

ESMA'S QUESTION & ANSWER (Q&A) TOOL

QUESTION SUBMISSION FORM

IDENTIFICATION	
1.	<i>Name of entity</i>
	German Banking Industry Committee (Die Deutsche Kreditwirtschaft)
2.	<i>Country of incorporation / Residence</i>
	« (Germany) »
3.	<i>E-mail address / Other contact details</i>
4.	<i>Sector</i>
	« (Banking) »
LEGISLATIVE REFERENCE	
5.	<i>Level 1</i>
	« (Central Securities Depositories Regulation (CSDR) Regulation (EU) No 909/2014) »
6.	<i>Article/s of Level 1 Legislative Act</i>
	Article 7 Measures to address settlement fails
7.	<i>Other relevant Act/s or Guidance</i>
	COMMISSION DELEGATED REGULATION (EU) 2018/1229
QUESTION	
8.	<i>Subject matter</i>
	Scope of provision for buy-ins
9.	<i>Question</i>
	<p>According to Article 7(3) of the CSDR: "Without prejudice to the penalty mechanism referred to in paragraph 2 and the right to bilaterally cancel the transaction, where a failing participant does not deliver the financial instruments referred to in Article 5(1) to the receiving participant within 4 business days after the intended settlement date ('extension period') a buy-in process shall be initiated whereby those instruments shall be available for settlement and delivered to the receiving participant within an appropriate time-frame."</p> <p>a) Are settlements which are not based on a trade (in the secondary market) outside the scope of Article 7(3) of the CSDR?</p>

- b) How can it be ensured that settlements which are not based on a trade and which are therefore outside the scope of Article 7(3) of the CSDR do not suffer the disadvantageous consequences of a mandatory buy-in?
- c) How should the situation be dealt with if the parties to a trade use different transaction codes?

10. Proposed answer

- a) Yes. Article 7(3) of the CSDR only covers settlements which are based on a trade in the secondary market. Buy-in processes have to be initiated in these cases because, contrary to what was originally agreed, the purchasing trading party does not receive the financial instruments on time.

The purpose of the buy-in is to help a party to a transaction concluded in the (secondary) market obtain as quickly as possible a financial instrument which the counterparty has failed to deliver in breach of their contractual agreement. In principle, this also covers operations composed of several transactions, such as securities repurchase agreements (repos) or securities lending agreements, though the CSDR provides for special exemptions (cf. Article 7(4) of the CSDR).

- b) Trading parties should ensure that transactions, including composite transactions, which are concluded on trading venues in accordance with MiFID II or on an OTC basis in a secondary market are identified as a “trade”. To this end, the corresponding transaction code should be used in the settlement instruction.

Intermediaries submitting settlement instructions to a securities settlement system on behalf of their clients should try to ensure that their clients provide the appropriate transaction code for the instruction. The ISO transaction codes in the attached list should be used since they make it possible to identify the types of transaction to which Article 7(3) of the CSDR does not apply.

- c) If the transaction code is specified in the settlement instruction in accordance with the above list, matching will not be necessary. Transaction codes are not a necessary matching criterion, but have been introduced as a voluntary measure in order, among other things, to facilitate the identification of transactions which are not subject to buy-in requirements and which are covered by the exemption in Article 7(4) of the CSDR. This will be determined by the transaction code used in the settlement instruction for the receiving trading party.

11. *Relevant background*

Without clarification that a buy-in process only has to be initiated if the failed settlement is based on a trade in the secondary market, uncertainty may arise as to how to deal with other transactions. In particular, ESMA's comments on the scope of buy-ins in its final report on the RTS could lead to a lack of clarity causing the initiation of buy-in processes that serve no useful purpose from either an economic or a sanctions-related perspective.

In its final report, ESMA stated:

"93. In respect of transactions concerned, some respondents argued that instructions not resulting from a trade i.e. from a transaction with an economic purpose, such as a portfolio transfer, a re-alignment or margins, should be excluded from the scope of the buy-in rules. 94. It is important to stress that ESMA has 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."

This is to be understood as meaning that ESMA itself cannot change the requirements of the CSDR. ESMA may, however, make recommendations to lawmakers as to how Level 2 requirements should be designed in a way to eliminate any misunderstandings, though without setting these requirements at Level 2 itself. ESMA issued such recommendations and these are reflected in the final RTS.

Naturally, a competent authority can and must be able to determine what transactions are in scope of the rules it monitors compliance with. It must also be able to interpret an ambiguous legal provision and clarify the will of lawmakers if lawmakers themselves have failed to do so.

It is clear from recital 12 of the CSDR that timely delivery between two parties to a trade is a focal point of settlement discipline ("buying or selling"; "should settle its obligation on the intended settlement date"). The phrase according to which participants "in a securities settlement system" buy or sell financial instruments is open to misunderstanding, however.

Recital 12 of the CSDR says: "In order to ensure the safety of settlement, any participant in a securities settlement system buying or selling certain financial instruments, namely transferable securities, money-market instruments, units in collective investment undertakings and emission allowances, should settle its obligation on the intended settlement date."

In consequence, the requirements of Delegated Regulation (EU) 2018/1229 (RTS) which specify the details of the buy-in process also stipulate that the CCP, the trading venue member or the trading party which would have received the financial instruments have to initiate a buy-in process at the expense of the counterparty obliged to deliver the instruments. If, however, in the absence of a secondary market trade there is no trading party and thus no “defendant” counterparty for a buy-in, Article 7(3) of the CSDR cannot be applied. In particular, the buy-in requirements have no relevance to securities portfolio transfers or primary market transactions.

For this reason, lawmakers followed ESMA’s recommendation and clarified in the delegated regulation that it is not the CSD participants but the parties to the trade which are subject to the buy-in requirements, cf. the provisions of Articles 27(1), 29(1) and 31(1) of the RTS.

The fact that only trading parties are bound by the buy-in and thus that only trades can fall within its scope of application may also be inferred from various recitals of the delegated regulation. Recital 26 expressly refers to the “buyer”.¹ Recital 31 says that “the parties that originally concluded the relevant transaction should be responsible for the execution of the buy-in.” Recital 32 specifies that a “buy-in should therefore be effected at the level where the **contractual** obligations to **buy and sell** securities have been created.”

Article 35 of the delegated regulation also shows unequivocally that only trades can possibly be meant since it is the price of the financial instruments “agreed at **the time of the trade**” which determines the amount of compensation payable.²

Furthermore, recital 26 of the RTS, which addresses the handling of cases where partial delivery is possible, refers to the rights of the “buyer”, which presupposes that settlement is based on a “buy”. When primary market transactions are concerned, by contrast, reference is usually made to “subscribers” and “subscriptions”. No buyer is involved in a securities portfolio transfer.

¹ Recital 26 of the RTS: “Mandatory partial settlement on the last business day of the extension period referred to in Article 7(3) of Regulation (EU) No 909/2014 strikes the right balance between the rights of the **buyer** to receive the financial instruments **bought** and the need to minimise the number of financial instruments subject to buy-in. Every bought-in financial instrument should therefore be delivered to the **buyer**, even if the number of bought-in financial instruments does not allow for the full settlement of the relevant settlement instruction.”

² Article 35 of the RTS: “1. Where the price of financial instruments referred to in Article 5(1) of Regulation (EU) No 909/2014 agreed at the time of the **trade** is lower than the price effectively paid for those financial instruments pursuant to Articles 27(10), 29(10), and 31(10), the failing clearing members, failing trading venue members or failing trading parties shall pay the price difference to the CCP, receiving trading venue members or receiving trading parties, as applicable.

Where transactions are cleared by a CCP, the price difference referred to in the first subparagraph shall be collected from failing clearing members by the CCP and paid to the receiving clearing members.

2. Where the price of the shares agreed at the time of the **trade** is higher than the price effectively paid for those shares pursuant to Article 27(10), Article 29(10) and Article 31(10), the corresponding difference referred to in Article 7(6) of Regulation (EU) No 909/2014 shall be deemed paid.”

What is more, a buy-in for securities portfolio transfers or primary market transactions would make no sense and be economically detrimental. In the case of a securities portfolio transfer, a holder of a security would be forced to execute a buy-in against themselves even though they already held the security. In addition, they would have to pay more than the market price for the additional securities acquired through the buy-in. A delay in transferring a security from one account to another belonging to the same client would therefore force the client to acquire the same instrument again. The only beneficiaries of the delay would be third parties (e.g. providers of the security, who would be able to charge a higher price than the market value, or intermediaries, who would be able to charge for their services).

The outcome would be equally nonsensical in a primary market transaction. In this case, a buy-in would affect not the relationship between a buyer and seller of a financial instrument, but the relationship between an investor and an issuer. If, for example, an investor in a UCITS fund wanted to return their unit to the management company, meaning that the financial instrument would cease to exist, it would be absurd to require the management company to acquire this same financial instrument from another investor. This is because the management company would have no interest in acquiring the instrument itself. It would merely want to pay the investor who no longer wished to invest in the fund their share of the fund assets against delivery of the the unit.

The various types of transactions that do not fall within the scope of the buy-in rules can be seen from the attached list of ISO transaction codes. A uniform EU-wide approach to using these transaction codes would be welcome. A market practice would have to be developed to this end. It should be borne in mind, however, that some of the listed transaction codes cannot be used in the German market as things stand. Since there is currently no uniform market practice, some of the codes are used internally by CSDs for other types of transaction and therefore could not be used at present by CSD participants in the structured message fields but only, at most, as free text input.