ECSDA
European Central Securities Depositories Association

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The Operation of the Buy-in Process under the CSD Regulation

This paper constitutes ECSDA's response to the ESMA Consultation Paper of 30 June 2015 on "Regulatory Technical Standards on the CSD Regulation: The Operation of the Buy-in Process" (ESMA/2015/1065).

1. Summary

In its latest consultation on the buy-in process, ESMA raises important questions that need to be addressed prior to finalising the technical standards under the CSD Regulation (EU Regulation 909/2014 or "CSDR"). ECSDA especially welcomes ESMA's recognition that CSDs should not be required to play an active role in the processing of buy-in instructions, and that buy-ins should be executed at trading level whenever possible.

Of the three options put forward in the Consultation Paper, ECSDA believes that option 1 is the least disruptive, since buy-ins would be managed by the trading counterparties without CSDs and their participants being required to play an active role (other than transmitting the necessary information). Despite some limitations and practical difficulties, we understand that this option is supported by the majority of industry players because it would limit the amount of risk to which CSDs and their participants are exposed as a result of the buy-in process.

The alternative options could be problematic for some CSD links, since the CSDR definition of "participant" includes CSDs having an account with another CSD. This means that, depending on how the links are operated, CSDs could be impacted by the buy-in obligation and forced to collect margins from their participants, with a repercussion on their risk profile and the risk that cross-CSD links become less attractive.

Irrespective of the option ultimately chosen by ESMA, the technical standards should make it clear that CSDs are only able to issue notifications to their own participants, and that such notifications need to be passed on by each party in the transaction chain up until the trading counterparties. CSDs should not be expected to identify or communicate directly with trading counterparties, since they only have visibility on - and contractual relationship with - their participants. Operating without proper contractual protection would inevitably increase CSDs' operational risk.

2. Response to the consultation questions

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.

Under option 1, ESMA considers the possibility for buy-ins to be executed at trading level. Although it is probably less disruptive than options 2 and 3, the implementation of this option does not go without practical difficulties. As stressed in the ICMA briefing note of 21 July 2015, the Level 1 text of the CSDR creates an unprecedented process for buy-ins which in some respect goes against current practices. Keeping these limitations in mind, we generally agree with the description of the process in paragraph 11 of the Consultation Paper. CSD participants are always informed about failed settlement instructions, and are therefore able to communicate this information to their own clients. Such reporting is one of the core functions of a CSD, and a key component of the relationship between a CSD participant and its own client base.

As regards the weaknesses of option 1 described by ESMA in paragraph 14, ECSDA believes that most of them are not specific to option 1 but in fact characterise all 3 options. In particular:

- **All options require a strong contractual framework between CSD participants, their clients and trading counterparties.**

In the case of option 1, ECSDA does not fully agree with the statement that *"the participant and the intermediaries have no incentive to ensure an appropriate contractual framework as they would not be responsible for the buy-in process."* Given that CSD participants are ultimately liable for paying a cash compensation to the suffering participants in case a buy-in cannot take place, ECSDA considers that they have a real incentive to ensure an appropriate contractual framework with their own clients. These clients in turn, also have an incentive to protect themselves via appropriate contractual arrangements if they do not wish to be liable towards the CSD participants for fails caused by their own underlying clients. Having an appropriate contractual framework will also be a legal requirement going forward, so we expect all parties in the chain to have to set out such a framework for their own internal compliance reasons.

- **Extraterritorial provisions of the CSDR Level 1 text will unavoidably face implementation issues and Level 2 standards cannot be expected to solve this problem.**

We acknowledge that enforcement on trading parties and especially third country trading parties might constitute a challenge in practice for CSD participants. However the issue of enforcement outside the EU is not limited to option 1 and trading parties. The issue is the same for CSD participants established outside the EU. The difficulty resides in the Level 1 text of the CSD Regulation which includes some extraterritorial provisions, namely legal obligations imposed on all CSD participants including where

these are established outside the EU, in spite of the fact that actual enforcement of these provisions is impossible (third country regulators may not enforce EU law on the entities they supervise, and EU regulators, including national competent authorities of CSDs, have no authority over non-EU intermediaries). We do not think that Level 2 standards should be expected to solve this problem, especially since some of these provisions (e.g. article 38 of the CSDR) do not include technical standards.

More generally, irrespective of the option eventually selected by ESMA, the introduction of mandatory buy-ins and late settlement penalties will *de facto* raise level playing field issues with third country CSDs since the same security (single ISIN code) might be subject to a buy-in when settled in an EU CSD, whereas it might be exempt if settlement takes place in a non-EU CSD. Although this problem is inherent in the Level 1 text, ESMA should be aware that, for securities that can be settled both in EU and non-EU CSDs, mandatory buy-ins are likely to cause liquidity to migrate to CSDs outside the EU. This might not only drive investment decisions, but could also impact issuance decisions, resulting in less attractive EU financial markets.

- **Third country CSDs will be subject to the same requirements as any other CSD participants when they have an account with an EU CSD.**

In cases where *"a linked third country CSD is used by a participant"* (point d under paragraph 14), ECSDA would like to clarify that, although third country CSDs are by definition not subject to the CSDR as CSDs, they are subject to the CSDR obligations imposed on CSD participants when they open an account with an EU CSD (for the EU CSD, this is a standard CSD link). Indeed, the definition of "participant" contained in article 2(1)(19) of the CSDR includes CSD participants from third countries, and ECSDA thus does not believe that the issue of links with third country CSDs is fundamentally different from the issue of third country CSD participants. In the case of "outbound" links (where an EU CSD holds an account in a third country CSD to allow its participants to access third country securities), we understand that EU buy-in rules will not apply since the "fails" would take place in the third country CSD, and in almost all cases on securities issued outside any EU jurisdiction.

- **All options would require the establishment of a new and complex information flow, allowing for the notification and reporting of buy-ins.**

From a CSD perspective, ECSDA believes that the greatest challenge under all options will be to set up an information and notification flow through the chain of intermediaries beyond the level of CSD participants up until the trading counterparties, as described in article 17, Annex 2 of the Consultation Paper. The management of buy-in notifications will require harmonised and efficient communication channels between all parties involved. In order for the process to be workable, the following considerations will be particularly important:

- CSDs will always communicate with their participants, who in turn will communicate with their clients, up until the trading counterparties. CSDs cannot be expected to communicate with trading

counterparties directly as they might not have information on who the trading counterparties are, and they have no contractual relationships with such parties;

- If ESMA expects CSDs (or other entities) to report back to regulators on the execution of buy-ins, this will only be possible if CSDs are systematically informed in a timely and consistent way about the initiation, execution and result of buy-ins, as per article 17(4);
- CSDs cannot be held liable for the accuracy of the information provided to regulators or others as a result of article 17(3). When receiving information provided by trading counterparties to their participants, CSDs will often not be in a position to cross-check the information and should only be obliged to transmit the information provided. Any inaccuracy (e.g. error or omission) in the information transmitted should be the responsibility of the entity having provided this information in the first place;
- To ensure a consistent process for regulatory reporting, CSD reports on the execution of buy-ins could be part of the *"regular reports to the competent authority and relevant authorities, as to the number and details of settlement fails and any other relevant information, including the measures envisaged by CSDs and their participants to improve settlement efficiency"* required under article 7(1) of the CSDR. Moreover, if there is evidence that there is a failure to comply with the buy-in arrangements, this could be included as part of the "working flow" with the top failing participants, and could ultimately be a reason for categorising a CSD participant as a "systemically failing participant". This could trigger remedy actions up until the participant's suspension.

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.

As mentioned under our response to Q1, CSD participants are always informed about failed settlement instructions, and are therefore able to communicate this information to their own clients (although the CSD has no visibility on this process, and the participant's client will not necessarily be the trading counterparty). In the unlikely case of a fail persisting for more than four business days for which there is no lack of securities on the side of the trading counterparty, ECSDA expects the fail to be solved through the contractual arrangements among intermediaries: after a buy-in is triggered by the trading counterparty suffering from the fail, the CSD participant (and its own clients) will have an incentive to identify the responsible party in the chain in order to pass on the costs of the buy-in. If the client of a CSD participant is not itself liable for the failed delivery, it will seek to charge the cost of the buy-in or cash compensation to its own client, and so on until the intermediary responsible for the fail is identified.

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.

Option 2 would require CSD participants to pay for the cost of a buy-in or for the cash compensation in case the failing trading counterparty does not fulfil its buy-in obligation. ECSDA cannot estimate the costs of such a requirement and believes that CSD participants are best placed to answer this question.

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.

Like option 3, option 2 would require CSD participants to take collateral from clients to protect themselves against the associated settlement risk. Such collateral requirements would have an adverse impact on market efficiency and liquidity, thus increasing the cost of settlement without providing the guarantee that this would effectively help to foster buy-in execution.

Moreover, from a CSD perspective, options 2 and 3 have a disadvantage compared to option 1 in that they could impose new risks and liabilities on CSDs acting as participants in other CSDs, depending on how the links are operated. Indeed, when a CSD establishes a link with another CSD, it becomes a participant in that CSD, subject to the same terms and conditions as all other participants. In this context, if option 2 or option 3 is implemented, and unless the CSD enforces a pre-positioning functionality (requiring that securities be prefunded by requesting participants before the settlement instruction is sent to the receiving CSD), there is a risk that a CSD could be required, in its capacity as participant in another EU CSD, either to pay a cash compensation or to execute a buy-in on behalf of its participants if securities are not delivered on time. In such a scenario, a CSD might be liable to pay for the cost of buy-ins on participants' securities, which would increase its risk profile. As a result, the CSD would have to collect margins from participants in order to protect itself, which would make it look like a CCP. The need for such collateralisation and for the CSD to manage all of the related risks is not the core expertise of a CSD. It would expose CSDs to credit risk vis-à-vis their participants in connection with standard CSD links, which is not the case today and which would go against the objectives of the CSDR.

This would have a negative impact on CSD links (whether in T2S or outside), including links between EU CSDs and non-EU CSDs. Indeed, if the buy-in obligation is imposed on CSD participants, the resulting risks could cause third country CSDs to reconsider their links to EU CSDs, thus moving settlement activity away from infrastructures.

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.

Option 3 would make CSD participants, rather than the trading counterparties, responsible for the execution of buy-ins. As in the case of Q3, ECSDA cannot estimate the costs incurred by CSD participants as a whole. The main advantage of this option is that it would reflect the CSD's contractual framework, i.e. the fact that the delivery arising from the buy-in must be made by the CSD participants. Therefore it makes participants accountable for promptly acting in the interest of their clients, e.g. by seeking a bilateral cancellation or by executing the buy-in. That said we agree with ESMA's analysis that this option is potentially the most costly because it could require CSD participants - and CSDs themselves in some cross-border links - to fully collateralise settlement instructions, rendering settlement in the EU very complex and uncompetitive.

As regards the strengths of this option, ECSDA does not totally agree with the statement in paragraph 28 of the Consultation Paper that *"As the CSD is under the direct supervision of the NCA, the NCA will have the ability to ensure the buy-in rules are appropriately applied."* Whereas the national competent authority (NCA) of a CSD may review the internal rules of a CSD and require a CSD to ensure that all its participants comply with these rules, placing the responsibility for buy-ins on CSD participants does not fully solve the enforcement issue.

The NCA itself will often not be the competent authority for most CSD participants, and will only be able to penalise the CSD - not the CSD participants - in case of a breach. If a CSD participant does not abide by the buy-in requirement contained in the CSD internal rules, the CSD itself cannot force the participant to pay the cash compensation or the costs of the buy-in.

3. Comments on the draft technical standards (Annex 2)

ECSDA believes that the draft Technical Standards contained in Annex 2 of the Consultation Paper constitute a considerable improvement compared to the initial draft of the standards published in December 2014. We are convinced that they can form the basis of a more workable process for buy-ins under the CSD Regulation. We especially welcome the recognition, in Recital 3, that CSDs and trading venues should not incur undue risks as a result of being involved in the processing of buy-ins.

ECSDA supports option 1 and as a result we provide comments on the relevant sections of the draft standards (without commenting on the wording proposed for other options). Amendment proposals are provided in italics, with suggestions for additional wording in ***bold italics,*** and suggestions for deletions marked by ***~~a strikethrough~~***.

- **Definition of the entities involved in the buy-in process**

Recital 2 helpfully distinguishes trading counterparties from clearing members and CSD participants. We believe that such a distinction is essential for describing the operation of the buy-in process, and is all the more necessary since the Level 1 text lacks precise wording on the different entities involved.

- **CSD links**

As explained in our response to Q4, the buy-in obligation should not create a credit exposure for CSDs vis-à-vis their participants in connection with standard CSD links. We thus suggest the following addition to Recital 3:

Recital 3:
*The buy-in process should provide for a way to address settlement fails without jeopardising the risk profile of CSDs, CCPs or trading venues. Buy-in should not imply any unnecessary risk taking by a CSD, a CCP or a trading venue. A CSD or a trading venue should therefore not perform the buy-in as counterparty on its own account****, whether for internal settlement or in the context of cross-CSD links.***

- **Blocking of the settlement instruction when a buy-in is trigged**

Recital 7 states that the *"failing party should be allowed to deliver the financial instruments to the receiving party up to the moment when it is informed that the buy-in agent is appointed".* ECSDA agrees that, under option 1, CSD participants should be able to detect when a buy-in needs to be triggered based on the failed instruction and the length of the extension period and should thus be in a position to block the settlement instruction as of this moment (which in principle corresponds to the moment when a buy-in agent is appointed).

ECSDA understands that some market participants would prefer that the blocking of the initial settlement instruction be postponed to the moment when the buy-in is executed, even after it has been triggered. This could in certain cases avoid unnecessary buy-ins, but is only workable as long as the CSD itself is not expected to block the initial delivery instruction. Otherwise, there could be a risk of "double delivery" if there is any delay in notifying the CSD about the execution of a buy-in.

ECSDA thus recommends that CSD participants retain the responsibility of blocking the initial delivery instruction, as is the case today. Tools are available for CSD participants to instruct a blocking, and this may be more efficient that requiring the CSD to make a judgement as to whether a buy-in has been triggered, or executed, or not.

It should also be made clear that up until the moment of the notification, participants have the option to agree to bilaterally cancel their instructions.

- **Buy-ins and partial settlement**

Where a CSD offers a partial settlement functionality, ESMA suggests imposing partial settlement *"from the last business day of the extension period, irrespective of any contractual choice made by the participants"*. ECSDA understands that the main benefit of such a requirement would be to reduce the incidence and size of buy-ins.

Implementing mandatory partial settlement as proposed by ESMA would however not go without major difficulties. Today, where CSDs offer partial settlement, the option is typically activated 'by default', with the possibilities for CSD participants to opt out. There are different reasons why CSD participants might choose to opt out of partial settlement. It can be because of technical limitations of their system, or most importantly to avoid "taking securities from the pool" when one of their clients (the deliverer responsible for the fail) is short of securities. Imposing partial settlement on CSD participants which deliberately decide to opt out would go against their contractual choice and could create difficult situations.

In operational terms, CSD systems often do not make it possible for the CSD to amend the partial settlement indicator in an instruction. It should be avoided that CSDs be forced to create an amendment message to change the partial settlement indicator, thus intervening in participants' transactions flows. As with the blocking of instructions, a more workable option would be to require CSD participants (rather than CSDs) to activate the partialling indicator (or split the transaction) at the end of the extension period. Tools already exist to facilitate this process, and this would put the responsibility where the liability exists.

ECSDA believes that CSD participants have an incentive to opt for partial settlement if they wish to minimise the need for buy-ins but, should ESMA go ahead with its proposal of mandatory partial settlement at the end of the extension period, we recommend that the proposed article 16 should include an explicit mention of the fact that partial settlement should not apply to on hold instructions, in line with the proposed Recital 8.

- **Buy-in notifications**

ECSDA agrees that the notification of a buy-in is essential for an efficient buy-in process. Therefore we would like to recommend some adjustments to the wording proposed by ESMA in order to ensure that the notification process works in an optimal way:

First, as regards Recital 11, we believe that the phrase *"a CSD should allow the parties to pass on the buy-in notification"* should be redrafted:

- First, the term "allow" suggests that CSDs could prevent trading parties from passing on the buy-in notification which is not the case;
- Second, given that CSDs only have contractual relationships with their participants, and not with the "parties" to the transactions, the sentence is difficult to understand;
- Third, for the notification process to be efficient and reach its ultimate recipient, it would make more sense to require all parties in the chain to pass on the notification, rather than to require CSDs or intermediaries to "allow" for the notification to be transmitted.

As a result, we suggest the following amendments to Recital 11:

Recital 11 (options 1 & 2):
A transaction may in some cases be part of a chain of transactions and instructions. In order to avoid that a buy-in has to be performed for each settlement fail in a chain of transactions ~~***a***~~ *CSD* ***participants suffering from a fail*** *should* ~~***allow the parties to***~~ *pass on the buy-in notification* ***to CSD participants or other parties to whom they are due to deliver the same securities, while the CSD participants having failed to deliver*** *should, where applicable, pass on the notification*~~***, which could be further passed on***~~ *to other parties involved in the cause of the settlement fail. The CSD should remain informed of the pass-on and of the identity of the party receiving that notification.*

About ECSDA

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