into a TDN-procedure it will enforce settlement fails where they could be avoided by the former system.

Additionally, if the CCP was to be forced to modify its matching and netting systems, many CCP and CSD participants will be negatively affected. According to a market survey which was conducted by Eurex Clearing in connection with the services under T2S, choice was given to opt for the TDN or ASDN system. The survey showed that all participants wanted to continue working with the ASDN system. A change of this system would also imply major changes for T2S at this considerably late stage which should be avoided as no substantial justification is evident.

Here we wonder if the proposed system of disincentives - which gives the impression of complexity - is necessary at all. Instead we would recommend ESMA to follow a two-step approach. First ESMA could analyze how much the EU-wide settlement efficiency is improved following the new ESMA-standards for confirmation, allocation and matching. If the achieved EU-wide settlement efficiency is not satisfying - what we do not expect since a high efficiency in the German market is also achieved without comparable disincentives - in a second step additional measures like these could be considered.

Moreover the point in time described in para 23 when disincentives apply, i.e. where settlement instructions are not received by the end of "ISD-2" is much too early. In a t+2 market like Germany this would mean, that disincentives start already on the "intended settlement day minus two, that means t=0 which is the trading day. This cannot be intended and moreover seems to neglect differences in time zones completely. Again, we refer to the draft reply by the T2S AG, which we support: The AG does not consider it practical or necessary to impose a deadline of ISD-2 for input and matching of settlement instructions. Instead, the proposal is a deadline of ISD-1. In T2S the most efficient time for transactions to settle is the overnight batch, for this the instructions should have matched in T2S by the end of ISD-1. Matching earlier than ISD-1 would not bring any additional value, but may put an unnecessary burden on market participants. We are not only concerned by the administrative burden but also the cost aspect of "disincentives" ESMA considers. CSDs will have to adapt their systems and costs will increase for participants in general.

In para 24 we support the idea to inform participants about pending settlement instructions (hold/release) across all European markets. Here we expect major improvements with the introduction of T2S and corresponding rules. Hold and release facilities mean that transactions are blocked on ISD in order to avoid securities being delivered from omnibus accounts which are reserved or restricted for other transactions. Bilateral cancellation facilities can be used to avoid fails, if hold and release is not helpful.

Para 25 is favoured by the German market as information about pending settlement instructions will likely enforce efficiency. The timing of such information should be left to the needs of the participants of the CSD but the information should be available at least once at the beginning of the ISD.

Q6: In your opinion, should CSDs be obliged to offer at least 3 daily settlements/ batches per day? Of which duration? Please elaborate providing relevant data to estimate the cost and benefit associated with the different options.

We agree with the described system functionalities and ESMA's opinion in para 29, that CSDs should offer at least three daily settlements (batches) if no near-time/continuous settlement is offered and regard it to

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already be the status quo. Nevertheless, problems are encountered in specific European markets today where, due to the chain of intermediaries in a transaction, a specific trade can fail if it is received too late in a specific cycle and therefore cannot be onward delivered until the following business day, thereby attracting a CCP fine (under the SSR) or a CSD fine. Last but not least, we wonder if this is part of the requested technical standards ESMA shall provide due to the CSDR.

Moreover we are convinced, that most of the room for improvement and benefits for the whole European market will arise from ESMA's (minimum) standards for confirmation, allocation and matching, less from the daily settlement procedures themselves.

Remark: T2S will be a gross settlement system (hence no daytime batches as currently in CASCADE) with two night-time cycles for optimization purposes.

Q7: In your view, should any of the above measures to facilitate settlement on ISD be mandatory? Please describe any other measure that would be appropriate to be mandated.

We share ESMA's view, that there are other system functionalities that enhance settlement efficiency.

To optimize settlement a "linkage" function would be desirable as this functionality ensures that settlement chains will be settled only if the flagged chain settlements are released, meaning that if the first chain settlement is fulfilled the following ones are automatically settled (if-then-rule).

The function of shaping trades is common for CCPs, but not usual for CSDs since this leads to higher settlement costs if trades are split up into an unforeseeable number of smaller instructions. So as not to risk a fail of a whole trade/instruction it seems sufficient to achieve high efficiency by allowing partial settlement.

Q8: Do you agree with this view? If not please elaborate on how such arrangements could be designed and include the relevant data to estimate the costs and benefits associated with such arrangements. Comments are also welcome on whether ESMA should provide for a framework on lending facilities where offered by CSDs.

We support CESR-ESCB Rec. 5 for SSS and ESMA's view that lending facilities in a market improve settlement efficiency. Arrangements can lie within or outside of the CSD, so they should not be mandatory for the CSD. If the CSD offers a lending facility it is of the upmost importance that the CSD itself acts only as an agent and not as a principal to lending to avoid risks arising from this function, The transaction-related explicit consent of the borrower is a necessary prerequisite in our understanding.

Q9: Do you agree with the above monitoring system description? What further elements would you suggest? Please present the appropriate details, notably having in mind the current CSD datasets and possible impact on reporting costs.

We support ESMA's described system to monitor settlement fails, which seems to be sufficient.

We have only one remark on the required data, especially type of instrument: here it seems detailed enough to differentiate between shares and bonds, the ISIN-level approach would be too detailed.

Q10: What are your views on the information that participants should receive to monitor fails?

Here we also support ESMA's view that the participants need only the information on their own trades settled/to be settled that have failed or are about to fail. We believe that CSDs should not be required to send such information to their participants, as this may imply sending unnecessary data at an excessive cost, but should rather give their participants access to regular reports on their individual level of settlement fails. A helpful feature of these individual reports is considered to be the "benchmarking", showing the number of settlement fails in comparison to the market (monthly). Participants should be able to decide whether or not to subscribe to such service offerings – which should remain part of contractual arrangements - and therefore have access to the relevant information.

Q11: Do you believe the public information should be left to each CSD or local authority to define or disclosed in a standard European format provided by ESMA? How could that format look like?

Here we do not ask for a specific format, but would see benefit in a unique one for Europe for such information to be comparable. Nevertheless detailed information should be disclosed only between CSDs and their participants and not to the public.

Q12: What would the cost implication for CSDs to report fails to their competent authorities on a daily basis be?

No comment.

Q13: CSDR provides that the extension period shall be based on asset type and liquidity. How would you propose those to be considered? Notably, what asset types should be taken into consideration?

In order to establish a well-functioning, automated and reliable buy-in procedure, we support the idea that the extension period should generally be four business days. This would set a clear rule with predictable and reliable consequences. It would also take into account the fact that a four-business-day-period is already market practice as of today under Article 15 Short Selling Regulation (SSR) which will be substituted by Article 7 CSDR.

Asset type and liquidity should, therefore, be taken into account only for exceptional circumstances which justify lengthening the extension period beyond four business days. Liquidity should not be the only aspect but always one among others that ESMA will look at when determining which exemptions will apply to the rule of four business days. Liquidity should furthermore only be taken into account when it relates to the financial instrument itself rather than to a certain market. Specificities of a market are already considered by CSDR level 1 as regards SME growth markets and should thus not form the basis for more exemptions.

Most settlement fails due to technical reasons should be possibly settled within an extension period of four business days. We therefore expect no need for a longer extension period for most settlement fails.

In our view, exemptions to the four-day-period-rule in respect to short sales should only be made, where the experience in connection with Article 15 SSR has shown considerable difficulties or where other exceptional circumstances lead to the fact that delivery is not possible within an extension period of four business days after the intended settlement date. We believe that any exception to a rule can lead to confusion, difficulties in delineation and potentially unfair results. Therefore, any exemption should be chosen with good care and only for good reason in exceptional cases.

Any longer extension period should be clear and predictable and not subject to continuous changes or adjustments. It should be expressly stated for each ISIN or asset type to which it applies.

Q14: Do you see the need to specify other minimum requirements for the buy-in mechanism? With regard to the length of the buy-in mechanism, do you have specific suggestions as to the different timelines and in particular would you find a buy-in execution period of 4 business days acceptable for liquid products?

1. *Need to specify other minimum requirements:*

In connection with the last requirement in the list on page 21 of the discussion paper, we deem it necessary that any method or mechanism for the execution of the buy-in shall not contain any additional risk for the CSD. Our members support, therefore, ESMA´s approach that it should be left to the CSD to decide on the buy-in feasibility, provided that the parameters to be established in the RTS take into account that the CSD shall not be obliged to carry out the buy-in itself or get involved in the buy-in process in respect of any risks that can arise out of the buy-in. Moreover, the CSD should rather be entitled to obtain detailed information of the trade and the parties of the trade and forward them to the buy-in agent, CCP or person in charge for the buy-in in order to initiate /release the buy-in. Based on the existing buy-in procedures that are already known to market participants, a buy-in auction is clearly the preferred method or mechanism while the risks and responsibilities for the buy-in stay with the receiving participant. This means that although the CSD will initiate the buy-in when forwarding the necessary buy-in information to the buy-in agent, the receiving participant will be responsible to pay the price for the financial instrument and the buy-in fees if the failing participant does not pay the buy-in fees which it is obliged to reimburse. Our members would, therefore be in favour of ESMA developing parameters that enable the CSD to touch upon tried and tested buy-in mechanisms.

We would like to draw ESMA´s attention to the fact that a buy-in will be most successful if only one or very few institutions in the market (with many participants connected) execute the buy-in rather than offering too many options with limited success as regards the buy-in.

2. *Length of buy-in mechanism:*

As regards the second question of Q14, we would like to point out that there is no definition of the term "execution period". This term can be understood in different ways:

a. If "execution period" is to be understood as the timeline for the settlement of the financial instrument once the buy-in auction was successful and settlement can positively take place (i.e. the auction process is closed or the buy-in is confirmed): The period for the delivery of the instrument should be very short and should take place within one business day.
b. It could also be understood as the time starting after the extension period has elapsed until delivery of the financial instrument. Regarding the fact that the settlement has been failing for four days or more – depending on the respective extension period – this timeline should ideally be

rather short. The appropriate timeline will, however, depend on the concrete buy-in mechanism, the liquidity of the financial instrument and on the question of how many times the buy-in can be attempted. The more liquid the financial instrument is, the shorter the appropriate timeline should be.

We would like to underscore that, notwithstanding the CSD's obligation under Article 7 (10) (c) to include in its internal rules an obligation for its participants to be subject to a buy-in, the receiving participant will be responsible to pay the price for the financial instrument and the buy-in fees if the failing participant does not pay the buy-in fees which it is obliged to reimburse. It appears irreconcilable with the risk-averse approach of the CSDR to expose a CSD with the residual risk that the buy-in costs cannot be recovered from the failing participant. The same is essentially true for trading venues. Only CCPs are, by their nature, prepared to prepare for such risk (through collateral).

As a further requirement, we would deem it appropriate and in line with level 1 that a buy-in will not be executed if the receiving party objects to it by the end of the "extension period" and rather chooses to avail itself of its legal rights under applicable national law. This has to be distinguished from the receiving party's right according to Article 7 (7) which applies if the buy-in fails or is not possible.

Q15: Under what circumstances can a buy-in be considered not possible? Would you consider beneficial if the technical standard envisaged a coordination of multiple buy-ins on the same financial instruments? How should this take place?

1. *Buy-in to be considered not possible*

Reason lies in financial instrument:

- The financial instrument is not transferable,
- The product is unique or especially structured for a specific transaction
- The financial instrument has ceased to exist. The reason lies in failing participant – only relevant when buy-in is initiated by CSD.The failing participant is in resolution (this is not covered by Article 7 para 12 CSDR)

2. *Multiple buy-ins*

Generally, we support the idea that the RTS should coordinate to make multiple buy-ins. However, multiple buy-ins may occur for several reasons:

a. Several fails for the same product occur, but fails are not connected with each other: multiple buy-ins by way of one auction process is useful and most successful. RTS could suggest that multiple buy-ins may be coordinated by way of auction.
b. Several fails occur for the same product due to a chain fail:
The RTS should coordinate for these fails to be executed not in a multiple buy-in. Moreover, the buy-in should be executed only once and settle all open delivery obligations. Take into account all fails and costs – no multiplication of costs and papers– first in chain to bear the costs.

GBIC's comments on ESMA´s discussion paper "Draft Technical Standards for the Regulation on improving securities settlement in the European Union and on central securities depositories (CSD)"

Q16: In which circumstances would you deem a buy-in to be ineffective?

1. Timeframe

We agree with ESMA´s thoughts on the short timeframe for operations consisting of several transactions. Where the forward leg is due within the time until the second business day after the expiration of the extension period, the buy-in will be deemed to be ineffective.

This is particularly the case for repo and securities lending/borrowing transactions.

2. Types of Operations

Repo and securities lending/borrowing transactions typically consist of at least two transactions and involve two legs for the settlement of a financial instrument. Many of these operations are short term.

However, even where the timeframe for the forward leg is longer than two business days after the expiration of the extension period, contractual obligations for a settlement fail will occur. Standard agreements usually provide for the cancellation, netting or roll over of the late financial instrument. Due to these contractual obligations, a buy-in in respect of the settlement fail will be unnecessary and, therefore, ineffective.

3. Contractual obligations

Whenever contractual obligations are in place for the occurrence of a settlement fail, they will be more special and, therefore, should prevail over the rules in the regulation.
When the provisions of the contract apply, usually in these cases a buy-in of the instrument is always ineffective regardless of the timeframe within delivery and redelivery takes place.

Regarding Article 7 para 3 and 4 (b) CSDR, it remains unclear if the parties will, in this case both, be obliged to mutually cancel the transaction or if they will have to flag the transaction ("buy-in is ineffective") accordingly when setting the original instructions.

We would suggest a wider interpretation of the circumstances that render a buy-in ineffective than those suggested in No. 59 of the consultation paper. As a repo is generally a money driven transaction, whereby the price paid for the securities in both legs of the transaction is determined by (and differs merely by) the interest rate calculated on the purchase price, leaving aside fluctuations in the market value of the securities, the repo buyer has no genuine interest in the securities as such. In case of a fail, its interest is not determined by the economic control over the securities but the lost interest rate on the purchase price. Therefore, as a general rule, repo transactions should be exempt from the buy-in process. It could be further assessed, however, how repos with a very long duration should be dealt with.

Q17: Do you agree on the proposed approach? How would you identify the reference price?

We generally support the proposed approach as it mirrors the status quo. These rules however should stipulate special practical rules in combination and connection with the failed buy-in in order to seek a quick satisfaction of the interests of the concerned parties. It needs to be clear, however, that CSDR is not trying to harmonise national laws on compensation, or shall not interfere with the respective compensation law in the jurisdictions throughout the EU which will set the final rules and remain the exclusive source for the compensation of damages.

Q18: Would you agree with ESMA's approach? Would you indicate further or different conditions to be considered for the suspension of the failing participant?

We are well aware of the fact that Article 7 para 9 CSDR gives an opportunity/ imposes an obligation for CCPs, CSDs and trading venues to establish procedures that enable them to suspend any participant that fails consistently and systematically to deliver financial instruments.

However, we would like to point out that the participant is not necessarily responsible for the fails. Usually, the responsible person is a client of a participant or a client of a client and the reasons for fails can vary a lot (see also II. and Q13 above).

We would therefore support the idea that the respective FMI will not suspend the failing participant itself but will, instead, leave this decision to its competent authority and will reflect this mechanism in its internal rules. The conditions set out by ESMA in the RTS will serve as a basis for the FMI to inform the respective competent authority about the fail.

We would like to propose that ESMA´s approach taken on page 25 of the discussion paper can work as a condition to send out a warning to the participant that the FMI will inform its competent authority. The competent authority can then further investigate on the reasons for the fails, on the clients or clients of clients responsible for the fails and can handle the decision on whether or not the participant is to be suspended flexibly.

Q19: Please, indicate your views on the proposed quantitative thresholds (percentages/ months).

Considering the consequences of a suspension for the participant (and its other customers), the relevant thresholds must be high and require that regulatory attempts to restore the reliability of the participant have failed. We would consider a threshold based on a percentage of the number of the settlement instructions adequate, not however on a percentage of the overall value as monitoring the fail rates of one's customers by numbers provides CSD participants with more influence than the value of such fails which could increase more rapidly. We would therefore suggest to combine both thresholds.

Q20: What is in your view the settlement information that CSDs need to provide to CCPs and trading venues for the execution of buy-ins? Do you agree with the approach out-lined above? If not, please explain what alternative solutions might be used to achieve the same results.

The approach presented in No. 69 demands an important clarification: The obligation to open a segregated account must not imply that such a segregated account is opened by and in the name of the clearing member or participant to a trading venue. Instead, the account can also be opened by and in the name of a custodian bank, yet segregated by clearing member or trading venue participant. Hence, the settlement information to be provided to CCPs and trading venues is the settlement account with the CSD to be used. This is already the case in the German market.

GBIC's comments on ESMA´s discussion paper "Draft Technical Standards for the Regulation on improving securities settlement in the European Union and on central securities depositories (CSD)"

Addition: Penalties for settlement fails (page 27 of the consultation paper, although not subject to a question):

Cash penalties for settlement fails are new to the German market, as settlement discipline has in the past not been considered a problem in Germany. Insofar, the CSDR aims at fixing something that is in Germany generally not considered broken. With this in mind, we hope that the new penalty regime to be established will cause as little interference with existing processes as possible.
According to Article 7 (14) (b), ESMA shall develop RTSs for the processes for collection and redistribution of cash penalties. As regards the "redistribution", we see an intrinsic risk that such penalties might interfere with fundamental legal principles of the law of damages. This could materialize if such penalties were actually paid out to the receiving participant. In this case, the question would be whether such "enrichment" would have to be set off against the damages accrued, as damages aim at compensating the damaged party, not at creating a situation more beneficial than the expected contractual performance (see also Q 17). This issue could be avoided, if the redistribution would follow a different approach, based on some (to be defined) notion of settlement discipline of the relevant party.

Q21: Would you agree that the above mentioned requirements are appropriate?

We welcome and support any measures to achieve transparency, also in the field of settlement internalisation. We would like to make ESMA aware that the complete list of reporting obligations on pages 28 and 29 of the discussion paper will not only be burdensome for many financial institutions but also to the detriment of the clients and customers.

In view of the fact that no threshold is envisaged or exemptions are foreseen, all transactions are captured, even the ones that are clearly not in the focus of the reporting obligation. Transactions with retail clients, for instance, which are FoP-transactions will have to be reported, irrespective of their size or significance, as well as transactions by one and the same client who merely transfers securities from one of his accounts to another at the same bank. It should be borne in mind that such internal settlement transactions are executed at very low or no cost for the client. It cannot be excluded for the future, that banks may be unwilling to execute such transactions in order to be not obliged to fulfil the complete catalogue of reporting obligations. The client will then be forced to bear higher cost although no risk is involved in these kinds of transactions.

Therefore, we would like to suggest to revise the list on page and narrow it down to the objectively necessary information.

This will create transparency in order to evaluate the activity, dimension and potential risks that may be associated with internalised settlement.

However, there are a number of cases, where settlement internalisation takes place in volumes of unsubstantial importance. This could be covered by way of a de minimis-rule and take the burden of reporting away for bagatelle cases.

As regards internalized settlement, we find the suggested obligation to inform clients about the place of settlement (i.e. internalized or not) misconceived, as the account on which the settlement occurs depends on the account structure chosen by the client, so that he or she will know as from the opening of his or her account whether the transactions will be settled through an account segregated for him or her at CSD-level (wholesale customers) or through an omnibus account of his or her bank with the CSD (retail clients but also wholesale clients of custodian banks. Only in the latter case internalized settlement can occur, namely if his or her counterparty is a client of the same custodian, holding the securities through the same omnibus account of his or her bank with the CSD. Hence, whether a transaction is internal or not depends on the coincidence of who the counterparty is. We do not see a reason why this requires explicit disclosure, as it does not imply any risk for the client.

Q24: Do you see other risks and corresponding mitigating measures? Do CSDs presently have participations in legal persons other than CCPs, TRs and trading venues that should be considered? Would banning CSDs from directly participating in CCPs be advisable, in your view?

We would like to suggest a functional approach. The focus should, in our view, lie on the risk that the loss of the CSD in the participation could be higher than the mere loss in value of the participation. We agree with ESMA´s anticipation that under normal circumstances the loss is limited to the decline in the value of the participation. However, there can be circumstances when the loss is higher than this and additional obligations to pay or contribute (extra) funds can arise.

Q26: Do you agree with this approach? Please elaborate on any alternative approach illustrating the cost and benefits of it.

Third country CSDs need to fulfil the PFMI as a pre-requisite.

If this is the case, the approach taken by ESMA seems reasonable to us.

Q27: Do the responsibilities and reporting lines of the different key personnel and the audit methods described above appropriately reflect sound and prudent management of the CSD? Do you think there should be further potential conflicts of interest specified? In which circumstances, if any, taking into account potential conflicts of interest between the members of the user committee and the CSD, it would be appropriate not to share the audit report or its findings with the user committee?

1. *Sound and prudent management of the CSD*

Yes, the responsibilities and reporting lines described appropriately reflect sound and prudent management of the CSD. These responsibilities and reporting lines will always also be part of EU or national corporate and regulatory law which should also be reflected upon by ESMA.

2. *Audit report or findings*

All members of the user committee are bound to a non-disclosure obligation even in case of a potential conflict of interests. Therefore, we are of the opinion that it would not be appropriate not to share the audit report or its findings with the user committee. We are further of the opinion that material issues in the audit report or serious findings (for instance on custody) need to be disclosed to all users and not only to the user committee.

GBIC's comments on ESMA´s discussion paper "Draft Technical Standards for the Regulation on improving securities settlement in the European Union and on central securities depositories (CSD)"

Q29: What are your views on modality for maintaining and making available such records? How does it impact the current costs of record keeping, in particular with reference to the use of the LEI?

The use of an LEI with regard to CSD participants only could be generally possible. CSD participants are banks who should have obtained a LEI. However, as stated in para 132 of the discussion paper, the BIC has been used and the cost of change will be significant.

The BIC is coded for a maximum of 11 to 15 digits. The change to the LEI will imply another 8 to 11 digits.

It must be borne in mind that T2S is constructed on BIC and the use of it is mandatory. This would also imply a significant change – which the ECB has to estimate. Furthermore, SWIFT-massaging also uses BIC (SWIFT has invented the BIC).

Article 29 CSDR does not deliver the legitimation to introduce the LEI as a new standard codification. Instead it should be better to continue the use of existing standards/ codes.

And last but not least, we would like to point out that the use of an LEI for the customers of CSD participants will involve huge costs:

The issuance of an LEI costs e. g. € 150, followed by an annual fee of € 100 at WM Datenservice. Lessons learned from EMIR have revealed some difficulties with the use of LEIs including the unwillingness of some customers to obtain an LEI. Taking into account that the counterparties involved in the derivatives business amount to several thousand, we would like to point out that under CSDR millions of customers would be affected. In light of the fact that Article 29 para 3 and 4 CSDR calls for details of the records to be maintained by CSDs, the far reaching consequences of changing the BIC to an LEI should not be underestimated.

When looking only at Germany this would mean: approx. 180,000 accounts exist for nonfinancial legal entities. In total 23,578,000 accounts exist at German banks[2]. For the nonfinancial legal entities, this would involve costs of € 27 million in the first year and another € 18 million each following year. In case the LEI will be issued to private investors and retail clients, the costs would be as much as € 3,537 million for the first and € 2,358 million for each following year. This would also mean a substantial rise in the cost of maintaining securities accounts for customers (approx. € 100 annually).

Q30: Do you agree that the CSD risk analysis performed in order to justify a refusal should include at least the assessment of legal, financial and operational risks? Do you see any other areas of risk that should be required? If so, please provide examples.

Yes, we generally agree. However, the list of the risk analysis seems unnecessarily detailed. With regard to obligations under EMIR such detailed analysis is justified, particularly with respect to margin requirements. However, CSD participants are regulated banks. Therefore, the risk analysis is not in the

[2] Cf. Deutsche Bundesbank „Statistik über Wertpapierinvestments" April 2014, p.68

focus in connection with the access of participants but should be in the focus in connection with the access of issuers. See Q 47. Other areas of risk: political.

Q33: Do you identify other reconciliation measures that a CSD should take to ensure the integrity of an issue (including as regards corporate actions) and that should be considered? If so, please specify which and add cost/benefit considerations.

The measures described are sufficient. However, on days of high volume – i.e. when corporate actions take place – more reconciliation batches should be executed than on regular days. The details should be left to the discretion of the CSDs.

It should be ensured that the CSD can halt the settlement for a certain ISIN if problems in the reconciliation arise. This mechanism is also envisaged under T2S.

Q43: Do you agree that links should be conditioned on the elements mentioned above? Would there be any additional risks that you find should be considered, or a different consideration of the different link types and risks? Please elaborate and present cost and benefit elements supporting your position.

We are concerned that an important legal risk has so far not been addressed: For the German market it is of the utmost importance that before entering into a link arrangement the CSDs identify and assess the legal status of the securities that the requesting CSD holds with the linked CSD for its participants, in particular in terms of transferability by means of book entry in its own settlement system and in terms of protection of the ownership rights held by its participants against third party claims against the (foreign) linked CSD, especially in the case of insolvency of the CSD. This requirement goes much further than the stated obligation to "ensure that the choice of law that governs each aspect of the link's operations recognizes the finality of settlement of payment and delivery arrangements and the enforceability of the netting methods in the receiving CSD's jurisdiction".

Q44: Do you find the procedures mentioned above adequate to monitor and manage the additional risk arising from the use of intermediaries?

We strongly feel that the monitoring and managing of risks arising from an "indirect link or an intermediary to operate a CSD link with another CSD" (Discussion paper at 194) requires a more specific differentiation between the two types of arrangements. The Consultation states: "the primary source of additional risk in this context stems from custody risk, i.e. the risk of loss on the securities held via the intermediary [...]". While this is true for indirect links, it is not true for links which are merely "operated" by an intermediary. In such "operated links" the entity contracted to operate the link is not itself the owner of the accounts with the other CSD. The account owner is rather the requesting CSD. Thus, an operated link is a link within the definition of "CSD link" pursuant to Article 2 (1) (28), according to which the requesting CSD "becomes a participant in the securities settlement system of another CSD" (while the operating entity merely acts on behalf of the requesting CSD on the basis of a PoA). Hence, an operated link DOES NOT entail the aforementioned "additional risk" stemming from custody risk.
As opposed to this, an "indirect link" pursuant to Article 2 (1)(33) "means an arrangement between a CSD and a third party other than a CSD, that is a participant to the securities settlement system of another CSD". Hence, in an indirect link, the first CSD merely has an account relationship with the

intermediary while the latter (and only the latter) has an account relationship with the second CSD. The consequence of this structure is, indeed, an additional source of custody risk, moreover, a custody risk which is not mitigated through the strict regulatory limitations applying to CSDs. Such intermediaries are simply banks, subject (only) to general banking regulations.

While it is unfortunate that the CSDR has combined these two very different concepts in the same paragraph (Article 48 (5)), the RTS should address each of them according to their specific risk profile:

- In the case of an operated link, the risk related to the operating entity is primarily operational. The damages it can cause result mainly from its operational capacities and its availability. Insofar, the risk of insolvency would be relevant as an operational risk, not however as a typical insolvency risk, as the securities are held on accounts of the requesting CSD.
- In the case of an indirect link, the procedures stated in the Discussion paper at 194 appear adequate, provided they have to be read as also requiring that the intermediary has to be authorized as a credit institution.

Q45: Do you agree with the elements of the reconciliation method mentioned above? What would the costs be in the particular case of interoperable CSDs?

As regards interoperable links, we would consider a reconciliation of positions (only) on a daily basis as insufficient. For an interoperable link we generally would expect a level of reconciliation that comes as close as reasonably possible to the standards applied to the internal reconciliation of a CSD between its issuance accounts and participants' accounts.

Annex

EBF ref. 005072

EACH European Association of CCP Clearing Houses — ECSDA European Central Securities Depositories Association — EBF European Banking Federation, The Voice of European Banks — ESBG — ICMA International Capital Market Association — ICMA EUROPEAN REPO COUNCIL

Brussels, 4 November 2013

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Timing of CSDR article 7 implementation (settlement discipline)

We, the undersigned European industry associations, write to you to convey some comments in view of the Trilogue discussions on the draft CSD regulation (Commission Proposal COM(2012)0073) and in particular article 7 on settlement discipline measures.

Together, our associations represent major post-trade infrastructures and their users across Europe. We all support the aim of settlement efficiency, including improvements in the monitoring, reporting and prevention of settlement fails. We also fully recognise the benefits of harmonisation in this area to prevent regulatory arbitrage between individual EU markets, especially in view of the implementation of TARGET2-Securities.

Nonetheless, irrespective of ongoing discussions on the scope and details of the settlement measures to be implemented in CSDR, **we would like the European co-legislators to take into account the following constraints as regards the timing of article 7 implementation:**

The timing for implementing buy-in rules and late settlement penalties will be the same as for most other CSDR provisions, i.e. in the case of article 7 at entry into force of the respective regulatory technical standards. Most probably this will be around Q1-Q2 2015. At the same time, T+2 will apply on 1 January 2015, or between 1 January 2015 and 1 January 2016 if the Council text is adopted.

The signatories believe that such a timetable is far from optimal since buy-ins and penalties would be implemented just after some markets have moved to T+2, and potentially just before some other markets move to T+2. Market participants will need time to adapt to T+2 (from the current T+3) and it is quite conceivable that the number of settlement fails will temporarily increase in the first months following T+2 implementation. Implementing a new discipline regime just in this period could be counterproductive and generate unwelcome disruption in financial markets.

- **Secondly, CSDs and their participants need sufficient time to make the technical adaptions required by the new discipline regime.** Given the crucial developments under way to prepare for TARGET2-Securities implementation in many EU markets, as well as developments to support same day repo and tri-party system interoperability (which will ultimately support higher rates of on-time settlement), the complexity, time and resources required of all actors to implement the future CSDR discipline regime should not be underestimated. The migration onto TARGET2-Securities will take place in the time frame of June 2015 until beginning of 2017.

As a result, the signatories suggest that the European co-legislators could consider the following solution:

The introduction of a transition period, during which settlement fails will be monitored by infrastructures and regulators (perhaps including a special monitoring and reporting regime by ESMA), prior to the full implementation of the new discipline regime. This fixed transition period will serve to monitor the expected effects and benefits from harmonisation of the settlement cycles within the EU. Once harmonisation on T+2 has taken place and TARGET2-Securities is implemented in the participating markets, the effects on settlement efficiency can be reconsidered and provisions for a harmonised settlement discipline can be implemented – if warranted. A transition period could also give market participants at all levels the opportunity to anticipate and correct potential problems in relation to the numerous changes being implemented simultaneously. It will also ensure that infrastructures and their users have had sufficient time to develop robust systems to deal with the new regime and to minimise fails.

While we fully recognise that the harmonised settlement discipline regime under CSDR article 7 will also contribute to further the benefits of TARGET2-Securities, we do not believe that full implementation of article 7 is a pre-requisite for the first T2S migration wave in June 2015 but would be even more likely to hamper its successful implementation due to the many resources which will be committed to the migration to TARGET2-Securities.

We are grateful to the co-legislators for taking our comments into consideration when finalising the CSD Regulation and look forward to continuing our engagement with you as constructive partners in achieving a safer and most efficient financial market infrastructure for Europe.

Yours sincerely,

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