3 August 2015

Regulatory Technical Standards on the CSD Regulation: The Operation of the Buy-in Process

1. General comments

As ESMA is well aware, Bulgaria is one of the EU countries where transactions executed on a trading venue are not cleared by a CCP. As a means of risk management in connection with the settlement of the above transactions a special Guarantee fund is functioning within the local CSD. Resources of the Guarantee fund are raised mainly from deposits of CSD members and therefore they do not increase the CSD risk profile. However, currently the Guarantee fund does not cover OTC transactions for which mandatory buy-ins are also applied according to the draft RTS.

With regard to the above, Bulgarian Stock Exchange supports option 3 mentioned in the ESMA Consultation paper which lies closest to the current procedures on the Bulgarian capital market. Under option 3, ESMA considers the possibility for buy-ins to be executed at CSD participant level. Bulgarian Stock Exchange agrees with the description in paragraph 30 of the Consultation Paper stating that because of the direct relationship between the CSD and its participants, the flow of information is more efficient and shorter. Moreover, as mentioned in paragraph 29 of the Consultation paper CSD participants are usually supervised entities which is not the case with trading parties.

However, none of the options, incl. option 3, is suitable for countries where transactions executed on a trading venue are not cleared by a CCP and a special Guarantee fund is functioning within the CSD. We are seriously concerned that in future resources from that fund cannot be used for execution of buy-ins, but only for compensation in case of deficit of cash resources. In addition the operation of a remote entity such as a Settlement Guarantee fund, mitigates the risks for the CSD and the counterparties involved in the trade.

Bulgarian Stock Exchange disagrees with the proposed Article 14 (1) of the draft RTS stating that “the trading venue shall appoint a buy-in agent where the receiving party does not do so within two business days following the elapse of the extension period”. From a stock exchange point of view, we are able to appoint a buy-in agent only if it is a trading member of the Exchange, which is not always the case.

Also, we support mandatory buy-ins for OTC trades only if their regime is totally segregated from the one covering on-exchange trading. Both counterparties to an OTC trade which is not cleared by a CCP should bear the risk of each other as in the process of bilateral negotiations they are supposed to assess the risk of non-performance of the other side. Using funds of anyone but the non-performing party for execution of the buy-in (for instance guarantee fund's money) would be totally wrong and would create unlevel playing field. In addition, in case of OTC trades it is absolutely not acceptable that the buy-in agent is appointed by the trading venue since it has nothing to do with such trades and, unless its facilities are used for trade reporting purposes, it normally wouldn't be aware of the trade in the first place.

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.

Last but not least, in case of on-exchange trading where no CCP is involved, guarantee funds play a crucial role for the integrity of the market. As it was properly stated by ECSDA in their previous response to the draft regulatory standards, "The only CSDs which perform buy-ins do so in markets where there is no CCP and have to manage a special guarantee fund to cover the resulting risks". That is why blindly transferring the responsibility to either trading parties or CSD participants, including the responsibility to secure the funds that are needed for the buy-in dramatically increases the systemic risk on these markets. Given the fact these are predominantly frontier and emerging markets, such an approach would additionally drive back potential investors especially from developed countries. For the very same reason we strongly believe ESMA will properly assess all aspects of the potential impact, not just from technical perspective, and will also take into consideration the implications for the overall liquidity, especially on smaller-sized markets.

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.

From the vantage point of a small-sized market where no CCP exists, placing the responsibility for the buy-in on the trading party may lead to seriously detrimental effects for the whole market. Most of the concerns stem from the fact that it would involve asking the party to execute the buy-in provided it has already had numerous chances to do it on a best efforts basis before the formal buy-in commences. Moreover, as the failed settlement may be a result of default of the trading member, in that case by no means the same party would have to be responsible for the buy-in. In other words, option 1 is plausible only if the instruments are kept by a third-party custodian and the settlement is not delayed on trading party's fault. But even in that case, as all trading parties are duly informed about the timely settlement of their transaction, it has had many chances to do so, as stated above. Therefore, opting for Option 1 on markets where no CCP exists will bring much risk into the transaction chain and translates into voluntary relinquishment of timely settlement guarantee.

In addition, as explained above, in Bulgaria it is currently the Central Securities Depository that manages all activities related to ensuring timely settlement, including buy-ins, so Bulgarian Stock Exchange cannot provide quantitative data and cost-benefit elements in relation with the three options mentioned in the ESMA Consultation paper. That is why we believe that CSD participants and trading parties are best placed to answer this question.

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.

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.

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.

In general, Option 2 is an improvement to Option 1 but it still suffers from the serious drawback that no other trading party or CSD participant might be willing to execute the buy-in. This is especially true in the case where it can be reasonably believed that the original trading party is in default and therefore the executing party or participant will not be compensated for the buy-in. That is why, as stated above, we tend to support Option 3, provided it is further elaborated so it differentiates between markets that have and such that have no CCPs.

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.

As explained above, such information for Bulgaria could be provided only by the CSD.