EBF response to ESMA Consultation Paper: Regulatory Technical Standards on CSD Regulation – The Operation of the Buy-in Process

Introduction

- The EBF welcomes ESMA’s Consultation Paper (CP) and the possibility to comment on this complex operational issue.

- Indeed, as it is recognized by ESMA in this consultation many respondents to the previous CP, including the EBF, called for changing the approach on the buy-in process.

- We fully appreciate that ESMA, on this topic, takes into account market participants concerns and proposals. However given the tight deadline for submitting comments, and the coinciding vacation period, we have only been able to analyse cost aspects to a limited extent.

- EBF agrees with ESMA that the design of the buy-in process under CSDR is a very difficult challenge and we understand that the process of designing technical measures is bound by the framework of the level 1 text.

Key points

- In its response to the December 2014 consultation paper on CSDR Technical Standards, the EBF strongly argued that the responsibility for executing and processing buy-ins should be placed at the trading level, and not at the settlement level. The EBF is still of this opinion.

- Accordingly, the EBF believes that the most appropriate option of the three options proposed by ESMA is option 1.

- The EBF believes that option 1 (trading level executing the buy-in) is the option that is most workable and that minimises legal and other risk through the custody chain.

- The EBF believes that option 3 (CSD participant level operating the buy-in) has all the disadvantages identified by the EBF in its response to the December 2014 consultation paper.
The EBF believes that option 2 (trading party executing the buy-in with fall-back option) does not resolve the disadvantages associated with option 3. Among other things, option 2 will create a very significant exposure for delivering CSD participants, which will need to be collateralised; option 2 will also expose all entities at the settlement level to legal risk and uncertainty, as any cash compensation process at the settlement level does not necessarily have any effect on the contractual rights of the two trading parties.

The EBF notes that ESMA believes that option 2 is closer to the text of the CSDR level 1. The EBF believes that this view is unjustified. The EBF notes under a strict interpretation of level 1 all three options are not compliant with level 1. The EBF believes that option 1 is at least as compliant with the text of level 1 as are options 2 and 3.

The EBF urges ESMA to review the reporting obligations to the CSD under all three options. The EBF believes that these reporting obligations will be burdensome to end investors, to intermediaries, and to CSDs, while providing little useful information for supervisory authorities.

Background Remarks

It is of utmost importance that the forthcoming RTS do not expose CSDs or their participants to new risks as a result of the buy-in procedure. For this reason the EBF strongly opposes option 3 as EBF agrees with what ESMA states.

The costs of the buy-in process would be significant as the CSD participants being always responsible for the execution of the buy-in would need to require collateral from their clients in order to protect themselves against the risk of paying the costs of the buy-in. Under this option, the participants might ask for collateral for up to 100% of their settlement instructions, i.e. call for margins to cover the difference between the initial transaction value and the current securities value. These costs might be substantial.

Transforming the settlement activity into a fully collateralised system might be contrary to the objective of the level 1 text. The costs of this full collateralisation might not justify the potential benefits of reduced settlement fails that the buy-in regime can achieve.

The EBF also notes that all options require a strong contractual framework between CSD participants, their clients and their trading counterparties which will indeed result in extensive changes in infrastructure and contractual framework.

Analysis of ESMA’s options

A first thing to note is that all three options will be costly and burdensome for market participants as they will have to develop a new contractual framework including all participants obligations in the buy-in and also a new information structure (flow).

From a general point of view the most logical place to put the responsibility is the original parties of the transaction. In fact, they should at least have some information about the actual trade and the deliverance of securities.
The EBF also welcomes the introduction in the new draft RTS of a distinction between trading party and CSD participant. The EBF believes that at a conceptual level this distinction is important and necessary. However, we believe that in practice the concept of trading party may well need further clarification. This is because banks, brokers and investment managers may act as agents on behalf of underlying investors with respect to trading services (such as the purchase and sale of securities), so that there is a need for a clear delineation of responsibilities with respect to the buy-in process at the trading level. In this context, it should also be noted that this delineation will also depend on the precise definition of which activities and which securities are in and out of scope of the CSDR buy-in rules; as of yet, there is still no clarity on this point.

The EBF believes that, based on the text in the consultation paper, the direct impacts of the option 2 buy-in obligations on CSD participants and other custodial intermediaries are as follows:

1 - Legal agreements

Page 10: “the buy-in rules would need to be reflected in the contracts of the intermediaries in the settlement chain up to the trading parties”.

Changes to legal agreements are needed to ensure that all parties pass on the information as required by CSDR, and that a CSD participant and any other custodial intermediary that is debited for an amount of cash compensation can recuperate that amount from its client.

2 - Information flows

Beyond existing standard information flows (transmission of settlement instructions / cancellation of settlement instructions / hold and release of settlement instructions etc), option 2 will require the following flows of information:

a) Advising the CSD of any pass-on of a buy-in notification: “the CSD should remain informed of the pass-on and of the identity of the party receiving that notification” (Page 18, Recital 10).

This implies that each trading party in the middle of a chain of failing transactions advises its custodian, and the information passes up the custody chain to the CSD.

b) Advising the CSD of the buy-in process: “the receiving party shall ... ensure that the CSD is informed of the initiation, execution and results of the buy-in” (Page 20, Article 13, paragraph 4)

This means that the purchaser that is arranging for the execution of the buy-in should advise its custodian, and this information should pass up the information up the custody chain to the CSD.
c) Advising the CSD of any deferral of the buy-in or choice of cash compensation in case the buy-in failed: “the participant shall inform the CSD with respect to the choices it was informed of pursuant to point (a)” (Page 21, Article 14, paragraph 3)

This means that the information of any deferral or any choice of cash compensation has to be transmitted up the custody chain to the CSD.

- 3 - Operational impacts, including processing of the buy-in / cash compensation.

a) Procedure in the event that the CSD is not advised that a buy-in process has been completed for a failing transaction

Step 1: CSD advises failing delivering CSD participant that the buy-in has not been completed
Step 2: Failing delivering participant has one business day to provide evidence to the CSD either that “the trading party” is insolvent, or that the buy-in process has indeed been completed
Step 3: If failing delivering participant does not provide this evidence, then it shall pay the cash compensation amount to the receiving participant.

b) Obligation on receiving CSD participant to facilitate partial settlement

Page 17, Recital 8: “The receiving participant should accept partial settlement from the last business day of the extension period”.

c) Mandatory cash compensation at an accelerated schedule in the event of mandatory reorganizations

Page 18, Recital 10): “In some circumstances, a financial instrument may no longer be available on the market, for instance when a financial instrument has been redeemed or converted, in which case a buy-in is no longer possible. The buy-in process should in that case be accelerated, so that cash compensation could be paid before the end of the buy-in process, this limiting the period of uncertainty”.

This is both unclear, and not in line with the Market Standards for Corporate Actions Processing, and the T2S Corporate Actions Standards.

Specific answers to Q1-Q5

- Q1: Please provide evidence of how placing the responsibility for the buy-in on the trading party will ensure the buy-in requirements are effectively applied. Please provide quantitative cost-benefit elements to sustain your arguments.

From a conceptual and practical point of view, trading parties are the ones who have the strongest interest in the performance of the trade as a finality and not only as intermediaries earning a remuneration for processing the transaction, they shall be best placed to have access to information and to understand the dynamic of the trade. Accordingly they shall be the first ones to be able to trigger the buy-in. In other scenarios the different entities will have to rely on information provided by these parties in any case.
As regards the weaknesses of option 1 described by ESMA in the consultation paper EBF is of the opinion that most of those weaknesses are not specific to option 1.

We believe **that option 1 could be the most efficient and workable solution**. On the other side, **option 2 seems to hold the combined weaknesses of both options 1 and 3**. Additionally this mixed solution will lead to uncertainties on who should really be responsible for the buy-in even if for the fall back principle the participant is in fact required to pay the cash compensation as if the buy-in failed.

The **EBF considers that option 3**, namely putting the burden of the triggering of the buy-in on the CSD participant, is **not appropriate mostly because CSD participants are not in a position to know in advance/early enough potential failure of a trade**. They have to rely on information provided by other parties at an earlier stage. And because this is likely to lead, as a consequence of the need to manage the unknown, to higher demand of collateral, this will also represent a cost to the economy.

Option 3 entails a risk that the CSD member – in a settlement agent role – will demand collateral before accepting the assignment to settle the trade. Option 3 could also mean that routines are established, where it will first be examined whether delivery of securities can be expected or whether the securities could be borrowed before accepting the assignment. If the answer is negative the CSD members might refuse the assignment, which may end up that the trade will not be settled. Alternatively, any other part with less routine and experience but who are prepared to take greater risks (of penalties), at a higher price, taking the assignment to try to settle the trade.

On top of that, it is crucial to note that this option 3 will oblige the CSDs to bear risks not in line with the requirements. In our view, the actual goal of the buy-in requirement and in fact of the settlement disciplines regime in its entirety is to avoid bad behaviours and not simply eliminate old outstanding settlements. An example can be found in Article 7(6) CSDR. In fact, ESMA states in paragraph 14 g. of the consultation paper that the failing CSD participant will be liable to pay compensation to the receiving CSD participant. However, we were not able to identify any reference in Article 7.6 of compensation when the buy-in price is higher than the original price, but only when the buy-in price is lower than the original price. This could potentially leads to the conclusion that, ultimately, the trading party that purchased securities will benefit automatically from the buy-in at a lower price (where it would have profited by selling high and effectively buying low), and in addition, receive a bonus of the difference from the failing CSD participant. If the buy-in cost is higher, the failing participant would not be required to pay any compensation and the purchasing trading party would have to pay more for its securities than originally contracted. Thus, the failing CSD participant would not always be required to pay compensation. The EBF believes this will create the potential for abuse of buy-ins, from which the seller cannot protect itself.

Moreover, triggering the buy-in at the trading party level sounds the sole option possible on OTC transactions:

- Firstly, it will make the real defaulter aware of his responsibilities to a transaction.
Secondly, it will also allow the real receiving party to ask/receive the missing securities or equivalent cash compensation.

Thirdly, it will ease the reconciliation process as the trading parties would perfectly know who their failing counterparties are.

Finally, the trading level is the place where the distinction can be made between OTC transactions and transactions executed on a Trading Venue or cleared by a CCP even the sole place (for traded but not cleared transactions since a Trading Venue just do not exist per its definition beyond the trading level).

However, we do recognize that some additional improvements are to be made as well as controls and follow up need to be set up in order to allow for option 1.

Finally, we would ask ESMA to provide in its Technical Standards the main characteristics to be possessed by an entity in order to be potentially appointed as buy-in agent. Indeed, we believe that such an ex ante provision would help to identify, in a timely manner, the most appropriate entity to play such role, with consequent immediate benefits in terms of efficient and prompt completion of the entire buy-in process.

Q2: Please indicate whether the assumption that the trading party has all the information required to apply the buy-in would be correct, in particular in cases where the fail does not originate from the trading party, but would rather be due to a lack of securities held by one of the intermediaries within the chain.

The EBF believes that the trading parties are the ones having the maximum quantity of information on the trade and the most reasons to ensure that the trade settles. In fact, in a bilateral OTC transaction the trading party is the sole entity which has all the information required to apply the buy-in process: date of the transaction, quantity, amount and, above all, the name of the defaulting seller.

Regarding the second part of the question, we would like to highlight that a likely scenario is the case where the defaulting trading party (the last one in the trading chain) is not the real defaulter (the real one being another client of the same intermediary). But even in this case, the responsibility remains at the trading level.

Envisaging a case where the fail is not due to a trading party but to an intermediary within the chain, is very rare and will correspond to issues regulations have addressed through specific requirements (i.e. ban of use of clients’ assets for its own account, mandatory segregation between own account and client account).

Q3: Should you believe that the collateralisation costs attached to this option are significant, please provide detailed quantitative data to estimate the exact costs and please explain why a participant would need to collateralise its settlement instructions under this option.

Under a scenario where as an intermediary may be faced with unexpected risk upon which it has very few means of control, probably that one of simplest approach to buy a protection is in form of collateral to ensure the finality of a transaction. The criteria retained are likely to be based on perceived risk and volume, but as of today there are to our knowledge few data to build a sound scenario, except that it is likely that part of the current collateral may be “transferred” or topped to/by intermediaries in the chain, which will in any scenario create a dead pile of investable moneys set aside “just in case”: a high cost for the economy.
Option 2 would require a delivering CSD participant to pay for cash compensation in case the underlying purchaser does not fulfil its buy-in obligation. The EBF believes that the cash compensation amount is effectively uncapped, as it would be calculated based on the difference between the original trade price and the current market price (which is effectively unlimited). The EBF believes that this model is fundamentally unsound. A delivering CSD participant should not be forced to pay a cash amount based on actions of a party unknown to the CSD participant, and a party who may well have an incentive not to comply with its CSDR obligations given that it is guaranteed to receive compensation from the delivering CSD participant. Given the incentive for the purchaser not to initiate the buy-in process, given the uncapped nature of the potential exposure, and given the reality that the exposure of all intermediaries on the delivering side starts from point of transmission of a securities settlement instruction to the CSD or to next intermediary in the custody chain, it is difficult to imagine that intermediaries will not require collateral to cover the risks.

Q4: If you believe that option 1 (trading party executes the buy-in) can ensure the applicability of the buy-in provisions are effectively applied, please explain why and what are the disadvantages of the proposed option 2 (trading party executes the buy-in with participant as fall back) compared to option 1, or please evidence the higher costs that option 2 would incur. Please provide details of these costs.

EBF believes that if option 1 could rely on a strong, unique contractual framework it will be able to ensure the applicability of the buy-in provisions. However, this should not lead to the conclusion that adding a fall back provision (namely as indicated in option 2) will change anything and thus could be equally used.

We believe the fall back process present several drawbacks that will break the balance that could be obtained by pursuing option 1:

- It will blur the responsibility and miss the objective to avoid bad behaviours

ESMA considers that the fall back is an incentive for participants (point 19); on the contrary, we believe this could represent a disincentive for real defaulters (trading entities). A trading entity may be inclined to let the CSD’s participant pay if the latter is not directly linked to the former. In case of a custody chain with several intermediaries it is likely that the cash compensation may not reach the trading entity.

In our view, the fall back represents more the cure than the solution to the problem itself.

- Buy-in and fall back are not the same process

The buy-in (at the trading level) includes the analysis of all the transactions in order to determine the real defaulter and thus avoid multiple buy-ins (point 13b).

The original purpose of cash compensation is to put an end to an outstanding settlement when the buy-in attempt failed to find the entire missing quantity. This means that at this stage we already know who the defaulter is and who the one who suffered from the non-delivery is.
Fall back mixes both concepts in a way that is not workable. Indeed the idea of the fall back is to ask the failing participant to pay a cash compensation to the receiving participant if the buy-in has not been performed at the trading level. But if the buy-in has not been performed it is likely that no analysis has been made so how can the CSD ask the failing participant to pay if it doesn’t know who the failing trading party is and thus the failing participant representing the defaulter?

Does the fall back include also the requirement for a prior analysis? If yes, this will mean operational costs for the CSD as well as for any participants/intermediaries involved in the custody chain. If not, the fall back risks to apply to all failing settlements that are beyond the extension period and that cannot be linked to any current buy-in process.

Moreover, as written above, settlement instructions may not be identical to client instructions. For example:
A sold 1000 shares to B
C sold 2500 shares to A
P1 is a CSD’s participant representing A at the CSD level
P2 is a CSD’s participant representing B and C at the CSD level

P1 is instructed to deliver 1000 shares to P2 coming from A
P2 is instructed to receive 1000 shares from P2 coming from B
P1 is instructed to receive 2500 shares from P2 coming from A
P2 is instructed to deliver 2500 shares to P1 coming from C

P1 and P2 use a netting set-up so that P1 should receive 1500 securities from P2. The delivery from P2 to P1 is failing. Note that from a strict CSD’s perspective, P2 would have been the one to be bought-in if needed.

B has not performed any buy-in meaning that the fall back principle will apply.
A has performed a buy-in against C

What will happen? In this case the failing settlement between P1 and P2 is even not in the same way as the contract between A and B. How can the CSD detect that cash compensation should be paid by P1 to P2?

In order to be fair the fall back will need to rely on analysis, exchange of information between the CSD and its participants, between the latter and their clients. Again we are not in the case of an issue within the buy-in process (as a failing trading party unwilling to pay), we are in the case of no buy-in process started at the trading level (no buy-in agent appointed).

- Relation between the participant and its clients

It should be kept in mind that participants only act when being instructed by their clients. But cash compensation goes with the cancellation of the instruction so that the participant will need to get the agreement of its client, who in turn will need to ask his clients.
Need for collateralization

Despite ESMA’s explanation, since a participant may be exposed to financial risk due to the absence of a buy-in performed at the trading level to which, again, the participant may not be directly linked, the participant will at the end ask for collateral.

Due to the fact that the failing party may default between the launch of the buy-in and the reimbursement to the buy-in agent of all the amounts we are of the opinion that the buy-in agent will ask itself for collateral in order to cover its counterparty risk. In this case the participant will simply pass on the requirement to its client and so on until the trading entity.

In the unlikely event that the buy-in agent does not ask for any collateral the requirement for collateral will be made by the CSD’s participant and will apply to all settlements still outstanding after the ISD and until the actual settlement. As explained in the answer to the previous consultation, this will modify the relationship model between CSD’s participants and their clients and lead to additional costs for the latter.

It must be kept in mind too that CSDs may also be participants of another CSD and treated as such, meaning they will be concerned by the fall back.

Q5: Please provide detailed quantitative evidence of the costs associated with the participant being fully responsible for the buy-in process and on the methodology used to estimate these costs.

At this stage, to our understanding there are not enough failed trades leading to buy-ins to present credible options.

We believe option 3 would make CSD participants responsible for the execution of buy-ins and this option will be most negative for the markets and most costly because it would require CSD-participants to fully collateralise the settlement.

Transaction versus settlement instruction

Option 3 corresponds to the buy-in required at the settlement level (i.e. the CSD’s participant is responsible) but still to be applied to an OTC transaction (by the way it shows clearly that ESMA considers that the defaulter is at the trading level) whereas CSD’s participants only handle settlement instructions.

Without asking its clients for more information a CSD’s participant could simply not distinguish between a settlement instruction resulting from an OTC transaction or from a traded/cleared transaction except if its counterparty is known as a CCP. This is utmost true for transactions concluded on a trading venue but not cleared by a CCP. Indeed, since the trading venue does not interpose itself between the buyer and the seller, the trading venue is not part of the settlement process. The custodian of the seller will deliver directly to the custodian of the buyer, thus the settlement will be linked to a “100% OTC transaction”.

In other words, option 3 would lead to additional costs just to get the information needed to start any buy-in process.
Relationship between a client and a CSD’s participant

A CSD’s participant (as well as the CSD itself in relation to its participants) will send / cancel instructions only when requested by its client. This means that when article 15(3)(b) states, for option 3, that a participant shall communicate its choice in case the buy-in failed it should be understood as “a participant shall communicate the choice of its client in case the buy-in failed”. Indeed the CSD’s participant is not the one who decided to buy / sell securities; he is only the one who processes the settlement on behalf of his client.

Operationally it means that the CSD’s participant at each stage of the buy-in process will need to pass on the information to its client all along the custody chain until the trading entity. Decisions of the latter will then go downstream until the CSD’s participant for action.

Need for collateralization

As explained in Q4 a participant may be exposed to financial risk although not being directly linked to it, and therefore will ask for collateral. Due to the fact that the failing participant may default between the launch of the buy-in and the reimbursement to the buy-in agent of all the amounts we are of the opinion that the participant will be required by the buy-in agent to post collateral in order to cover the counterparty risk. As for option 2 the participant will in this case pass on the requirement to its client and so on until the trading entity.

In the unlikely event that the buy-in agent does not ask for any collateral, the requirement for collateral will be done by the CSD’s participant and will apply to all settlements still outstanding after the ISD and until the actual settlement. As explained in the answer to the previous consultation, this will modify the relationship model between CSD’s participants and their clients and lead to additional costs for the latter.

Conclusions

- The EBF believes that all three options presented by ESMA could present some problems and thus have some critical unintended consequences.

- However, although far from optimal, the EBF would favor the ESMA approach indicated in option 1.

- Regarding option 2 and 3 it is clear that they involve risk for CSD-participants, in particular option 3 will considerable raise the risk level for CSD-participants. The result (eventually unintended consequences) will be that the CSD-participants will request collateral to cover the increased risk, maybe in the form of a margining-system. Furthermore, CSD-participants will raise the requirement for their customers (among those indirect clearing members) and thereby in the same way as EMIR limit the access to CSDs. Finally, the new risk could also lead to a fall in trading of less liquid financial instruments.
The EBF is of the opinion that, irrespectively of the option finally chosen by ESMA, the timeframe for implementation will be fundamental. A short timeframe could cause serious detrimental effects on the securities settlement in the EU. In particular, we believe that any buy-in process should not be implemented before the final wave of T2S.