Comments

on the Consultation Paper "Guidelines on Internalised Settlement Reporting under Article 9 of CSDR"

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Introduction

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 1,700 banks.

GBIC welcomes ESMA's intention to issue guidelines to ensure consistent supervisory practices by clarifying questions of interpretation and providing assistance in completing the proposed reporting templates.

To make the guidelines as clear as possible, we would suggest starting by summarising the requirements of the CSD Regulation[1] (Levels 1 and 2) which have to be met in order for a reporting obligation to be triggered in the first place. This new section could be placed before section 4.1 and entitled something along the lines of "4.0 Scope of reporting obligations". Spelling out these legal prerequisites would probably be enough in itself to clear up a lot of the questions covered in the proposed guidelines regarding their scope and to indicate relevant categories with respect to the reporting templates. The following sections could then address any remaining problems and interpretation issues in a more targeted manner.

Our replies to the questions in the consultation paper deal with this point in more detail.

Q1: Do you have any comments or suggestions regarding the scope of the data to be reported by settlement internalisers? Please provide arguments supporting your comments and suggestions.

1. General comment

As mentioned in our introduction, we would like to suggest that ESMA consider adding a new section on the scope of the reporting obligations, summarising the conditions set out in Levels 1 and 2 of the CSDR which have to be met before a reporting obligation is triggered in the first place. This section could explain who is deemed to be a settlement internaliser, who is subject to reporting obligations and under which circumstances an internalised settlement occurs. Details on the "scope of data to be reported by settlement internalisers" could then follow.

2. Legal prerequisites for a reporting obligation

The conditions which must be fulfilled before a reportable internalised settlement may be considered to exist are as follows:

(1) A settlement instruction is issued by a client of the settlement internaliser;
(2) resulting in transfers from one account to another account in the settlement internaliser's own books;

[1] Regulation (EU) No 909/214 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 ("CSDR")

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(3) and there is no settlement instruction to an external third party (e.g. subcustodian or CSD) or record of an account entry in the books of an external third party;
(4) the underlying financial instruments are held by a CSD authorised in accordance with the CSDR and (if settlement were not internalised) they would be settled by a CSD authorised in accordance with the CSDR.

Article 9(1) in conjunction with Article 2(1)(11) and recital 28 of the CSDR, together with Article 1(1) and, in addition, recital 2 of the Delegated Regulation[2] specify the conditions which must be met in order for a securities transaction to be considered a reportable internalised settlement. These criteria alone, in our view, will determine whether a settlement is subject to the reporting obligation or not.

We agree with ESMA that there is currently some room for interpretation when assessing whether or not certain settlement transactions will need to be reported and that, in the interests of consistent supervision and in order to ensure common, uniform and consistent application throughout the EU, ESMA needs to clarify matters. We therefore welcome the endeavours to do so in the proposed guidelines.

It should nevertheless be remembered that the reporting requirement can only be generated by internalised settlement – irrespective of the underlying legal reason for the transaction. The trigger for the reporting requirement should therefore be the satisfaction of the legal prerequisites, not the presence of a specific type of transaction or legal basis.

With this in mind, we recommend that ESMA should make it clear in the guidelines that the legal prerequisites for the reporting obligation must have been met and should explicitly specify what these prerequisites are. Illustrative examples of reportable transactions could then be provided along the lines of those in paragraph 11 of the proposed guidelines (subject to our comments on paragraph 11 below).

It would be desirable to further clarify that, should these legal prerequisites not be met, no reporting obligation will exist. This could be followed by examples of cases where reporting is not required, as in paragraph 12 of the proposed guidelines (subject to our comments on paragraph 12 below).

In short: **transactions requiring reporting** are therefore orders for securities transactions which are settled only in the books of one bank, not also in the books of another bank or of a CSD somewhere in a custody chain, and which would otherwise have been settled in an EU-authorised CSD. Examples of such reportable transactions are:

- internally settled client trades,
- internal transfers from the account of client A to the account of client B,
- internal settlement of trades between a bank and the bank's clients,
- pledges which involve transfers between different accounts.

It should be borne in mind, however, that a custodian will normally not know (or be in a position to know) the legal background to a transaction it settles (e.g. whether a trade or a pledge is involved). The custodian can only make use of the information provided by the client and include this in its reports. If

[2] Commission Delegated Regulation (EU) 2017/391 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards further specifying the content of the reporting on internalised settlements

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the client fails to provide information, the custodian has no legal or contractual basis on which to obtain it.

We would also like to point out that, for many of the transactions mentioned in the proposed guidelines, no transaction code exists and, even if a code does exist, it may not be included in the settlement instruction. Settlement instructions are normally received as SWIFT messages, but may also take another form if, for instance, a retail client is involved. There are also differences in the way clients enter SWIFT transaction codes in SWIFT messages. This will be an issue when it comes to filling in the reporting template (for details, please see point b) of our reply to Q3).

3. Paragraph 11 of the proposed guidelines

Against this background, we have the following comments on the examples of reportable activities listed in paragraph 11 of the proposed guidelines:

Sub-para	Comments
a)	We agree, provided that settlements are internalised (please add wording along the lines of "where the settlement is internalised").
b)	We agree, provided that settlements are internalised (please add wording along the lines of "where the settlement is internalised").
c)	We agree, provided that settlements are internalised (please add wording along the lines of "where the settlement is internalised").
d)	We agree, provided that settlements are internalised (please add wording along the lines of "where the settlement is internalised").
e)	We welcome ESMA's intention to draw a distinction, by referring to point (k) of Article 2 of Directive 98/26/EC, between netting at trading level and pairing off at settlement level. We agree that netting at trading level cannot possibly fulfil the prerequisites for the reporting obligation because trades are netted at trading level in such a way that no settlement instructions are generated, thus ruling out the possibility of internalised settlement. This could be explicitly mentioned in paragraph 12 g) ("transactions that are cleared"). We cannot, however, agree with ESMA's assumption that transactions paired off at settlement level will always be subject to the reporting requirement. A further distinction needs to be made here. • If the settlement internaliser's systems are – on the basis of contractual agreements with the clients – programmed to pair off, they will first set two clients' settlement instructions off against each other and only make an (internal) account entry for the net difference. This is achieved by cancelling the original settlement instructions and replacing them by a new instruction to settle the net difference

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	amount. The offset settlement instructions cannot, therefore, be regarded as internalised settlement in this case since there will be no corresponding account entries. Only the settlement of the net difference actually transferred to another account can be internalised and reported accordingly ("net reporting"). And if this net difference is settled externally (by a CSD, for example), no report will be required at all. The reason for employing a pair-off procedure of this kind is to minimise settlement risk by avoiding settlement fails, thus making settlement more efficient. There are no grounds whatsoever to fear that the purpose is to circumvent a reporting requirement. • If, on the other hand, systems are not programmed to pair off and settlement instructions are executed as and when they are received from clients, account entries will be made for the full amounts involved, even if it is only the net difference which is ultimately transferred between accounts. In this case, all the settlement instructions will have to be reported in full as internalised settlement ("gross reporting"). The guidelines should take account of this distinction. The current wording of paragraph 11 e) should be deleted and added instead to paragraph 12 g) with the clarification that only net reporting of the net difference will be required.
f)	It would be helpful to use the term "investment funds" instead of "funds" or to add further clarification along the lines of "funds such as AIFs and UCITS".
g)	We suggest deleting subparagraph g) since Article 9 of the CSDR and Level 2 already specify in full when a reporting obligation will exist (see section 2 of our reply to this question). In the absence of a definition of what is covered by "intragroup transactions", there is a danger of inconsistency and confusion. As explained above, the background to a transaction is not relevant. Provided that settlement is internalised, transactions between two legally independent units of the same entity will always be reportable.
h)	We agree, provided that settlements are internalised (please add wording along the lines of "where the settlement is internalised").
i)	These activities are already covered by paragraph 11 a) to d). This subparagraph should therefore be deleted to avoid misunderstandings. As mentioned above in section 2 of our reply to this question, account-maintaining custodians will have no way of knowing the legal background to the transaction underlying the transfer (e.g. if "inheritance" or "gifts", which have no ISO transaction code, are involved); for further comments on this point, please see section b) of our reply to Q3 below. And in any event, the legal background to the underlying transaction is totally irrelevant when it comes to determining whether or not settlement has to be reported.
j)	Please see our comments on subparagraph i).

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k)	Please see our comments on subparagraph i).
l)	If the prerequisites for a reporting obligation are met, i.e. if settlement is internalised at the instigation of a client, these activities are already covered by paragraph 11 b) or c). Subparagraph l) should therefore be deleted.
m)	We agree that these activities should be reported, provided that the original transaction was also reportable. It is not the corporate action as such which will trigger a potential reporting obligation, however, but the underlying transaction. If this already constitutes internalised settlement and has to be reported, the adjusted transaction – as in the case of transformations, for instance – will also be reportable. *Example*: Settlement instructions are issued for shares which have been sold. If these settlement instructions are internalised, they will have to be reported as such. If, in the meantime, a corporate action in the form of a transformation is initiated, the existing settlement instructions will be cancelled and replaced by new ones making reference to the new ISIN. These will then have to be reported as instructions for internalised settlement. This is not because a corporate action is underway, however, but because the original settlement instructions were already reportable. Conversely, no reporting obligation can be triggered by a transformation with no link to internalised settlement.

4. Paragraph 12 of the proposed guidelines

We welcome ESMA's illustrative examples of transactions and operations which are not subject to the reporting requirement. We nevertheless have the following comments on certain aspects of these examples.

Sub-para	Comments
a)	./.
b)	./.
c)	./.
d)	./.
e)	./.
f)	./.
g)	See also our comments above on paragraph 11 e). The phrase following the semicolon ("however, if…") should be deleted. Instead, it should be clarified that the net difference after "netting as defined in point (k) of Article 2 of Directive 98/26/EC" is subject to a reporting requirement provided the settlement was internalised.
h)	The corresponding reportable transactions are already mentioned in paragraph 11 b) and c) (provided that securities are transferred between the accounts of two different clients). It is therefore superfluous to mention these types of transactions again here. To avoid inconsistency with paragraph 12 d) ("accounts of the same client"),

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	subparagraph h) should either be deleted or the phrase "belonging to different clients" should be added to the end.
i)	In the example described in brackets, the custodian should also be mentioned.

5. Paragraph 13 of the proposed guidelines

In our view, internalised settlement instructions can only be subject to reporting if they refer to financial instruments which are (or may be) maintained by EU CSDs and which would have been settled in an EU CSD if they had not been internalised. This is because Article 2(1)(11) of the CSDR mentions a securities settlement system (SSS), which, under Article 18(2), may only be operated by a CSD authorised in accordance with the CSDR or by an EU central bank acting as a CSD. The settlement internaliser can determine whether a financial instrument would otherwise have been settled in an EU CSD by checking the special PSET field delivered with the settlement instruction (see also the explanation in our reply to Q6).

We would therefore suggest adding the following wording to paragraph 13 a) and b):

13. The following types of financial instrument should be considered in scope of internalised settlement reporting:

a) financial instruments that are initially recorded or centrally maintained in CSDs authorised in the EU **and would have been settled in a CSD authorised in the EU if their settlement had not been internalised**;

b) financial instruments initially recorded and/or centrally maintained outside of CSDs authorised in the EU but **which would have been** settled in an EU CSD **if their settlement had not been internalised**;

This would mean that transactions involving the following types of financial instrument would not be reportable either, which would also be consistent with paragraph 14 of the proposed guidelines:

- Securities in the form of paper certificates kept in individual safe custody (so-called "*Streifbandverwahrung*" under Section 2 of the German Safe Custody Act (*Depotgesetz* – DepotG) as opposed to book-entry securities). It is not possible to settle instruments of this kind in an SSS – SSSs are only able to settle book-entry securities, for example, in accordance with Section 5 of the German Safe Custody Act.
- Exchange-traded derivatives that are not securities, and OTC derivatives, since these constitute contracts, not securities; as such they are not held by CSDs and cannot be settled in an SSS.
- Promissory notes loans, since they are not fungible and therefore cannot be settled in an SSS.
- Money market instruments in markets in which they are not held by a CSD.

The above list is illustrative and not exhaustive.

Please also see our reply to Q3 for additional comments on further aspects of reporting parameters.

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Q2: Do you have any comments or suggestions regarding the entities responsible for reporting to competent authorities? Please provide arguments supporting your comments and suggestions.

We welcome the clarification by ESMA as regards which entity, particularly within a group with branches in different Member States, is responsible for reporting to which national competent authority.

Paragraph 15: The term "technical sub-account" is unclear, especially the wording "Entity B is aware of the securities movements between the two technical sub-accounts...". This is not possible under the account structures in Germany. Either B maintains an omnibus account for A and A maintains accounts for its two clients (e.g. X and Y) – but then these accounts are not "technical sub-accounts" and B is not aware of the securities movements between the accounts of X and Y in A's books – or B maintains two sub-accounts (one for A's client X and another for A's client Y). In this case, the securities do not belong to the same omnibus account of bank A and A cannot internalise settlement between these accounts.

We suggest redrafting the example and deleting the term "technical sub-accounts".

In contrast, the examples in paragraph 17, in conjunction with paragraph 20, make very good sense. The headquarters of a settlement internaliser reports internalised settlements for itself and for all its EU branches. A separate report has to be made for each Member State in which one or more EU branches operate, but this has to be transmitted together with the headquarters' report to the headquarters' national competent authority.

<u>Reporting entity</u>

There is no mandatory reporting requirement for a bank if it arranges for all securities transactions (including transfers and pledges of securities) to be settled externally.

In addition, we suggest clarification with regard to account operators:

A so-called **account operator**, which makes entries in the books of a bank on behalf of the bank (as a service), is only to be regarded as an external entity if, as part of the safe custody chain, it at the same time makes entries in its own books as well. If, when performing the service, the account operator only makes entries in the books of the bank, the bank, as the settlement internaliser, remains the reporting entity. For it must be assumed that outsourcing the service does not automatically transfer either responsibility or mandatory reporting to the service provider. The service provider (account operator) would, however, have to make available the data required for reporting to the settlement internaliser (on the basis of a contractual arrangement). If the account operator were to be regarded as the reporting entity, this might lead to it reporting to a national competent authority other than that which would be responsible for the settlement internaliser.

Outsourcing mandatory reporting to a service provider should, however, be possible and permissible under existing general rules.

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Q3: Do you have any comments or suggestions regarding the proposed data reporting parameters? Please provide arguments supporting your comments and suggestions.

a. Reporting on an actual settlement date basis

In paragraph 25 of the proposed guidelines, in particular, it seems that ESMA intends to set different reference points for the treatment of internalised settlement, depending on whether the settlement is executed or fails. We, however, see the actual settlement date as the crucial reference point for the inclusion of settlement instructions in reports. It is not only more suitable than the intended settlement date, but also expressly stipulated under points f to l of Article 2(1) of the Delegated Regulation. Even though the wording of Article 2(1)(m) of the Delegated Regulation suggests at first glance that the intended settlement date is crucial for settlement fails,[3] consistency with the requirements under points f to l of Article 2(1) of the Delegated Regulation should be ensured by using the actual settlement date here, too, since points f to l expressly stipulate that "**settled** instructions" have to be reported, but not pending instructions as well. Adopting a different approach only for settlement fails would, moreover, have various disadvantages:

- Reports might have to be regarded as non-final over a prolonged period and would make continuous correction necessary, e.g. in the following cases:
  - Should, for example, settlement instructions be cancelled on both sides after the intended settlement date, reports would have to be corrected, as no settlement whatsoever, i.e. also no internalised settlement, takes place.
  - In the event of transformations (corporate actions in the area of mandatory reorganisations) too, the originally entered settlement instructions would have to be replaced by new instructions once the corporate actions have been carried out. This would also make corrections of reports necessary, which would not be the case with reporting based on the actual settlement date.
- It is, moreover, unclear how such corrections are to be made; these are not provided for in the template annexed to the Implementing Regulation. It is also unclear when a correction would have to be made and how often. A quarterly report might thus be repeatedly corrected and could, as a result, influence the competent authorities' risk assessment.
- Furthermore, bank systems are already geared to recording the actual settlement date. Adjusting systems only for settlement fails appears disproportionate, since the sole difference between reference to the actual settlement date as compared to the intended settlement date would be that a fail whose intended settlement date lies at the end of the reporting period would not be reported until the following reporting period. This delay in reporting appears negligible, however, given the burden that adjusting systems would impose and the expected need for correction of reports for delayed settlements, where it is not sure at the time of reporting whether these are reportable in the first place.

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[3] *" … the aggregated volume and value, expressed in euros, of failed internalised settlement instructions referred to in points (f) to (l) that fail to be settled as during the period covered by the report;"*

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b. Details of reportable data

Types of securities transactions
As the settling bank generally has no knowledge of the underlying contractual transaction, the involvement of the client is essential. This means that a classification according to certain types of securities transaction is only possible on the basis of the information provided by the client, e.g. on indication of the ISO transaction codes in the settlement instructions. These codes, which the bank must be able to rely on, should, however, be indicated (independently) by the client and cannot constitute any obligation on the part of the bank to explore the reason for the transaction (the nature of the original trade).

The Implementing Regulation stipulates ISO transaction codes for "collateral management operations" and "repurchase transactions", on the basis of which these can be categorised. Accordingly, we are of the opinion that the following ISO transaction codes should be used to categorise into

- "purchase or sale of securities": PLAC / ISSU /SYND / TRAD / TURN;
- "securities lending or borrowing transactions": SBRE / SECB / SECL / SRLE;
- "other securities transactions": all other ISO transaction codes and all transactions which are usually initiated without an electronic order, i.e. not via SWIFT, and without an ISO transaction code, so that their background is unknown, or where the client has provided no information on the transaction background. This field should be usable as a catch-all element or a default field. In this way, inheritance and gifts, where there is a transfer of securities between accounts, or other transfers of securities between accounts could be recorded here (see above comments on paragraph 11 k).

c. Further comments on the proposals in the guidelines

We also have the following specific comments on this section of the proposed guidelines:

Paragraphs 21 and 22: We welcome the clarification as to how the Issuer CSD country code field has to be filled in, particularly the clarification that the first two characters of the relevant ISIN code can be used in the report.

Paragraphs 23 and 24: We welcome the clarification. However, this was not taken into account in the example in paragraph 25. The volume in the report can only consist of even numbers, not of odd numbers.

Paragraph 25:
According to Article 1 (2) of the Delegated Regulation, "'failed internalised settlement instruction' means non-occurrence of settlement […] of a securities transaction **at the date agreed** by the parties concerned […]." For reporting purposes, a fail can only be counted once (namely, with respect to the intended settlement date) and not on each (other) day when the settlement instruction fails to settle. Furthermore, taking into account the individual days on which an instruction failed to settle may be possible and make sense where reporting is performed on a daily basis. We wish to point out, however, that internalised settlement reporting takes place on an aggregated basis over a three-month period, which is why cumulating the same settlement instruction across several days is out of the question.

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Otherwise this could produce misleading or misunderstandable information, particularly also when it comes to determining the fail rate.

Paragraph 26:
As regards indication of amounts in euros, it would make sense for the reporting parties to use an exchange rate conversion method similar to that adopted for other reporting (e.g. Article 26 of MiFIR, etc.) and to stipulate that, particularly in the event that an ECB exchange rate is not available, the conversion rate will be determined in line with same rules as for other reporting.

Q4: What are your views regarding the proposed requirement according to which settlement internalisers should use an XML format based on the ISO-20022 compliant XSD schema?

Paragraph 19:
With budget planning in mind, and because of the time needed to prepare programming and adequate testing of the new reporting requirements, we believe the draft XSD schema should be published early, ideally before the end of 2017.

Paragraph 27:
We greatly welcome the clarification on the date when the first report is due and on the reporting period and assume that, when it comes to timeliness, the usual established procedures (timestamp, acknowledgment of receipt or, where applicable, "not acknowledged" notice, plus the usual periods) will apply, like in other reports.

Our members consider it necessary for the guidelines to stipulate that an "acknowledged" or "not acknowledged" notice should be sent immediately on receipt and also to state how much time is allowed for further or renewed transmission of reports.

In addition, we recommend that the guidelines stipulate that the new reporting system should be tested between settlement internalisers and national competent authorities (NCAs). This could be included in the guidelines by way of a separate section. Our members would welcome a sufficiently long testing phase, starting around three months before the first report is due.

Q5: Do you have any comments or suggestions regarding the proposed process for submission of internalised settlement reports? Please provide arguments supporting your comments and suggestions.

Paragraph 31:
The guidelines should stipulate that the national competent authorities perform a validation check already on receipt of a report and communicate the result of the check to the reporting entity immediately after receipt to allow any correction needed in a timely manner. In addition, the same processes and timelines should be used by all NCAs.

General comment:
We also recommend stipulating in the guidelines that the NCAs should be required to enable the reporting entities to test the new reporting system. The ideal time for such testing over an adequate period would

be three months before the first report is due. We suggest inserting a new section that deals with the details of testing between the reporting entities.

Q6: Do you have any additional comments or suggestions regarding the proposed guidelines? Please provide arguments supporting your comments and suggestions.

General comment:
Bearing in mind the fears expressed in recital 28 of the CSDR that internalised settlement could give rise to risks, **banks which perform securities settlement solely for retail clients should not be regarded as settlement internalisers**. For internalised settlement takes place here, as a rule, in the case of (FOP) transfers of securities between accounts, where the securities are available and consequently no risks arise. Trades for clients are settled by these banks externally. Only in an insignificantly small number of cases do these banks deliver securities of their own from the same omnibus account to settle trades for retail clients. Recital 28 of the CSDR justifies a mandatory reporting requirement, however, by referring precisely to potential risks arising from internalisation compared with settlement through a securities settlement system (SSS). Even entering contrary instructions with the CSD would be unable to reduce the risk that does not exist in any case.

<u>Comments on determining the relevant CSD: "PSET" approach</u>
A transaction is reportable where it is "settled by the settlement internaliser in its own books and not through a securities settlement system".[4] Consequently, only transactions that can be settled through an SSS as well can be reportable. This is only the case if the financial instruments to which the transaction relates are also **held and settled** by the CSD operating the SSS ("all securities settled in an EU CSD"[5]).

To determine which transactions in which financial instruments trigger a mandatory reporting requirement, the "PSET" field could be helpful. The "PSET" field is a special field in a settlement instruction which indicates the place of settlement. The PSET is, in our view, appropriate in many respects, since it appears suitable as a differentiation criterion when it comes to the following questions:

- Can the type of financial instrument in question actually trigger a mandatory reporting requirement in the first place?
- How should it be determined whether generally reportable financial instruments are held and settled by an EU CSD?

A transaction would thus be reportable if the PSET in the settlement instruction is an EU CSD. If, on the other side, it is a non-EU CSD, the transaction would not have to be reported. Both clients would have to indicate the PSET consistently so that the information in their settlement instructions is a reliable reference point.

<u>Example:</u> Transactions in US government bonds where the PSET indicated by the client is "Euroclear" would fall within the scope of the mandatory reporting requirement if they are settled internally. Transactions in US government bonds where the client enters "DTCC" as the PSET would not, on the other hand, fall within the scope.

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[4] Article 1(1) of the Delegated Regulation
[5] ESMA/2015/1457, paragraph 239

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If a financial instrument is not actually settleable by an SSS, there is consequently no PSET either. Transactions in such financial instruments would therefore also not be reportable.

Example: A client "purchases" a derivative, e.g. an exchange traded derivative (ETD), which falls under the definition of "financial instrument". ETDs are not securities, however, and, as such, cannot thus be held in safe custody. ETDs are, instead, contractual agreements which give rise to mutual obligations for the contracting parties, but which are classified for supervisory purposes as financial instruments (just like OTC derivatives, which are also contractual agreements). Yet this classification does not, in legal terms, make them eligible for safe custody either by banks or by CSDs. On conclusion of a derivatives trade, no settlement instruction (and thus no PSET) is therefore transmitted either.