DACSI

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Principles and operations of the Buy-in process

Reply to ESMA' consultation on Regulatory Technical Standards on the CSD Regulation - The operation of the Buy-in Process of 30 June 2015

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DACSI (the Dutch Advisory Committee Securities Industry) is the trade association in The Netherlands for firms active in the securities industry, representing the interests of its members as users/clients of infrastructure providers in the field of securities, e.g. exchanges, central counterparties, central securities depositories. With 11 members, DACSI represents the vast majority of the banks active in The Netherlands, and positions the Dutch view to the market infrastructure service providers and the regulatory authorities in The Netherlands and the European Union.

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Thank you for the opportunity to comment on the consultation paper "Draft regulatory technical standards on the CSD Regulation with regard to the operation of the buy-in process".
We hope that our contribution is helpful in developing these draft texts into final ones and are of course more than prepared to provide further detail and explanation on particular items when useful.

As we represent the interests of our members as users/clients of infrastructure service providers in the field of securities, our comments focus on that perspective.

General remarks

Answering the questions of the consultation, which focus on the advantages and disadvantages of the Options 1, 2 and 3 as described in the CP requires that some essentials about buy-in are addressed first.

In what typical situations do problems exist or arise that should be addressed in this part of the CSDR?

When a securities transaction is done OTC or on a non-regulated trading platform, and is not cleared by a CCP:

- the securities are to be delivered through a CSD,
- settlement of the transaction is not performed timely.

The majority of this type of transactions applies to bonds. So, the relevant transactions are non-cleared, there is no CCP involved and no CCP initiated buy-in process can be applied.

What steps can be taken to reduce or mitigate these problems?

The most radical and probably most effective step in reducing the occurrence of the typical situation is forcing transactions towards trading platforms with (mandatory) CCP clearing (where the CCP is responsible for and guarantees the settlement of the trade). The movement started and continued with MiFID II/MiFIR will drastically reduce the problem.
Obviously, any direct form of clearing obligation for "cash" securities would be evenly effective in this context.
The remaining problem situations - still without CCP clearing – may or may not need measures in the context of the CSDR.

What are the objective and the nature of the proposed measures? (not explicitly given in the CSDR Level 1 text)

We assume the objective to be providing support to the "confidence" in the trading place and – even more important - in the involved infrastructure by restoring the imbalance between the delivering and the receiving party in case the intended (agreed) settlement does not take place:

- when a buyer does not receive the securities he has bought (and not paid for), he should have the possibility to receive ownership by other means;
- when a seller does not receive the proceeds of the securities he has sold (and not delivered), he should have the possibility to receive the agreed proceeds by other means.

Another objective – secondary to the above restoration - is that uncertainty about the timing of effective settlement is minimised.

When transacting over-the-counter or on a platform without mandatory CCP-clearing counterparties have the possibility to create their rights and obligations for such compensations under civil law. In balanced markets (without highly dominant players) these arrangements can be made. In practice, many transactions are concluded without detailed documentation and without buy-in arrangements. With the CSDR the European legislator has chosen to make such arrangements compulsory, regardless of the relative market power of buyers and sellers. When assessing the proposed measure for effectiveness however, it has to be checked whether the arrangements can be enforced in practice.

Such measures fit within the broader context of the CSDR:
- they provide an incentive for timely settlement;
- without (timely) settlement, negative effects are compensated as far as possible;
- when deemed necessary, incentives can be reinforced by means of a penalty mechanism;
- when used correctly, penalties would create a cost for a party not fulfilling its obligations, but should not create a windfall profit for the other party: there is no justification for letting the other party be better off than would have been the case under orderly settlement.

If such a mechanism is built, what requirements should it meet?

We think the following elements are key:
- any buy-in (or sell-out) mechanism should just be designed to restore the imbalance between buyer and seller due to the non-settlement;
- any “overcompensation” for the non-failing party would by itself create an adverse incentive, and should be avoided;
- the party who would be negatively affected by the non-settlement is best positioned to trigger the process: the buyer when the seller fails to deliver the securities or the seller when the buyer fails to pay.

Will the suggested measure be effective in typical situations?

Can the buy-in procedure be made compulsory for an unregulated trading mechanism and for not EU-regulated counterparties?
If not – and we indeed have our doubts – then the most important non-cleared market places – e.g. Bloomberg TOMS for bonds – will not be affected. Where other relevant trade flows are driven towards regulated platforms (by MiFID II/MiFIR), what will be the ultimate effect of the CSDR provisions for buy-in?

Strong arguments do exist for leaving room to counterparties to trade on privately negotiated conditions, including arrangements with regard to failed settlements. On the other hand, many transactions conducted OTC or on non-regulated trading venues are not backed by detailed documentation and are not backed by such arrangements.

Anyhow, for securities held in, and to be delivered through, EU CSDs the legislator has chosen to make buy-in compulsory. The current consultation is seeking feedback on three alternative structures for buy-in principles. DACSI believes that:
- making counterparties to the trade responsible for the buy-in (Option 1) best fit with the objectives and ismost compatible with practical possibilities;
- the effect of the mandatory buy-in will be modest when realising that many transactions are done outside the reach of the EU regulator;
- creating direct or indirect clearing obligations will be much more effective .

Answers to questions

We answer the consultation questions based on the above assumptions about the objectives of any buy-in (and sell-out) mechanism.
Whatever option is chosen, the following should be kept in mind:
- the CSDR Level 1 text does not specify the objectives of any buy-in mechanism; we think ESMA should make this explicit on Level 2;
- the CSDR Level 1 text does not specify whether the bought-in securities have to be delivered to the buyer directly (1) or first to the failing seller and hence to the buyer (2).

1. Buy-in at the receiving side

Buy-in at the receiving side implies that the settlement of the buy-in transaction is connected to the (ultimate) buyer (probably through an agent), where the price of the securities is:

a. above the original transaction (settlement) price, or
b. below the original transaction (settlement) price.

In case a. the buyer should be entitled to compensation up to the price difference (plus costs if applicable) in order to restore/resemble the situation of regular settlement of the original transaction.
In case b. the buyer should pass his price advantage (minus costs if applicable) to the failing (counter)party, again in order to restore/resemble the intended settlement.

The CSDR Level 1 text – in Article 7(6) – reads that the buyer has to receive a compensation in case b. If this is not an error ("higher" to be replaced by "lower" meaning to create a compensation for case a.):

- this is not in accordance with the assumed objective, because it introduces a payment that is not necessary to compensate for a loss due to the alternative settlement, since there is no loss; it should be analysed whether this text implies another objective or another buy-in mechanism (e.g. alternative 2);
- an additional provision is necessary to create (any form of indemnification) for the buyer who is forced to buy at a higher price than the original transaction.

2. Buy-in at the delivering side

Buy-in at the delivering side implies that the bought-in securities are to be delivered to the failing seller enabling him to fulfil his settlement obligations. The securities will be delivered against the original price. Whether the buy-in price is above or below the original price, there will be no effect for the ultimate buyer. As an effect, there will never be a reason to pay the buyer/receiver cash compensation. Consequently, there is no rationale for a compensation payment as described in Article 7(6). We conclude that either the text of this sub-article is erroneous, or the objective of the buy-in mechanism goes beyond compensation/restoration. Even in the latter case, when a payment is to be made to the "receiving participant"/buyer in the absence of any loss on that side of the chain, and a payment as described would have another objective, we do not see why this payment would be dependent on an proportional to the price difference.

Overall:

i. we see ample support for the assumption that the objective is providing compensation/restoration;
ii. we see ample support for the assumption that the text of Article 7(6) is erroneous ("higher" is to be replaced by "lower");
iii. the question whether type 1 (buy-in at receiving side) or type 2 (buy-in at delivering side) is aimed at is still unanswered;
iv. the question where exactly in the chain the buy-in process should be triggered is still unanswered as well.

The five consultation questions focus on pros/cons and consequences of the various Options (1-3), and therefore address items iii and iv. We will answer them consistently under the conditions i and ii.

Question 1:
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.

If the buy-in has to take place at the receiving side (type 1):
Once the buy-in process is started, three elements have to be safeguarded:

- securities have to be delivered to the ultimate buyer from an alternative source, while the buyer has to pay another than the original price;
- a compensating payment has to be made (either to the buyer or to the seller), covering:

    - consequence of the price difference;
    - missed proceeds due to late delivery of the securities (regular arrangements for corporate actions on flows);
    - missed interest due to late payment;
- the original settlement instruction has to be cancelled.

If the buy-in has to take place at the delivering side (type 2):
Once the buy-in process is started, the following elements have to be safeguarded:

- securities have to be delivered to the original - failing – seller, who has to pay another than the original price;
- the original settlement instruction is – although late – processed;
- compensation has to be given for late delivery of the securities (regular arrangements for corporate actions on flows) and for late payment.

As illustrated by current practice (and documentation when applicable) this process is most efficiently outsourced to a third party buy-in agent; engaging a third party optimises the transaction(s) in the market and the calculation of the compensation payments.

With regard to the question which of the trading parties (the buyer or the seller) should be responsible for performing the buy-in (or sell-out), this should obviously be the non-failing party: the buyer when the securities are not delivered, the seller when payment fails. This party has the strongest interest in the timely execution of the process and has the most up-to-date relevant information.

Question 2:
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.

Fail chains typically occur when there is a chain of transactions with multiple counterparties in the chain. Option 1 holds any failing party in the chain responsible and involves such a party in the buy-in process. In case one settlement fail causes another fail in the chain, each party will be subject to the buy-in requirements under Option 1.

A chain of fails when there is only one transaction, where the ultimate settlement would fail because one of the intermediaries would have a lack of securities, is both atypical and unrealistic. Such a fail would be the effect of the intermediary re-using client's securities without proper borrowing/lending arrangements. Other instruments are more appropriate to prevent or eventually repair such a situation. Constructing the involvement of the entire settlement chain – of which nobody is a counterparty in a trade – through Option 2 would be extreme overkill with unintended negative consequences (which are detailed under Question 4).

Question 3:
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.

We cannot provide the requested data, because buy-ins in OTC transactions are very scarce.

Question 4:
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.

A cash compensation remedy applied at the settlement participant level, as opposed to at the trading counterparty level, would create market risks for:

(a) the delivering settlement participant (including investor CSDs);
(b) the purchasing counterparty;
(c) the selling counterparty,

Under Option 2, the delivering settlement participant cannot assume that it is anything other than guarantor for the deliveries of its selling clients' trades (so, exactly the same as under Option 3), and will therefore need to mitigate this risk, most likely through requiring collateral from its selling clients.

DACSI believe*s* the fall back process *of Option 2 would* present several drawbacks break*ing* the balance that could be obtained by *O*ption 1:

- I*t would* 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.

Question 5:
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.

We cannot provide this, because buy-ins in OTC transactions are very scarce.