Frankfurt am Main,
2 February 2021

BVÌ`s position on the EU-Consultation for the Review of the Regulation on Improving Securities Settlement in the European Union and Central Securities Depositories

BVI[1] welcomes the initiative by the EU Commission to review the regulatory regime on the Central Securities Depositories Regulation (CSDR).

German investment fund managers acting on behalf of regulated investment funds (UCITS/AIFs) are important users of the securities markets in the EU. We support the aim to achieve an efficient, integrated and safe market for securities clearing and settlement in the EU, particularly for cross-border transactions. Efficient and safe securities settlement systems with an EU wide harmonized settlement discipline regime will benefit all investors and further promote a pan-European securities market.

German investment fund management companies are not directly involved in the value chain of clearing and settlement of securities transactions. They instruct the custodians of the relevant investment funds to match and settle securities (e.g. equity, bonds, fund units) belonging to such investment portfolios. The custodians have a direct access with the CSDs. Investment fund management companies have to rely on the information obtained by the custodians in order to react in cases of settlement fails or buy-ins.

The custodians have to ensure that all relevant settlement information needs to be sent as fast as possible to the fund management companies. This will enable the investment fund management companies to solve all discrepancies for unsettled and failing trades where a decision is required by the custodians from the investment managers. (Institutional) investors defined as professional clients in MiFID are not involved in the clearing and settlement process of securities transactions. There is a direct relationship between the fund management company, the counterparty of the transaction (e.g broker/dealer) and the fund custodian.

We will focus our answers to chapter 6 and 7.

6. Scope

Question 31: Do you consider that certain requirements in CSDR would benefit from targeted measures in order to provide further legal certainty on their scope of application?

☐ Yes

☐ No

☐ Don't know / no opinion

[1] BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Asset Managers act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's 114 members manage assets more than 3.6 trillion euros for retail investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 27%, Germany represents the largest fund market in the EU. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

Question 31.1: If you answered "yes" to Question 31, please specify what clarifications/targeted measures could provide further legal certainty.

We will focus our clarifications to the chapter settlement discipline (Art. 6 and 7 CSDR):

- **Inconsistent definition of relevant market participants subject to the buy-in-regime**

German investment fund management companies licensed under the UCITS/AIFM regime are not directly involved in the value chain of clearing and settlement of securities transactions. Typically, they instruct the custodians of the relevant investment funds to match and settle securities (e.g. equity, bonds, fund units) belonging to such investment portfolios. The custodians have a direct relationship with the CSDs. The fund management companies do not have a direct access to the CSD in order to obtain the relevant settlement information of the failed securities transactions.

In the context of the settlement discipline/buy in regime neither level 1 or level 2 of CSDR clearly defines legally the market participants responsible to initiate the buy-in. The definition of a participant refers only to the “failing participants” and the “receiving participants”. It could be possible to consider the participant as a direct member of a CSD. Asset Manager do not principally have a direct access to the CSDs. Such an unclear definition could result in a legal dispute between the fund management companies, the fund custodian or the settlement agent to clarify the responsibility for initiating the buy-in. As a consequence, the implementation of the buy-in regime could not be processed in time due to the unclear legal definition in level 1 and 2, thereby enhancing also the operational complexity to access/onboarding the buy-in-agent. We encourage the EU Commission to clarify within level 1 and 2 the definition of participants to have legal certainty for all involved market actors within the settlement chain.

- **Scope of market transactions for the buy-in provisions**

Market participants (e.g. Asset Managers) can currently not clearly assess which market transactions should be within the scope of the buy-in provisions as the legal definition of what constitute a transaction is not legally clear within CSDR on level 1 and 2. For example, fund management companies need to know if primary market transaction such as subscription/redemption of fund units or ETPs are within the scope or not. We strongly encourage the EU Commission to clarify within level 1 and 2 which market transaction should be within the scope of the buy-in provisions. As a starting point of discussion, the EU Commission could use the list of financial instruments exempted for the MiFIR reporting obligation as laid down in regulation 2017/590 (please consider Art. 2).

Question 31.2: If you answered "yes" to Question 31, please specify which provisions could benefit from such clarification and provide concrete examples.

- **Inconsistent definition of relevant market participants subject to the buy-in-regime**

Please consider our answer as given above. We encourage the EU Commission to clarify within level 1 and 2 the definition of participants in order to have legal certainty for all involved market actors within the settlement chain. We are of the view that the term participants should only refer to market actors with a direct access to the CSDs (e.g. fund custodian, settlement agents).

- **Scope of market transactions for the buy-in provisions**

Please see our answer to question 31.1. Market participants require a clear definition of financial instruments which should be subject to the buy-in provisions. The purpose of the buy-in is to help the Asset Manager to a transaction concluded in the secondary market to obtain as quickly as possible a financial instrument for the relevant investment fund (UCITS/AIF) which the counterparty has failed to deliver in breach of their contractual agreement.

The level 1 text states an exemption under Article 7 (4) b for operations composed of several transactions including securities repurchase or lending agreements. The buy-in process referred to in paragraph 3 shall not apply where the timeframe of those operations is sufficiently short and renders the buy-in process ineffective. The exemption has been granted for securities financing transactions (SFTs) with a term less than 30 days.

In this context, we encourage the EU Commission to clarify how to treat ‘open’ or ‘rolling’ trades:

- As open SFTs can be terminated at any time with a short notice period, the earliest possible termination is < 30 days, open SFTs should be deemed as out of scope for the mandatory buy-in regime.
- Rolling SFTs such as “Evergreens” or “Extendables” should also be deemed as out of scope. UCITS concludes securities loan transactions without a fix term (“open-ended”). Any and all of these transactions can be terminated at any time. There are no exemptions from that practice as UCITS and their fund managers have to comply with para. 30 of ESMA’s Guidelines on ETFs and other UCITS issues (ESMA/2014/937).
- With respect to SFTs such as securities loan transactions the so-called “evergreens” are also concluded as isolated agreements. “Isolated” because this agreement exists separate from any SFT transaction. It is not a SFT itself and therefore not subject to any buy-in requirement. The isolated evergreen agreement has a fixed term (but includes termination rights for certain cases). Within this fixed term, one party is obliged to provide the other party (on demand of that other party) with securities of a pre-determined class of securities at a limited volume. The obliged party provides those securities by entering with the other party into open-ended securities loan transactions, which can be terminated at any time. This allows the lender to maintain the full flexibility with respect to which concrete security (pertaining to the pre-determined class of securities) it lends to the borrower at which volume and for how long. If the lender requires the security lent (e.g. to sell it), it just terminates the open-ended securities loan transaction and lends to the borrower one or more other securities pertaining to that class of securities. With respect to investment funds respectively their fund manager as lender, it is even possible to enter into the new (replacing) open-ended securities loan transaction for the account of one or more different investment fund(s).

  However, experience from SFTR shows, that depending on different interpretations and IT systems, many market participants book those evergreens as fix term securities lending transaction with an automated rolling function. We see therefore a need to distinguish between different contractual setups:

  a) setting out a fixed term with a termination optionality
  b) as described above as an isolated agreement

As long as the loaned security can be terminated and substituted at any time, these type of evergreens and extendable should be deemed as out of scope of the buy-in regime as they are treated as open-ended transactions although some IT systems book those deals with a fix term.

- Collateral movement should also be excluded from the mandatory buy-in regime: The characteristic of SFTs is to provide a loan against collateral. For German fund management companies, § 200 KAGB German law clearly defines, that for FOP trades a loan can only be released, if the required collateral is delivered and vice versa for the end leg, i.e. when the loan is received back, the collateral will be returned. In this respect, when collaterals fail to settle, especially in collateral substitution movements, a mandatory buy-in, which should reflect the intention "to preserve the economic position of the parties by the compulsory enforcement of the original agreement" would not be supportive.

  A buy-in for a collateral will cause operational burden than support the settlement efficiency. We would suggest providing a best practice for the industry to treat collateral transactions which fail to settle, i.e. cancellation of the collateral settlement instruction and replace in time rather than a mandatory buy-in.

Furthermore, we are also of the opinion that all margin transfers, e.g. margins used in the EMIR regulation for the collateralisation of uncleared OTC derivatives, should be also considered out of scope of the buy-in provisions. A margin transfer of securities (e.g. equities bonds) is not a normal secondary market transaction. In respect of OTC derivative margin transfers as collateral, the original trade is a transaction between the relevant counterparties (e.g. Asset Managers) which would expose the market actors to a counterparty risk. A margin transfer, by contrast, provides that one party (the collateral provider) will mitigate the credit risk to which the other party (the collateral receiver) is exposed under the separate original agreement by delivering cash and/or securities as collateral. A failure to do so by the collateral provider will typically allow the collateral receiver to mitigate such credit risk by other means (e.g., triggering a default notice, close-out netting, etc) which are already included in OTC derivative standard agreements. As such, if CSDR were read to require a buy-in of the failed margin transfer, this would not equate to a compulsory enforcement of the original agreement.

The application of buy-in to margin transfers would not support the collateral receiver in mitigating its credit risk in any event, would be inefficient, and expose the receiver to additional risk: the collateral provider's obligation to deliver margin securities would be replaced by an obligation on the receiver to initiate a buy-in, appoint a buy-in agent, (pre-)fund the buy-in agent for the bought-in securities, sell these bought-in securities to another counterparty to cover the open risk, and then try to recuperate the costs from the failing delivering trading party.

ESMA mentioned in their final report on the settlement discipline[2] that they have no specific mandate in order to further determine the scope of application of the buy-in rules with regard to the geographical scope, the financial instruments or transactions within or outside the scope of the buy-in provisions and that the Level 1 text does not provide for a sell-out mechanism. Therefore, we strongly encourage the EU Commission to legally clarify the scope of buy-in provisions. Only secondary market transactions should be subject to the buy-in-regime. Primary market transactions and the above mentioned SFT transactions should be out of scope.

[2]https://www.esma.europa.eu/sites/default/files/library/2016-174_-_final_report_on_csdr_rts_on_settlement_discipline_0.pdf

Furthermore, it could be good for all market actors involved in the settlement chain to have a list of all financial instruments which are in the scope of the buy-in provisions. We suggest that ESMA through their FIRDS data base could provide such a list.

Question 32. Do you consider that the scope of certain requirements, even where it is clear, could lead to unintended consequences on the efficiency of market operations?

☐ Yes

☐ No

☐ Don't know / no opinion

Question 32.2: If you answered "yes" to Question 32, please specify which provisions are concerned.

Question 32.1: If you answered "yes" to Question 32, please specify what targeted measures could be implemented to avoid those unintended consequences while achieving the general objective of improving the efficiency of securities settlement in the Union?

Please see our answers to questions 31.1 and 31.2. In respect to the buy-in provisions, primary market transaction should be out of scope, especially in cases of subscriptions/redemptions of fund orders or ETFs:

- In the case of a subscription, a transaction whereby units in a fund are purchased by the investor from the fund or the fund management company, we do not see that any issues exist with the settlement, either from the issuer to the CSD or between their designated agents and those to whom the instruments have been allotted.
- In the case of a redemption, a transaction whereby units in a fund are sold back by the investor to the fund or fund management company, there would be no knock-on impact in the market should the holder be unable to deliver - they will simply not receive the proceeds.

7. Settlement Discipline

Question 33: Do you consider that a revision of the settlement discipline regime of CSDR is necessary?

☐ Yes

☐ No

☐ Don't know / no opinion

Question 33.1: If you answered yes to Question 33, please indicate which elements of the settlement discipline regime should be reviewed (you may choose more than one options):

☐ Rules relating to the buy-in

☐ Rules on penalties

☐ Rules on the reporting of settlement fails

☐ Other

Question 33.2: If you answered "Other" to Question 33.1, please specify to which elements you are referring.

- **General remarks on the settlement for securities transaction**

German investment fund management companies are not directly involved in the value chain of clearing and settlement of securities transactions. They instruct the responsible fund custodians of the relevant investment funds to match and settle securities (e.g. equity, bonds, fund units etc.) belonging to such investment portfolios (UCITS/AIFs). The fund custodians have a direct access with the CSDs. Therefore, Investment fund management companies have to rely on the information obtained by their fund custodians in order to react in cases of settlement fails, penalties or buy-ins.

There have been considerable discussions among our members, fund custodian and the Buy-In-Agent on the implementation of the legal and operational penalty- and buy-in regime. As a consequence, it is of utmost importance, that all relevant market actors within the settlement chain such as CSDs, settlement agents and fund custodians have regulatory to ensure that they deliver all relevant settlement, penalty and buy-in information as soon as possible and a standardised format to the Asset Managers thereby enabling them to adhere the CSDR settlement discipline regime. Otherwise, our members are not able to proceed e.g. in time penalties or a buy-in.

Therefore, we strongly advocate for a proportionate phase-in approach, meaning that CSDs and their direct participants (e.g. custodian, settlement agents) have to implement and adhere in a first stage to the penalty- and (buy-in) regime before the Buy-Side as the last actor in the settlement- and custody chain are required to follow the settlement discipline rules. As soon as the CSDs and their direct participants have successfully implemented the provisions the Buy-Side could also adapt to the same requirements. Any liability of not providing the relevant settlement discipline information on time to the Buy-Side and possible associated penalty costs should sit solely with the CSDs and their direct participants. There should be no recourse back to the Buy Side as they are not in the position to obtain the settlement discipline information at first hand.

Question 34: The Commission has received input from various stakeholders concerning the settlement discipline framework. Please indicate whether you agree (rating from 1 to 5) with the statements below:

	1 (disagree)	2 (rather disagree)	3 (neutral)	4 (Rather agree)	5 (fully agree)	No opinion
Buy-ins should be mandatory	x					
Buy-ins should be voluntary					x	

Rules on buy-ins should be differentiated, taking into account different markets, instruments, and transaction types.					x	
A pass on mechanism should be introduced					x	
The rules on the use of buy-in agents should be amended					x	
The scope of the buy-in regime and the exemptions applicable should be clarified					x	
The asymmetry in the reimbursement for changes in market prices should be eliminated					x	
The CSDR penalties framework can have procyclical effects.					x	

The penalty rates should be revised					x	
The penalty regime should not apply to certain types of transaction (e.g., market claims in cash)				x		

Question 34.1: Please explain your answers to question 34, providing where possible quantitative evidence and concrete examples.

1. Mandatory/voluntary buy-ins

We strongly support the proposal that buy-ins should be made optional. An optional buy-in mechanism offers the purchasing party (e.g. the Asset Manager) the flexibility to initiate a buy-in on a failed transaction incorporated into a harmonised regulatory framework for such a process.

Within the fund industry, most settlement fails are generally caused by brokers/dealers and not by UCITS/AIFs as they are typically on the long only side. Based on the current CSDR buy-in framework, UCITS/AIFs could have more legal and operational burden to implement then in existing settlement practise and will also need more liquidity to cover all buy-in agent requirements (e.g. provision of collateral or fully pre funded buy-in transactions). Such an effort is therefore disproportionate to the benefit of more settlement efficiency.

Furthermore, current contractual agreements (e.g. Deutscher Rahmenvertrag für Wertpapierdarlehen §8) have already remedies in place which satisfy the requirements of Article 25 RTS (settlement discipline). Should the trading party fail to deliver, the receiving party is able to initiate a buy-in under such existing contractual terms for their respective market. The obligation is a mandatory right and therefore an enforceable contractual provision.

In respect to the existing mandatory buy-in approach, German fund management companies have to appoint a buy-in agent who will be carrying out the mandatory buy-in in case of delayed settlement. However, the costs for connecting to and appointing a buy-in agent (as it stands, currently only one major market player – Eurex STS GmbH - offers the service of a neutral buy-in-agent) are rather prohibitive. The only major buy-in agent can design their terms and conditions as they want which means that the trading parties (e.g. Asset Managers) have to adhere to such agreements.
It should be kept in mind that it is the goal of CSDR that the actual use of the buy-in-agent, i.e. transactions being subject to the mandatory buy-in, should be limited to the extent possible and is only an “emergency solution”. In an ideal world with perfect and timely settlement, no buy-in-agent would ever be needed.

Nevertheless, all market participants dealing in financial instruments and settling them via CSDs need to appoint a buy-in-agent. It goes without saying that the services of a buy-in-agent are not available free of charge: the buy-in agents have to keep the whole system up and running – even if no one ever uses it. The costs associated with these services are for the German fund manager prohibitive – some start even considering changing their business model in order to avoid the requirement to connect to a buy-in agent. Thus, CSDR will result in limited liquidity (especially for fixed-income products) in the relevant financial instruments and fewer securities trading providers.

Currently, the only Buy-In Agent requires a prefunding ahead for the execution of an buy-in. Therefore, market participant (e.g. Asset Manager) have to provide the Buy-In Agent with sufficient liquidity. In terms of the additional liquidity for buy-in transactions, German law (KAGB § 93) do not permit to provide collateral for buy-in transactions out of the funds. Therefore, the fund management company needs to provide sufficient liquidity in terms of buy-ins, although the funds itself is deemed as the trading counterparty. Investment funds (UCITS/AIFs) do not normally hold a high portion of liquidity within the fund which could be used very swiftly to require the prefunding for the only Buy-In agent. Investment funds are generally fully invested. Therefore, such a prefunding requirement enhance further the operational burden for the investment fund management companies to connect to the only Buy-In agent.

We understand that the only Buy-in agent model in question includes service fees for maintaining the accounts required to initiate a buy-in and ex-post charges that are highly inefficient to recover from the failing participants. Fund management companies will therefore be damaged with high sunk costs because of being forced to adopt to the only buy-in model that is available although they have no relevant buy-in transaction. The potential buy-in agent mechanism will also require the adoption of IT processes and interfaces that, for the buy-side at least are bespoke and are therefore highly inefficient to be implemented compared with the very rare cases of buy-ins.

If the EU Commission wants to preserve the mandatory buy-in regime in the future, we suggest that the entire efforts for the handling of the buy-ins is covered exclusively by the failing participant (e.g. broker/dealer) or the trading venues. This also includes the provisions to provide the relevant prefunding resource to the only Buy-In agent. Over the couple of years, fund management companies have already established well-functioning onboarding- and order routing processes with the broker/dealers and trading venues. Therefore, it is not necessary for the Buy Side to create a completely new third party buy-in agent system which will never outweigh the cost compared to the benefit.

2. A pass on mechanism should be introduced

We are supportive of a pass on mechanism. Pass on mechanism should be allowed for securities in a settlement chain in order to reduce multiple buy-ins for the same security, which also affects market volatility. Furthermore, a pass on mechanism would reduce operational costs and only actually incur expenses at the parties responsible for the failed transactions.

3. The rules on the use of buy-in agents should be amended

The obligation to appoint a buy-in agent should be removed. This creates a strong dependency of the trading parties to market providers and therefore advantage a monopolistic position if only one buy-in agent exists on the market. It needs to be ensured that the processes of a buy-in agent do not entail large separate effort. This applies to both operational processing and financial expenditure. It should be possible to initiative a buy-in transaction like any other securities transaction without additional collateral or pre-funding costs/procedure. In the case of the only current Buy-in agent service offering, we do not consider it necessary to register all funds separately and to bear unnecessary costs for this.

The anticipated model of the buy-in agent for the buy-in auction is to use network partners. The network partners need to be connected to the buy-in agent. This means that in the case the network is too small, unsuccessful buy-ins via the buy-in agent could occur although the financial instrument could be bought on the market (e.g. for illiquid fixed income products).

This could impact the buy-in price, as the price might be lower if the relevant asset can be directly bought in the market instead of from the network partner. The situation would worse off the failing trading party in case of an increased price. Therefore, the mechanism of the buy-in auction should be extended for all market participants (e.g. Buy-Side) without any additional connectivity costs (fix cost on a monthly basis) and the settlement of the buy-in trades should occur with t+2 according to the normal market mechanism.

4. The penalty regime

We believe that the penalty regime should be revisited and should not apply to certain types of transactions (e.g. market claims in cash).

Question 35: Would the application of the settlement discipline regime during the market turmoil provoked by COVID-19 in March and April 2020 have had a significant impact on the market?

-Yes
- No
- Don't know / no opinion

Question 35.1: Please explain your answer to Question 35, describing all the potential impacts (e.g. liquidity, financial stability, etc.) and providing quantitative evidence and/ or examples where possible.

The absence of a mandatory buy-in regime allowed greater tolerance of settlement fails during that period than otherwise would have been possible, which enabled market makers to provide much-needed liquidity for Asset Managers to protect those investors to a much greater extent.

Question 36: Which suggestions do you have for the improvement of the settlement discipline framework in CSDR? Where possible, for each suggestion indicate which costs and benefits you and other market participants would incur.

Please see our answers as given above. We would like to welcome an adjustment of the standing settlement instructions (SSIs) confirmation process required in RTS Art. 2 para 1 settlement discipline with respect to UCITS/AIFs. Basically, asset managers are not the source to provide the SSI information. The sources are the appointed fund custodians who always have the up-to-date knowledge of what the current SSIs are and where the securities are held. Therefore, as part of the process for trade allocation and confirmation process, it would be advisable to make the custodians responsible to provide this settlement information as they have the real time information on that.

The lack of legal clarity in the overall responsibility pushes asset managers into the situation to provide the relevant SSI information to the investment firm. SSI information changes regularly over time and needs to be therefore updated. However, fund custodians are less willing to provide the updated SSI information in time as required by the fund management company. In order to achieve improved settlement efficiencies as intended by the CSDR settlement discipline regime, we would welcome more standardization and clarity on the responsibility for the asset management industry in respect to the SSI, for instance in level 3 guidelines.

If this does not occur, additional processes have to be established between the asset manager and the fund custodian, which ultimately could cause additional costs and from the asset manager's point of view will not add any value for the investors of the fund.

Penalty regime

The penalties regime should be leveraged as a tool to drive settlement efficiency. We recommend that ESMA should be empowered to set targets for settlement fails and to obtain a mandate to adjust the various penalties rates periodically where the targets for particular instruments are being missed consistently.

ESMA should be required to undertake proper analysis of the fails data provided by CSDs in order to determine the target ceiling for fail rates, and the associated penalties, which would also consider the type of instrument and its MiFID liquidity assessment. The mandate should also require ESMA to assess both the likely impact of the rates it determines on reducing fail rates and the increase they may bring in everyday costs for the market as a whole.

A particular factor to consider, we believe, is that the penalty rates should be higher than the financing cost to obtain the instruments through securities borrowing or the repo market - if the penalty rate is lower, there would be little incentive for a failing party to source the instruments by securities financing in preference to suffering the penalties.

9. Other areas to be potentially considered in the CSDR Review

Question 43: What other topics not covered by the questions above do you consider should be addressed in the CSDR review (e.g. are there other substantive barriers to competition in relation to CSD services which are not referred to in the above sections? Is there a need for further measures to limit the impact on taxpayers of the failure of CSDs)?

We are very concerned that the entry into force of the current regime scheduled for 1 February 2022 will leave insufficient time for any amending legislation to be implemented in law and in practice.

Therefore, we urge that the EU Commission provides clarity as early as possible in respect what will need to be implemented and from when, bearing in mind that fund management companies will need at least 9-12 months to develop, test and implement new changes to their systems and interfaces, once they have certainty of the requirements. This will only be when the final legislation is published in the Official Journal, which we do not believe could be envisaged until sometime after February 2022.

We therefore strongly demand that the financial industry should be provided with a clear understanding as soon as possible of what will remain to be implemented in February 2022 and the mechanism(s) by which those aspects that are to be altered will be deferred in order to allow time for the new legislation to enter into force with an appropriate period for implementation.

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