

ICMA: Response to ESMA CSD Regulation Level 2 Consultation Papers

February 19th 2015

Overview of the response

This document represents ICMA's response to the ESMA Consultation Papers on [Technical Standards](#) and [Technical Advice](#) under the CSD Regulation that was formally submitted on February 19th 2015.

Settlement discipline

ICMA fully supports initiatives to improve the safety and efficiency of settlement systems in the European Union, whether infrastructure driven, such as the ECB's Target2-Securities settlement platform, or regulatory such as the CSD Regulation (CSDR). In responding to the Consultation, ICMA decided to narrow its focus to Settlement Discipline, which is the component of CSDR that most directly impacts users and providers of the European capital markets¹. In fact, it has been pointed out by a number of ICMA members that Settlement Discipline should not in fact be a feature of CSDR, and would have been more appropriately included in MiFID II/R.

Of the three key tenets of CSDR Settlement Discipline, ICMA and its members broadly support two: measures to prevent settlement fails and cash penalties. ICMA's European Repo Council Operations Group, independently of CSDR, is already championing a market-wide initiative to standardize trade matching fields and confirmation best practice, while ICMA's Secondary Market Practices Committee and European Repo Council are both supportive, in principle, of a well-designed and appropriately calibrated, harmonized cash penalty and redistribution mechanism for settlement fails.

Mandatory buy-ins

ICMA's members, however, have remained vehemently opposed to the inclusion of a provision for mandatory buy-ins, which will not only be detrimental to European bond market efficiency and liquidity (and so a cost borne by investors and issuers), but is unlikely to improve settlement efficiency. Despite the intense efforts of ICMA and others to highlight the inherent flaws in a mandatory buy-in regime, it remained included in the Level 1 text that was passed into European law in September 2014. ICMA and its members remain opposed to the concept of mandatory buy-ins, and in the interest of market efficiency and stability continue to call for the Regulation to be revised to remove this particular provision.

Despite ICMA's opposition to the inclusion of mandatory buy-ins in the regulation, ICMA's response focuses on recommendations and enhancements of the draft regulatory technical standards (RTS) that

¹ ICMA's response therefore only addresses Questions 1-14 of the Technical Standards CP and Questions 1-4 of the Technical Advice CP

will best support the successful implementation of settlement discipline, including mandatory buy-ins, while minimizing adverse effects for the smooth and orderly functioning of the financial markets. ICMA's recommendation for an implementable mandatory buy-in mechanism is broadly aligned with that proposed by AFME, and which builds on the existing discretionary buy-in provisions available in the OTC bond markets under ICMA rules. Critically, this recognizes the buy-in process as a trading level mechanism and so minimizes the unnecessary involvement of CSDs or trading venues. However, that does not negate the fact that the provisions in the Level 1 Regulation relating to buy-ins are poorly constructed, and even with a significant re-write of the RTS, mandatory buy-ins may be technically unimplementable.

The call for data

ICMA notes ESMA's request for quantitative as well as qualitative responses, and the call for data and analysis to support recommendations provided in the consultation response. Despite the relatively short response time (which included the Christmas period), ICMA conducted an impact survey among its sell-side members to quantify the effect of a mandatory buy-in regime on European bond and repo pricing and liquidity across various asset classes. The results are significant and support the argument that the longest possible extension period should be applied to all fixed income instruments in line with the provision in the Level 1 text to maintain smooth and orderly markets. In turn, this would also lessen the adverse impact of a buy-in regime for the repo market, by taking another 25% of the existing market out of scope of buy-ins.

In its response, ICMA also cross references studies conducted by AFME and ECSDA, which also help illustrate the costs and challenges associated with implementing Settlement Discipline, in particular mandatory buy-ins. Furthermore, these studies and analyses support the case for the recommended delay in implementing Settlement Discipline.

Key recommendations

In responding to the various questions, ICMA provides a number of recommendations to support the successful implementation of Settlement Discipline measures, as well as suggested enhancements to the draft RTS text. At a high level, the key ICMA recommendations can be summarized as:

Preventing Settlement Fails

- As much as possible, same day trade matching and allocation should be encouraged.
- An automated and standardized matching process.
- All CSDs to offer a hold-and-release mechanism and the possibility to opt-in-or out of an automatic partialling settlement facility.

Cash Penalties

- A harmonized mechanism for cash penalties and re-distribution, based on centralized reference prices.

- Penalty rates for the relevant security categories will need to be calibrated to provide a sufficient deterrent to failing and an adequate incentive to cure fails, while at the same time not being so punitive as to deter securities lending, particularly for less liquid securities.
- Within the first year of implementation, ESMA should review the effectiveness of the mechanism and recalibrate rates, and possibly security categories, as appropriate.
- To monitor the effectiveness of the mechanism, mandatory buy-ins should not be implemented in the 18 months of cash penalties.

Mandatory Buy-ins

- Buy-ins should be initiated and managed at the trading level, with a 'pass-on' mechanism between trading counterparties with interdependent transactions (chains).
- CSDs can play a limited 'control' role in respect of identifying potential buy-in triggers within their own settlement system, and monitoring buy-in initiations or pass-ons, as well as the corresponding execution and results.
- For both cleared and non-cleared fixed income transactions, trading venues should not be involved in the buy-in process.
- MiFID II/R RTS liquidity measures for post-trade transparency are unfit for the purpose of determining the appropriate extension periods and buy-in timeframes and should be removed from the CSDR RTS.
- Fixed income securities should be subject to the maximum extension period and buy-in timeframes allowable under Level 1 (7 days).
- Failing counterparties should be able to continue to deliver securities during the buy-in timeframe, up until the execution of the buy-in.
- In determining the exemption threshold for SFTs, the possibility for deferral of the buy-in should be considered, along with the appropriate extension period and buy-in timeframe.
- The difference between the buy-in price (or cash compensation reference price) and the original trade price should be paid from the receiving counterparty to the failing counterparty where the former is lower.
- A centralized mechanism should be established to hear and resolve buy-in related disputes.

Appropriate timeframe for implementation

- Settlement Discipline should not be implemented until after the successful roll-out and testing of T2S.
- Adequate time should be allowed for CSDs and participants to develop and implement the required operational and technical builds (likely to be 18 months to three years).
- Cash penalties and mandatory buy-ins should not be implemented at the same time; cash penalties should precede the implementation of mandatory buy-ins by at least 18 months (but after T2S).

Glossary of acronyms used in this document

AFME	Association of Financial Markets in Europe
ATS	Automatic Trading System
CCP	Central (Clearing) Counterparty
CP	Consultation Paper
CSD	Central Securities Depository
CSDR	Central Securities Depositories Regulation
EC	European Commission
ECSDA	European Central Securities Depositories Association
EU	European Union
ESMA	European Securities and Markets Authority
GMRA	Global Master Repurchase Agreement
GMSLA	Global Master Securities Lending Agreement
ICSD	International Central Securities Depository
ICMA	International Capital Market Association
ISLA	International Securities Lending Association
ISO	International Organization for Standardization
MiFID II/R	Markets in Financial Instruments Directive (II)/Regulation
MTF	Multilateral Trading Facility
NCA	National Competent Authority
OTC	Over The Counter
RTS	Regulatory Technical Standards
SFT	Securities Financing Transaction
SFTR	SFT Regulation
STP	Straight Through Processing
SWIFT	Society for Worldwide Interbank Financial Telecommunication
T+2	Two business days after trade date (standard settlement)

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Consultation Paper on Technical Standards

Preventing Settlement Fails

Q1: Do you think the proposed timeframes for allocations and confirmations under Article 2 of the RTS on Settlement Discipline are adequate?

If not, what would be feasible timeframes in your opinion?

Please provide details and arguments in case you envisage any technical difficulties in complying with the proposed timeframes.

ICMA is fully supportive of same day trade matching (confirmation and affirmation), including allocation where possible. Accordingly, ICMA supports the proposed timeframes in Article 2.2 of the draft RTS for the matching of allocations and confirmations. However, this is predicated on the universal adoption of automated confirmation and affirmation processes, which may not be practicable for some professional clients that rely on manual affirmation. This may make compliance with a mandated same-day matching and confirmation requirement a challenge for some professional clients. In this instance the RTS may need to afford a little more flexibility, particularly with respect to allocations which may not be practical until after trade date (but in good time for intended settlement date). However, ICMA supports the ultimate goal of automation of client onboarding and centralized storage of standard settlement instructions to ensure the timely and efficient loading of information for allocation and confirmation processing.

ICMA also feels that it is an important requirement in the RTS to define exactly what is meant by the terms 'confirmation', 'matching', and 'allocation' (as well as 'affirmation') within the context of CSDR. It should be noted that not all market participants have the same interpretation of these processes, which, in the absence of a clear definition, will make implementation of the regulation difficult.

Q2: Do you agree with the cases when matching would not be necessary, as specified under Article 3(2) of the draft RTS?

Should other cases be included? Please provide details and evidence for any proposed case.

ICMA is fully supportive of an automated and standardized matching process and would advocate that manual intervention be minimized as much as possible.

It should be noted, that the term 'already matched' (Article 3 of the draft RTS) is purely a Target2-Securities concept that does not exist outside of T2S.

Q3: What are your views on the proposed approach under Article 3(11) of the draft RTS included in Chapter II of Annex I?

Do you think that the 0.5% settlement fails threshold (i.e. 99.5% settlement efficiency rate) is adequate? If not, what would be an adequate threshold? Please provide details and arguments.

Do you think that the 2,5 billion EUR/year in terms of the value of settlement fails for a securities settlement system operated by a CSD is adequate? If not, what would be an adequate threshold? Please provide details and arguments.

ICMA does not understand the rationale underlying Article 3.11, particularly as this exemption does not help contribute to improved settlement efficiency. It is the firm view of ICMA and its members that all CSDs should offer its participants both a hold and release mechanism and the possibility to opt-in or out of an automatic partial settlement facility.

Q4: What are your views on the proposed draft RTS included in Chapter II of Annex I?

ICMA is supportive of the mandatory matching fields specified in Article 3.3, but notes that to support successfully the implementation of the proposed settlement discipline mechanism additional mandatory matching fields will be required.

For the proposed partial-exemption for securities financing transactions to be implemented effectively, additional fields will need to be:

- (i) Settlement date of the second-leg of the SFT (required to calculate the number of calendar days of the transaction)
- (ii) Whether the SFT is an 'open' transaction
- (iii) Whether the SFT is 'callable'

These points are explained in more detail in the response to Q8, with reference to the challenges of enforcing a mandatory buy-in regime for SFTs.

If buy-ins themselves are to be treated as exempt from settlement discipline (as discussed in the response to Q7), an identifier will be required for buy-ins in the transaction type matching field.

ICMA would also point to the potential intersection with SFT Regulation, which will require the reporting of SFT trade data. If SFTR is to mandate the reporting of certain trade data, this should also be considered with respect to any mandatory matching fields under CSDR.

Monitoring Settlement Fails

Q5: What are your views on the proposed draft RTS on the monitoring of settlement fails as included in Section 1 of Chapter III of Annex I?

Details of the system for monitoring settlement fails

Since the purpose of the measures in Articles 4-6 of the draft RTS are to monitor settlement fails, ICMA feels that the CSD need only monitor settlement data related to trades that do not settle on the intended settlement date (i.e. actual fails rather than potential fails).

As for the actual data that is available to CSDs, this needs to be consistent with the mandatory matching fields outlined in Article 3.3 (see response to Q4), and to provide enough information for CSDs to be able to implement and manage a cash penalties system, and, if they are to be involved in the buy-in process, to at least identify when a buy-in *may* need to be initiated by the receiving counterparty (see response to Q7). With this in mind, ESMA should probably revise Article 4.2 to include only data that is relevant for these purposes.

Key to the relevance of both monitoring settlement fails, and the successful implementation of settlement discipline, will be identifying why a trade has failed, as well as whether it is a true fail. It is difficult to see how a CSD would have the necessary information to do this. Ultimately, the CSD can only see settlement information, which may not fully reflect the nature of the underlying transaction. This is an important consideration in attempting to implement a settlement discipline regime.

Finally, ICMA does not see the value of such a prescriptive standard as Article 4.5. While CSDs should be encouraged to set up 'working flows' with participants that display higher than normal rates of settlement fails, limiting this to the 'top ten' serves no obvious purpose, and ultimately it should be left to the CSD to identify which participants it should work with to improve settlement efficiency.

Cash Penalties

Q6: What are your views on the proposed draft RTS related to the penalty mechanism? Do you agree that when CSDs use a common settlement infrastructure, the procedures for cash penalties should be jointly managed?

Cash Penalties: Draft RTS Articles 7-10

The majority of ICMA's members agree that a well-designed and suitably calibrated cash penalty and redistribution mechanism, unlike mandatory buy-ins, can make a positive contribution to improving settlement efficiency. This is particularly the case in a low interest rate environment, but could still be relevant under more normal interest rate conditions.

Harmonized mechanism

ICMA fully agrees with ESMA on a harmonized mechanism that will apply to all in-scope CSDs. This will avoid the risks associated with participants selecting CSDs on a 'cheapest to fail' basis. ICMA further agrees that where CSDs use a common settlement infrastructure, the process for penalties and redistribution should be jointly managed. Common settlement platforms such as Target2-Securities will assist in providing CSDs with the information they require to implement successfully the mechanism.

Full redistribution and costs

ICMA supports the RTS related to full redistribution of the collected penalties to the receiving counterparty (Article 8) as well as the provision that the penalties should not be used by the CSD to cover related costs, and that rather these should be charged to participants separately with full disclosure (Article 10).

Partialing thresholds and penalties

ICMA feels that there is a need to offer clarification regarding the application of cash penalties in the case of a partial settlement not being triggered as the quantity of securities available falls below the CSD's minimum threshold for partial settlement. In this instance, would the participant be subject to cash penalties on securities that they technically could deliver, but are restricted from doing so due to CSD thresholds?

Frequency of notification, charges, and distribution

ICMA agrees that the net charging and redistribution of penalties on a monthly basis is sufficient (Articles 7.4 and 8.2). However, to help participants better track and monitor their penalties, and to identify possible disputes in a timely fashion, ICMA feels that CSDs should provide daily reports to participants detailing the calculation of fails and redistribution per account for each failed instruction.

Securities Financing Transactions and interest claims

The Global Master Repurchase Agreement (GMRA), which is the contractual framework for the vast majority of the European market, provides for the disappointed counterparty due to receive cash on the failing leg of a repo to claim for interest on the unpaid cash amount for the duration of the fail. ESMA should make clear whether such contractual claims relating to failing transactions will co-exist with the cash penalty mechanism, particularly as this may require updating existing contracts such as the GMRA to remain consistent with the regulation.

It should be noted that in the case of securities financing transactions, where the ability to claim interest due to fails will co-exist with a cash penalty system, the cost of failing will be compounded, particularly in higher interest rate environments.

Technical advice

Other member feedback related to the proposed mechanism, including the proposed categories of financial instruments and rates, is provided in the response to the Consultation Paper on Technical Advice under the CSD Regulation.

The Buy-in Process

Q7: What are your views on the proposed draft RTS related to the buy-in process?

In particular, what are your views on applying partial settlement at the end of the extension period?

Do you consider that the partialling of the settlement instruction would impact the rights and obligations of the participants?

What do you think about the proposed approach for limiting multiple buy-in and the timing for the participant to provide the information to the CSD?

1) Introduction

While ICMA fully appreciates that the Level 1 text regarding mandatory buy-ins (Article 7) is now in law, and that the RTS must be written within its constraints, it would be a disservice to ICMA's members, and the users of the European capital markets in general, if we did not restate the over-riding opinion of our members that the inclusion of mandatory buy-ins in CSDR is a grave error, and that Article 7 of the Level 1 text is fundamentally flawed. Furthermore, if or when a mandatory buy-in regime is enforced in the European capital markets this will have severe negative repercussions for market efficiency and liquidity. This is illustrated with data and analysis in this response.

However, given that for now the assumption must be that a mandatory buy-in regime will be imposed on the European capital markets in near future, our response will focus on the draft RTS with a view to supporting a buy-in regime that could be implemented and enforced relatively effectively, while minimizing market disruptions. To this end, and within the parameters of the Level 1 text, ICMA's key recommendations are:

- (i) MiFID II/R post-trade transparency liquidity calibrations are unfit for purpose within the context of CSDR settlement discipline and should be removed from the RTS (see also response to Q8).
- (ii) All fixed income securities be afforded the maximum allowable extension period of 7 days (see also response to Q8).
- (iii) For non-cleared trades, mandatory buy-ins be initiated and managed at the trading counterparty level, although with the possibility of some CSD involvement from a control perspective.
- (iv) For transactions in fixed income securities, trading venues should not play a role in any buy-in process, as they are not adequately placed to do so.

These recommendations are elaborated on below.

2) Buy-ins must be initiated and managed at the trading level

Article 11: Buy-ins

Article 11.1 of the draft RTS states: *The buy-in process shall be set in the contractual documentation applicable to each participant of the CSD, CCP and trading venue.* Subsequent paragraphs of Article 11 provide for trading venues appointing buy-in agents, as well as sending buy-in notices to the relevant participants including confirmation of the buy-in results. The role of trading venues and CSDs in implementing and enforcing settlement discipline is further discussed in paragraphs 68, 73, 83, 88, 107, and 110 of the Consultation Paper.

The contractual obligation to deliver securities

In the case of a non-cleared transaction in financial securities, this is a legal contract between two trading entities (the buyer and the seller), including an obligation to deliver the securities in a specified timeframe at an agreed place of delivery. In the case of centrally cleared trades, this contractual obligation exists between both the buyer and the seller with the central clearing counterparty. Therefore, any remedies relating to the legal obligation (such as buy-ins) relate to the contracted parties.

Article 11 complicates this contractual relationship between buyer and seller by broadening it not only to include the agreed place of delivery, but also the trading venue where the buyer and seller transacted. This effectively places a contractual responsibility on both the nominated place of delivery and the chosen trading venue to ensure that the transaction agreed between two counterparties settles, and to enforce remedies in the event that it does not.

One of the weaknesses of both the Level 1 text and the draft RTS of CSDR is that it offers no clear definition of a buy-in, its purpose, or its context as a legal remedy with respect to the contractual agreement between two counterparties to deliver securities.

The role of fixed income trading venues

A number of trading venues, or automatic trading systems (ATSs), exist in the European bond and repo markets, and many more new systems are expected to enter the space as the market place becomes ever more competitive. Electronic bond trading platforms such as Tradeweb, MarketAxess, Bloomberg, MTS, BrokerTec, and Eurex are well established competitors, with a raft of new entrants also joining the ATS space for bond trading. For repos, BrokerTec, TP Repo, MTS, and Eurex Repo are the established and competing ATSs. Bond and repo dealers are largely agnostic as to which platform they trade on, and are driven primarily by price and liquidity. Thus most, if not all, use aggregators that connect across platforms, such as ION or LIST.

While many platforms provide straight through processing (STP) to support trade confirmation and settlement instructions, they do not remain part of the post-trade life cycle. For instance, they will not know whether a trade settles, and will certainly not play any part in any post-trade disputes or contractual remedies involving the trading counterparties.

Optimizing the buy-in process

To understand better how a buy-in process could work efficiently and effectively within the European fixed income space, it is necessary to look at how the market works, and the transaction, information, and settlement flows related to a trade.

Below are two relatively simple examples of cleared and non-cleared trades, which could be either outright bond transactions or repos (note that from a settlement perspective there is currently no distinction between the two).

Example 1

Figure 1: a centrally-cleared transaction

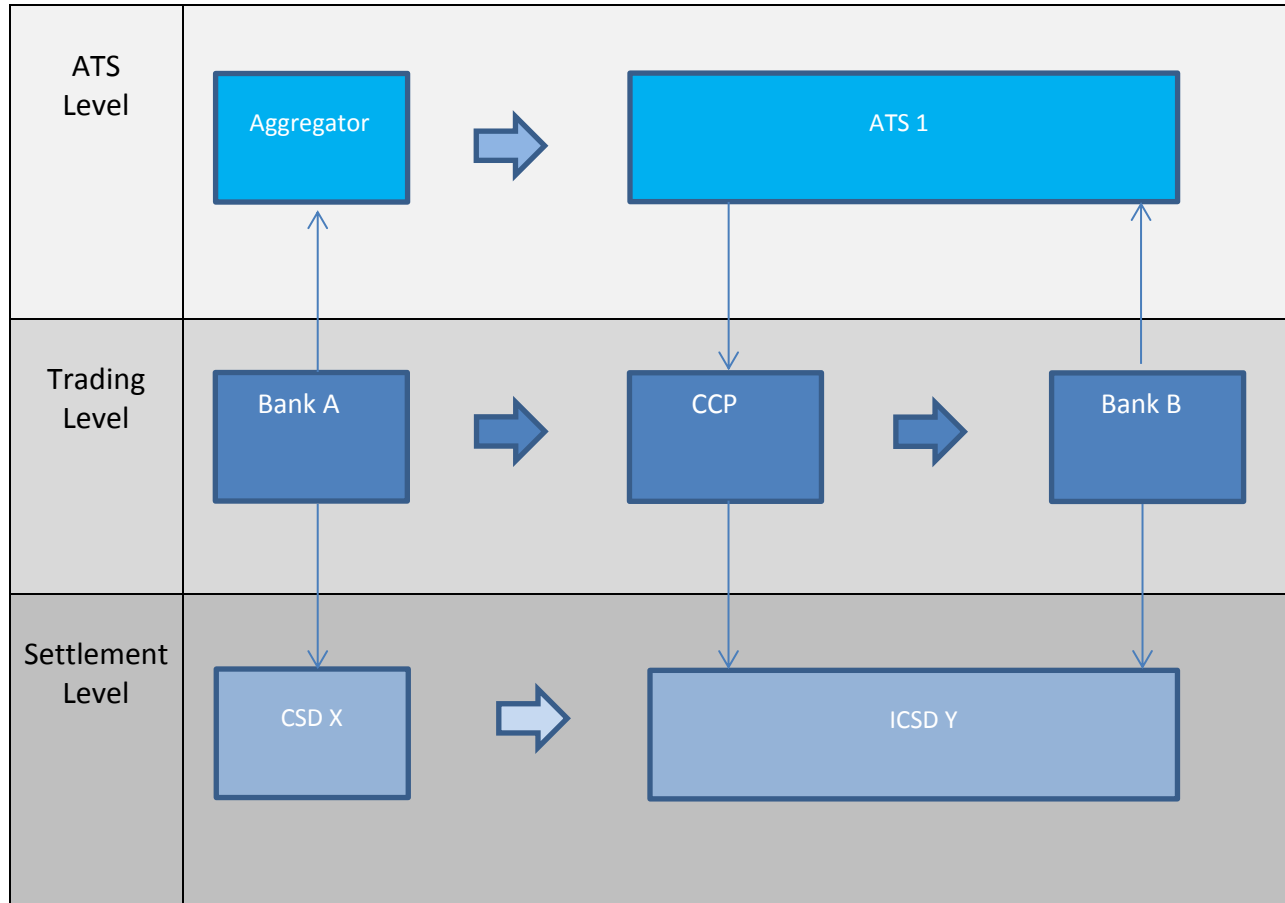


Figure 1 illustrates a straightforward cleared trade between two clearing members. This could be Bank B showing a bid on Broketeq (ATS1 in Figure 1), and with Bank A, using ION (the aggregator in Figure 1) hitting the bid. The trade details are then given up to the CCP (LCH Clearnet) who is the central counterparty for both banks. From a settlement perspective, Bank A holds bonds in Monti Titoli (CSD X), so will re-align to be able to settle in Euroclear (ICSD Y).

From an optimization perspective, in the event of A failing to make delivery to the CCP, the CCP is best placed to identify which counterparty should be bought in and to manage the process. Beyond the ICSD (Euroclear in this example) reporting that a transaction has not settled, little value can be added at either the settlement or ATS levels.

Example 2

Figure 2: a non-cleared transaction chain

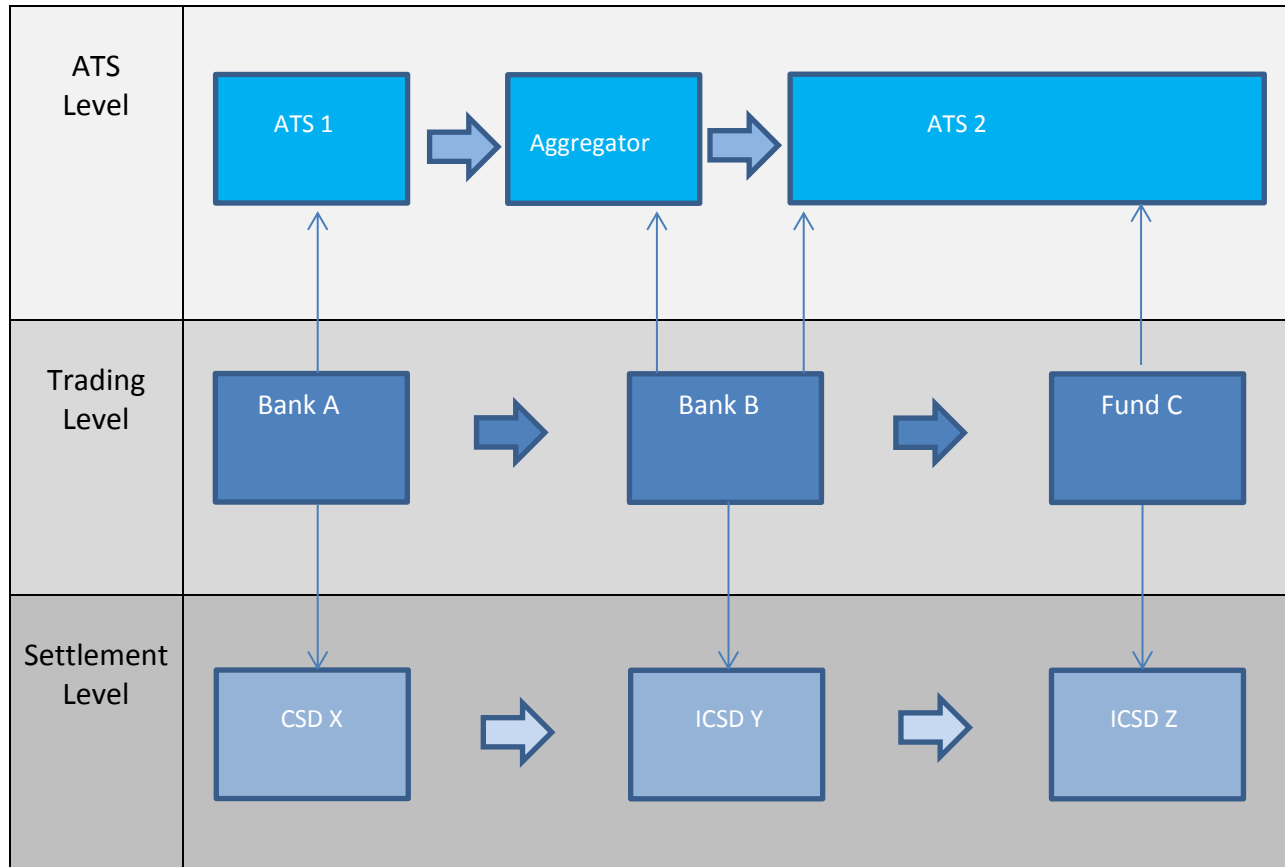


Figure 2 illustrates a typical non-cleared transaction chain involving three counterparties. This could be an insurance fund (Fund C) placing an RFQ on Bloomberg (ATS 2). Bank B, who receives the RFQ, uses ION, an aggregator, to look for market offers. Bank A is showing an offer on MarketAxess (ATS 1). Bank B intermediates between Bank A's offer and Fund C's interest. From a settlement perspective, Bank A holds the bonds in Monti Titoli (CSD X), but sells them to Bank B for settlement in Euroclear (ICSD Y). Fund C requires settlement in Clearstream (ICSD Z).

What happens if Bank A fails to deliver to Bank B, who in turn fails to Fund C? Currently, the process for a buy-in would be driven by Fund C, who is at the end of the chain and who has no onward deliveries. So Fund C would issue a buy-in to Bank B. Bank B, knowing that it was failing to Fund C due to a failing receipt from Bank A, would simply pass this buy-in on to Bank A.

Again, from an optimization perspective it is difficult to see how any value can be added at the ATS level. This would not only require the coordination of both ATSs (and possibly the aggregator?), but they lack the information necessary to a) identify a fail and b) identify the fails-chain. This would require them

coordinating with three separate settlement systems as well as with the three counterparties involved in the chain.

Given the number of individual transactions that ATs process each day, the number of different counterparties involved, the variety of different, competing ATs, as well as the different settlement systems being used, the notion of implementing and enforcing settlement discipline as part of an AT's contractual obligation with its members is a fantastical proposition.

The role of a CSD

ICMA strongly believes that from a practical perspective CSDs are not in a position to initiate or manage buy-ins. Firstly, this would require that the CSD can identify the nature of the failing transaction and the cause of the fail (see response to Q9). Secondly, while the CSD may be able to identify interdependent fails (chains) in its own settlement system, it does not have the visibility to identify chains that relate to fails in other CSDs. In Example 2 above, which CSD would ESMA suggest manage the buy-in? How would the chain be identified and who would take responsibility for initiating the buy-in and against which participant? This becomes even more complicated when one or more of the involved settlement systems exist outside of the EU.

All the information necessary to identify where a counterparty sits in terms of a chain, and for the process of settling the chain to be managed efficiently, exists at the trading level, and not at the CSD level. The counterparty at the end of fails-chain knows that they are at the end of the chain since they will have a failing receipt but no onward delivery. A CSD, with only visibility of its own settlement system, cannot know this. Similarly, a counterparty in a fails-chain will know that it is in a chain since it will have a failing onward delivery and a failing receipt in the same security. Again, where these transactions are across different settlement systems, an individual CSD does not have the necessary information to identify this. The most efficient and practicable way of resolving a fails-chain is for the counterparty at the end of the chain to instruct a buy-in against its failing counterparty, and for the buy-in to be passed along the chain, at the trading counterparty level, until it reaches the counterparty at the start of the chain who is responsible for causing the initial fail.

Furthermore, not only will the CSD, in many cases, not have sufficient information or visibility to initiate the appropriate buy-in against the correct participant, but nor do CSDs have the expertise to manage buy-ins, which are a trading level function. This introduces an unnecessary and unwarranted level of operational risk to CSDs.

Recommendation

Both the Level 1 text and the draft RTS of CSDR fail to reflect the realities and complexities of how bond and repo trades are transacted in the European markets. By attempting to put the responsibility for initiating and managing the buy-in process on trading venues or CSDs, CSDR is complicating the process to a point where it is at best impractical and at worst un-implementable. As more ATs enter the market place, this will compound the complexities, as will the introduction of new ICSDs. As the above examples clearly illustrate, the optimal level for managing the buy-in process for both bond and repo transactions is at the trading level, and not the AT or CSD level. The RTS need to be amended to reflect this in order to ensure an efficient buy-in regime that is not only workable, but that minimizes the incidents of multiple buy-ins related to a single fail.

3) The buy-in process

Article 11.3 of the draft RTS specifies that the buy-in shall take place either by the appointment of a buy-in agent or through the means of a buy-in auction. As explained above, ICMA firmly believes that in the case of fixed income securities, it should be the obligation of the receiving trading counterparty, or CCP, to initiate the process and to appoint the buy-in agent or to instruct the auction (and not that of the CSD or trading venue). Given difficulties in finding willing buy-in agents in the current market environment of relatively infrequent buy-ins, it is reasonable to assume that this problem will only be compounded in a mandatory buy-in regime where the incidents of buy-ins are likely to increase exponentially (see ECSDA Impact Study suggesting over 7,500 new buy-ins per day). Unless broker-dealers are to invest in specialized 'buy-in desks' whose primary function is to execute buy-ins on behalf of disappointed counterparties, it may be that the current mechanisms for buy-ins are insufficient to support a mandatory buy-in regime.

With this in mind, ICMA advocates that automation be used as much as possible to support the buy-in process:

- (i) For buy-in notices between the receiving and failing counterparties
- (ii) For passing-on buy-in notices and details between counterparties in a chain
- (iii) For executing the buy-in (such as auctions held on electronic platforms)
- (iv) For informing and passing-on the buy-in results between buy-in agent/auction host and relevant counterparties

This will possibly require investment and development by market participants to ensure the requisite level of technology to support an efficient and automated buy-in process. ESMA should take into account the time (and cost) associated with such technological development (see also response to Q14). This may also require the willing cooperation and participation of trading platforms to provide a buy-in auction process.

4) Partiallying

ICMA is broadly supportive of the proposal for mandatory partiallying which should help reduce the incidence (and total size) of buy-ins. For non-cleared transactions, ICMA members are divided on whether mandatory partiallying (subject to a minimum threshold) should be imposed on intended settlement date, or whether it should be later in the extension period. However, from a practical perspective, and to allow enough time for inter-CSD settlement movements, it is recommend that mandatory partiallying be enforced no later than one day before the end of the extension period. However, the failing counterparty should be allowed to continue partiallying or make full delivery through the buy-in timeframe up until the day before the buy-in is executed, or even on the same day of the buy-in up until a point when the settlement can be practicably communicated to the agent executing the buy-in (see also response to Q8).

In the case of cleared transactions, CSDs should provide auto-partiallying throughout the extension period in light of the multilateral netting processes of CCPS that require partial settlement and therefore do not allow for discretion on the part of participants.

5) Proposed approach to limit multiple buy-ins

ICMA believes that the proposed approach to limit multiple buy-ins (Article 11.10) is poorly constructed and highly inefficient. As explained earlier in this response, the only stakeholders with sufficient information to identify and settle efficiently a fails-chain are the trading level counterparties that are in the chain. What ESMA proposes seems to negate this fact, and by attempting to involve the CSDs from a ‘control’ perspective this only serves to provide an additional and unnecessary level of complication to the process.

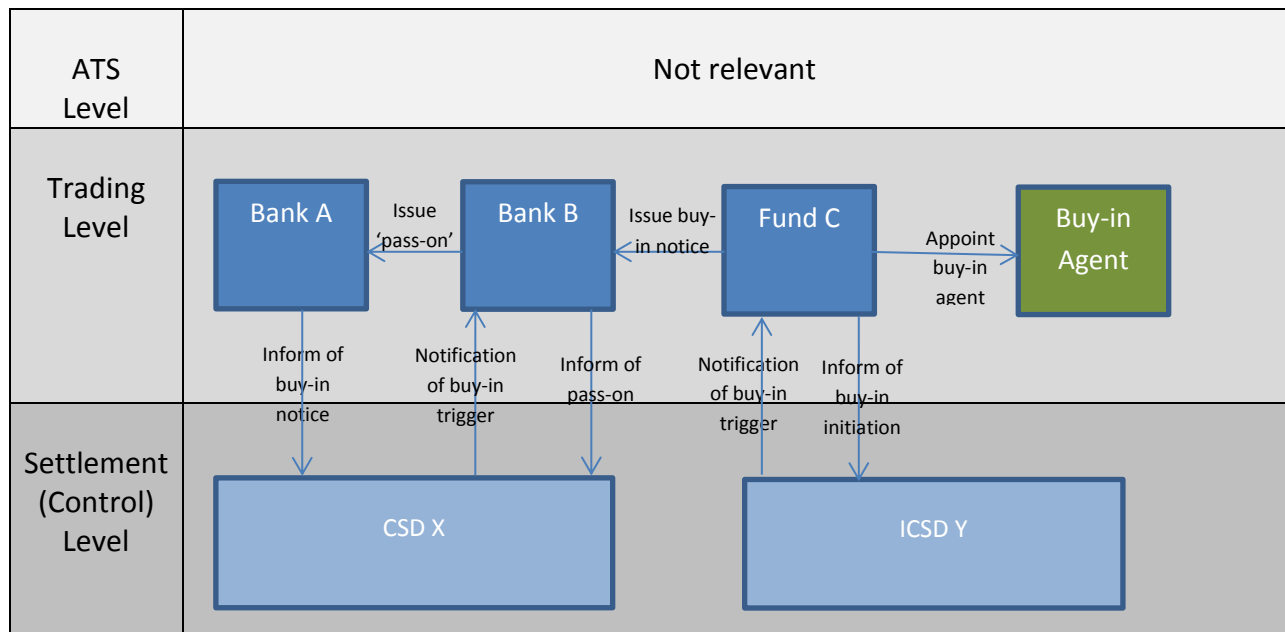
As explained previously, where interdependent transactions (chains) cross more than one settlement system, a CSD no longer has the information necessary to instruct or manage a buy-in optimally since it does not have full overview of the chain. Furthermore, it is not in a position to verify the nature of the transaction failing in a different settlement system, nor the cause of that fail. Thus the verification process that ESMA proposes is not only redundant (since the trading level counterparty will already know that they are in a chain – see earlier), but in many cases it may not be possible.

As illustrated previously, the most efficient and effective approach to avoiding multiple buy-ins is to employ a pass-on mechanism (ideally automated) at the trading counterparty level.

6) Enforcing a trading level mechanism for non-cleared transactions

As explained, ICMA believes that a mandatory buy-in mechanism can only be successfully implemented at the trading counterparty level. However, ICMA also appreciates the limitations of the Level 1 text that requires CSD involvement in the process, if only from an enforcement perspective. With this in mind, the mechanism proposed by ICMA is intended to be consistent with Article 7 of CSDR while still providing for a trading level resolution. This is illustrated below.

Figure 3: The buy-in initiation process for a non-cleared trade

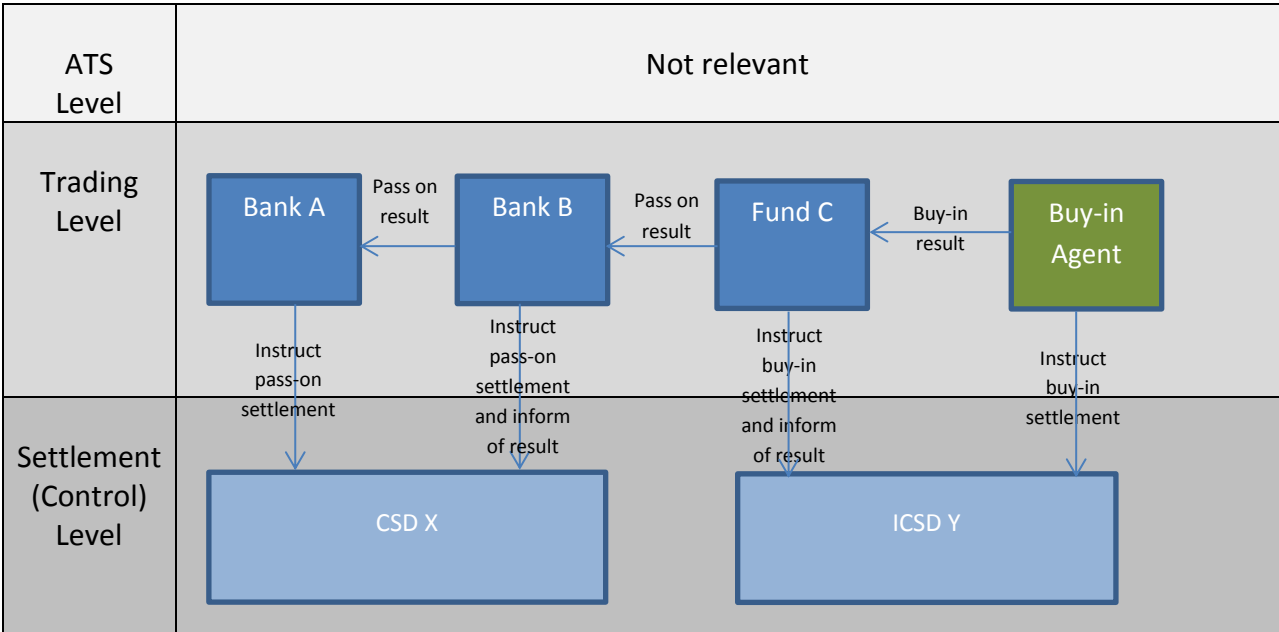


CSDs would be responsible for notifying failing participants of when a fail that may be subject to a mandatory buy-in has reached the end of the extension period (the buy-in ‘trigger’). In this example of a fails-chain across two CSDs, ICSD Y notifies Fund C that they may need to initiate a buy-in. Meanwhile, CSD X notifies Bank B that they may need to initiate a buy-in. Fund C initiates a buy-in notice to Bank B, and appoints a buy-in agent to execute the buy-in. Fund C informs ICSD Y that it has issued a buy-in notice (to Bank B) and appointed a buy-in agent.

Bank B, on receiving the buy-in notice from Fund C, passes-on the buy-in notice to Bank A (in the form of a ‘pass-on’). At the same time it informs CSD X that it has received a buy-in notice (from Fund C) and has passed this on to Bank A.

At this point the buy-in process will have been initiated across the chain, and from the perspective of both CSDs, they will be satisfied that the fail in their respective settlement systems has triggered the mandated buy-in process.

Figure 4: Notification of the buy-in result for a non-cleared trade



On execution of the buy-in, the Buy-in Agent informs Fund C of the result. Fund C passes this on to Bank B, who in turns passes this on to Bank A. Bank A, at the end of the chain, is then able to sell immediately its position to flatten its exposure.

Fund C informs ICSD Y of the buy-in result and both the Buy-in Agent and Fund C instruct the buy-in settlement details. Similarly, Bank B will inform CSD X of the buy-in results, and will instruct the necessary cancelation of the original trades with Fund C (in CSD Y) and Bank A (in CSD X) as well as the required movements of cash with both counterparties. Bank A will also instruct the trade cancelation

and movement of cash with Bank B in CSD X. (Note that this will require a buy-in and pass-on trade identifier in transaction-type matching fields - see response to Q4.)

Both ICSD Y and CSD X are satisfied that the fail in their respective systems triggered the mandated buy-in process and that the buy-in process successfully remedied the fail.

This proposed mechanism is based largely on how buy-ins are successfully initiated and managed today, while adding a level of control in that CSDs will notify the disappointed receiving counterparties that they may be required to initiate a buy-in, and in turn the disappointed receiving counterparties being required to inform the CSD (a) that a buy-in process has been initiated (or issuance of a pass-on) and (b) of the result of the buy-in (or pass-on).

This allows a CSD to activate and monitor the buy-in process as it relates to fails in its own system, without being required to have overview of the entire fails-chain. Furthermore, it does not require identification of the initial failing counterparty, nor interaction with the Buy-in Agent.

For this mechanism to work successfully, particularly in light of the anticipated significant increase in buy-ins that market participants and CSDs will experience, a high degree of automation for standardized, real-time messaging and settlement instructions will be required, both between trading level counterparties and between CSDs and participants.

Recommendation

The RTS allow for a buy-in mechanism that requires CSDs to notify disappointed receiving counterparties of the potential requirement to issue a buy-in, and for the notified receiving counterparty, within the allowable timeframe of the buy-in, to inform the CSD with details of (a) the initiation (or pass-on) of a buy-in, and (b) the results of the buy-in, or (c) any reason why a buy-in would not be appropriate (see response to Q9).

ICMA notes that this recommended approach for the buy-in process is largely aligned with that proposed by AFME.

7) A buy-in dispute resolution mechanism

As ESMA will be aware, buy-ins can often be contentious, particularly where the buy-in price is considered by the bought-in counterparty to be significantly above fair market value. In some instances, this can lead to accusations of negligence on the part of the buy-in agent, or market abuse by either the counterparty executing the buy-in or the counterparty selling into the buy-in. While disputes over buy-ins are relatively infrequent in a discretionary buy-in regime, these are likely to become a regular aspect of a mandatory buy-in regime.

ECSDA's impact study on CSDR Settlement Discipline suggests that based on current settlement efficiency data, the European markets could see 1.8 million buy-ins being executed a year under the proposed RTS (with a market value of more than €2.5 trillion). Even if only a small percentage of these

result in disputes, this would still suggest several hundreds, if not thousands, of unresolved disputes at any time, with significant monetary value to the disputing counterparties.

To ensure consistency and fairness, and to discourage market abuse, ICMA recommends that a centralized mechanism be established to hear and resolve buy-in related disputes, with a standardized buy-in complaints procedure. Such a mechanism may be essential in order to ensure ‘the smooth and orderly functioning of the financial markets’.

8) Other Level 1 issues that need addressing in the RTS

ICMA and its members have identified a number of potential ambiguities or additional implementation challenges relating to the Level 1 text that ESMA should address in the RTS.

Passing on the buy-in cost

While not specifically addressed in the draft RTS (with the exception of Article 15(b) relating to cash compensation – see response to Q10), Article 7.6 of CSDR suggests that where the price of the executed buy-in is higher than the price agreed in the original transaction the difference shall be paid to the receiving participant by the failing participant (by no later than two business days after the buy-in is executed). While ICMA would agree with this, it seems to imply that where the price of the executed buy-in is lower than the price agreed in the original transaction, the difference should not be paid to the failing participant by the receiving participant. This is inherently flawed. As discussed already, the absence of a definition for a buy-in in the Level 1 text is a key weakness of the regulation. Given that a buy-in is intended to return both counterparties to a financial transaction to the economic position they would have been in had the original trade settled on the intended settlement date, this has to allow for the payment of any differential between the buy-in and original trade price to be paid in both directions. This is critical if a buy-in is considered as a settlement remedy, rather than purely as a penalty mechanism for failing counterparties.

Given that Article 7.6 of CSDR does not explicitly rule out the possibility of a price differential moving in both directions, the RTS should clarify that this is indeed possible, and that it cannot only be to the benefit of the receiving counterparty.

Furthermore, if it is ESMA’s intention that price differentials (including cash penalties – see response to Q10) are only to be paid where it is to the benefit of the receiving counterparty, this is likely to create arbitrage opportunities, particularly in less liquid, or ‘special’ securities, at the expense of the liquidity provider. Effectively, this will provide the purchasing counterparty with a free put option in the event of a buy-in, where they will benefit in the case of the price rising, but are indemnified, at the expense of the seller, in the event of the market price falling. It is ICMA’s belief that providing such incentives for market abuse is not the intention of the regulation.

Finally, it should be clarified in the RTS whether ‘shares’ as described in the Level 1 text covers all securities within scope of mandatory buy-ins, or whether Article 7.6 applies specifically to equities.

Possibility for sell-outs

Another fundamental flaw in the Level 1 text is that the provisions for buy-ins are predicated on a selling counterparty having insufficient securities. It neglects to allow for the possibility that a fail can equally be the result of the receiving counterparty having insufficient cash. The current market remedy for this scenario is a 'sell-out', where the disappointed selling counterparty has the right to sell the bonds to a third party, and for any price differential between the sell-out price and the original trade price to be settled between the original counterparties to the trade.

While CSDR does not mandate sell-outs in these situations, it may still be helpful if the RTS acknowledge that fails can equally be caused by the receiving counterparty, and that in this event a buy-in is the wrong remedy and should not be initiated (possibly with reference to Article 14 in the draft RTS).

It is presumed that where provided for in the terms of the trade, counterparties will retain the right to issue sell-outs after CSDR implementation, and that this right will not be negated by the regulation.

When a buy-in fails

Neither the Level 1 text, nor the RTS, outlines what happens in the event of a buy-in being executed, but the buy-in transaction subsequently failing. In this eventuality, will either the selling party to the buy-in, or the buy-in agent, be subject to settlement discipline, including cash penalties and buy-ins?

ICMA recommends that in order to avoid dis-incentivizing both buy-in agents and potential sellers of securities in a buy-in, as well as to avoid compounding multiple buy-ins, both buy-in agents and sellers of securities to a buy-in be exempted from settlement discipline, including mandatory buy-ins. Furthermore, where the buy-in does not settle on intended settlement date, the buy-in should be considered unsuccessful and the buy-in trade canceled. This should be clearly outlined in the RTS.

Trading venues in a third country

Article 7.13 of CSDR provides an exemption from 'measures to address settlement fails' for 'shares' where the principal venue for trading is located in a third country. It would be helpful if the RTS could elaborate on this exemption and clarify whether it is only intended to apply to equities, or whether this also applies to other securities (such as bonds or ETFs) traded on venues located in third countries.

9) Analysis: market impacts of mandatory buy-ins

In January-February 2015, ICMA conducted a survey of its sell-side members to quantify better the likely market impacts of a mandatory buy-in regime. The study, which includes data from many of the larger market-making banks for European bond markets, captures the increase in offer-side pricing that market-makers will need to pass on to investors in order to cover the additional costs and risks of operating under mandatory buy-in requirements. The results illustrate that when mandatory buy-in regulation is implemented, liquidity across secondary European bond and financing markets will reduce significantly, while bid-offer spreads will widen dramatically. The results suggest that even the most

liquid sovereign bonds will see bid-offer spreads double, while secondary markets in less liquid corporate bonds may effectively close. The survey further suggests that for many less liquid bonds, including sovereign and public issues, market-makers will retrench from providing liquidity altogether.

The re-pricing of offer spreads highlighted and quantified by the study is driven partly by the proposed extension periods (Article 12.1) that use the MiFID II/R liquidity calibrations for post-trade transparency as the basis. For most of the fixed income market, and virtually all of the sovereign bond market, this would mean an extension period of only 4 days.

ICMA believes that the basis of using MiFID II/R post-trade transparency liquidity calibrations as the determinant for the appropriate extension period is deeply flawed, and that a shorter extension period for the bond markets will compound the detrimental impact on market liquidity and pricing. ICMA further believes that this study, which will be made available to ESMA separately, supports the case that Article 7.4(a) of CSDR should apply to all fixed income instruments, affording them the maximum extension period of 7 business days. This point is elaborated on in the response to Q8.

Recommended enhancements to the RTS

Article 11(1)

1. ~~The buy-in process shall be set in the contractual documentation applicable to each participant of the CSD, CCP and trading venue. CSDs, CCPs, and trading venues shall include in their rules that participants will be subject to buy-in rules under CSD Regulation. Their rules should also state who is responsible for appointing a buy-in agent or executing a buy-in auction.~~

Article 11(3)

3. ~~As specified in the rules of the CSD, CCP or trading venue, t~~The CSD, CCP, trading venue or the receiving participant shall appoint a buy-in agent or execute the buy-in by auction. The buy-in agent shall not have any conflict of interest in the execution of the buy-in. ~~Where applicable t~~The CSD and the trading venue shall allow the participant to provide the identification of its failing client or underlying client for which the buy-in shall be executed. Securities shall be delivered to the receiving participant and the related settlement instruction shall be deemed executed.

Article 11(4)

4. Where applicable ~~(T~~The CSD, CCP, or trading venue, as applicable in accordance with Article 7(10) of Regulation(EU) No 909/2014, shall send a notice to both the failing and the receiving participants:

(a) at the end of the business day when the extension period elapse informing them that the buy-in will be initiated the following business day;

(b) at the end of the business day prior to the buy-in being executed , informing them that the buy-in will be executed the following business day;

(c) immediately following the execution, or attempted execution, of the buy-in~~on the last business day of the buy-in period at the latest~~, informing them of the results of the buy-in or that the buy-in is not possible.

Where the receiving participant is responsible for appointing the buy-in agent or executing the buy-in by auction, the receiving participant in accordance with Article 7(1) of Regulation(EU) No909/2014, shall send a notice to both the failing participant and the CSD:

(a) at the end of the business day when the extension period elapses informing them that the buy-in will be executed the following business day;

(b) at the end of the business day prior to the buy-in being executed , informing them that the buy-in will be executed the following business day;

(c) immediately following the execution, or attempted execution, of the buy-in, informing them of the results of the buy-in or that the buy-in is not possible.

Article 11(6)

6. The partialling functionality offered by the CSD, referred to under Article 3 (7), shall be applied ~~on the last~~ no later than the day prior to the final day of the extension period when the financial instruments are available in the account of the delivering participant irrespective of any opt out elected by the receiving participant.

Article 11(10)

~~10. For transactions not cleared by a CCP, the failing participants or the trading venue shall provide to the CSD, by the day preceding the expiration of the extension period, the details of the settlement instructions on the same financial instruments and with the same date of expiry of the execution period that are causing the failure to deliver. The details shall contain the identification of the failing participants in the chain, the identification of the settlement instructions.~~

~~The CSD shall test consistency of this information with pending receipt settlement instructions in the account of the participant and process that information in order to limit the number of buy-ins to be executed.~~

For transactions not cleared by a CCP, where the failing participant is failing as the result of a failing receipt of securities, on receipt of a buy-in notification the participant shall pass-on the notification to the participant causing the fail, where a buy-in is possible in accordance with Article 7 of Regulation(EU) No909/2014. The participant instructing the 'pass-on' shall notify the CSD that it has passed-on the buy in and the identification of the participant in receipt of the pass-on.

Where a participant passes-on a buy-in, they will be responsible for notifying both the participant who issued them with the buy-in or pass-on, and the CSD, of the buy-in execution and results, in accordance with Article 6(4) of this Regulation.

Q8: What are your views on the proposed draft RTS related to the buy-in timeframe and extension period?

1) Extension periods

ICMA and its members understand that the Level 1 text (Article 7.3 and 7.4(b)) offers limited scope for recommending appropriate extension periods before which a buy-in becomes mandatory, and this is effectively limited to 4 business days, with the possibility of extending this to a maximum of 7 business days 'where a shorter extension period would affect the smooth and orderly functioning of the financial markets concerned'. As is made clear in the responses to Questions 7 and 9, it is the firm belief of ICMA and its members that a mandatory buy-in regime in itself threatens the smooth and orderly functioning of the European bond and financing markets, and which is evidenced in the analysis referenced in these responses. With this in mind, ICMA and its members would strongly recommend that all fixed income securities be subject to the maximum allowable extension period under Level 1 (i.e. 7 business days) to minimize the negative impacts and market disruption that mandatory buy-ins will cause.

ICMA and its members are concerned by the attempt to link the extension periods to the eventual liquidity calibrations of MiFID II/R (Article 12 of the draft RTS). Apart from creating an additional layer of complication for those parties responsible for identifying, notifying, or executing buy-ins, as ESMA will be well aware there is a significant degree of controversy around the proposed methodology for liquidity calibrations in the draft RTS of MiFID II/R. Without significant modification, the methodology is likely to define a large universe of fixed income products as 'liquid' when they are by most measures clearly 'illiquid' (i.e. 'false positives'). Furthermore, even if we assume that the eventual liquidity calibrations are even faintly credible, these relate to pre- and post-trade transparency requirements, which is a very different consideration to both settlement efficiency and the ability to execute for guaranteed delivery (both of which are security specific and inherently dynamic).

ICMA would therefore argue that applying MiFID II/R liquidity calibrations in determining the extension period achieves no useful purpose other than complicating the process and most likely creating even more market disorder than is necessary by applying a shorter extension period to a large universe of illiquid bonds. ICMA therefore suggests that the maximum allowable extension period of 7 business days be applied to all fixed income securities.

2) Buy-in timeframe

ICMA finds the draft RTS relating to buy-in timeframe somewhat confusing, and would welcome further clarification from ESMA on a number of points.

Firstly, it is inferred that it is not possible for the failing participant to cure the fail, and so halt the buy-in during the buy-in timeframe (paragraph 90 of the Consultation Paper). This is inconsistent with how buy-ins currently work, and where it is possible for the failing counterparty to deliver securities up until the buy-in being executed. Given the suggested timeframes in the draft RTS, and given that a buy-in will most likely be executed for T+2 settlement, this potentially creates a scenario where for two business days for 'liquid' securities, and for five business days for 'illiquid' securities, securities could possibly be delivered before the buy-in is executed, but will not prevent the buy-in from taking place. It would be

helpful to understand the rationale underlying this, and ICMA suggests modifying the RTS with respect to non-cleared transactions to allow for the possibility of delivery of securities during the buy-in timeframe at least up until the end of day before the buy-in is actually executed, and possibly on the same day of execution up until a point where the settlement can be practicably communicated to the buy-in agent (see also response to Q7). This would not only help reduce the overall number of buy-ins, but would also eliminate the unnecessary risk and cost to participants who may be in a position to deliver securities but are still subject to a buy-in.

Secondly, as with the proposed determinant of the extension periods, ICMA questions the rationale of using the MiFID II/R liquidity calibrations to determine the appropriate buy-in timeframe. If the buy-in timeframe is to allow participants adequate time to find and appoint a buy-in agent, to allow the buy-in agent to locate potential sellers of the securities being bought-in, or to organize a buy-in auction (for example, buy-in auctions on MTFs may be run as weekly rather than daily events), then the recommendation is that in the case of fixed income securities, a standard timeframe of seven business days be applied, with the possibility for the failing counterparty to deliver securities up until the buy-in being executed.

Recommended enhancements to the RTS

Article 12

1. Shares or bonds, including those shares cleared by a CCP or those shares or bonds that are SME growth market instruments, shall be available for settlement and delivered to the receiving participant within:

(a) 4 business days after the end of the extension period where ~~the bonds or~~ shares are considered to have a liquid market, in accordance with point (a) of Article 2(1)(17) or point (b) of Article 2(1)(17), respectively, of Regulation (EU) No 600/2014;

(b) 7 business days after the end of the extension period where the ~~bonds or~~ shares are not considered to have a liquid market, in accordance with point (a) of Article 2(1)(17) or point (b) of Article 2(1)(17), respectively, of Regulation (EU) No 600/2014.

2. ~~The Bonds,~~ depositary receipts, exchange-traded funds, certificates and other financial instruments that are not covered by paragraph 1 shall be available for settlement and delivered to the receiving participant within 7 business days after the end of the extension period.

3. In the case of non-cleared transactions, the failing counterparty can continue to deliver securities up until the day of the buy-in being executed.

Article 13

1. The extension period ~~for bonds and~~ for shares, excluding those shares cleared by a CCP or those ~~bonds and~~ shares that are SME growth market instruments, shall:

(a) not be prolonged where the bonds or shares are considered to have a liquid market in accordance with point (a) of Article 2(1)(17) or point (b) of Article 2(1)(17), respectively, of Regulation (EU) No 600/2014;

(b) be prolonged where the bonds or shares are not considered to have a liquid market, in accordance with point (a) of Article 2(1)(17) or point (b) of Article 2(1)(17), respectively, of Regulation (EU) No 600/2014.

2. The extension period for the financial instruments other than those referred to in paragraph 1, including bonds, and that are not traded on SME growth market shall be prolonged.

3. The extension period under paragraph 1 or 2 is prolonged by 3 days and the buy-in process shall be initiated after the end of the 7th business days following the intended settlement date.

Q9: What are your views on the proposed draft RTS related to the type of operations and their timeframe that render buy-in ineffective?

The response to Question 9 is in two parts. Part (a) relates to operations composed of several transactions (namely securities financing transactions), while part (b) relates to other types of operations that could render a buy-in ineffective.

a) Securities Financing Transactions

1) Introduction

While ICMA and its members are well aware of the inflexibility of the Level 1 text (with reference to Article 7.4(b)), it would be irresponsible not to use this consultation to restate the firm view of our members that the enforcement of mandatory buy-ins with respect to the first-leg of a securities financing transaction (SFT) is wholly inappropriate with respect to the type of transaction, and will most likely achieve the opposite outcome to the intent of the regulation by reducing settlement efficiency.

The key recommendation of ICMA's members is that the first-leg of all SFTs be exempted from mandatory buy-ins on the grounds that it is the inappropriate remedy, and would affect the smooth and orderly functioning of the repo market (with reference to Article 6.4(a) of CSDR).

If it is felt that the limitations of the Level 1 text do not allow for a blanket exemption of the first-leg of all SFTs, then ICMA recommends that:

- (i) The RTS reflect the possibility for deferral of a buy-in (with reference to Article 7.7 of CSDR), which, in keeping with Article 6.4(b), would require a longer exemption period for SFTs.
- (ii) In line with the recommendations in the responses to Q7 and Q8, all fixed income securities underlying an SFT be afforded the maximum possible extension and buy-in timeframe periods.

These recommendations are elaborated on below.

2) Partial exemption of SFTs

Providing exemptions for the first-leg of short-term SFTs on the purely practical basis of the time mandated to complete the buy-in (extension period plus buy-in timeframe) being longer than the term of the SFT introduces an additional and unnecessary level of complexity which will result in the bifurcation of the SFT markets based on term, creating very different demand and supply skews depending on the fixed term of the SFT.

The repo and securities lending markets play a vital role in supporting both market liquidity and settlement efficiency. They allow market-makers to make offers to investors in securities that they do not necessarily hold on their books (but can then subsequently buy), and they are a means to hedge settlement risk or to ensure the settlement of trades in the event of a fail (thus remedying fails-chains).

If SFT markets are impaired, this will have very direct negative consequences both for secondary market liquidity and settlement efficiency.

Many lenders of securities, such as institutional investors, agency lenders, or corporates, do so for incremental returns. Similarly, intermediary bank repo and securities lending desks provide liquidity to the financing markets for relatively small margins. Essentially, the SFT market is high volume, low margin, low-risk. Accordingly, lenders and intermediaries are extremely sensitive to any increases in their costs. As ESMA will be aware, buy-ins can result in significant costs to the counterparty being bought in. From the perspective of a lender or SFT intermediary, the potential cost of a buy-in, even if afforded very low probability, will far outweigh any potential income from engaging in SFT activity. It is therefore reasonable to assume that lenders will no longer be incentivized to lend securities where there is even the remotest possibility of being bought-in. In other words, lenders will no longer lend securities for fixed terms that would be considered in-scope of buy-ins under CSDR. Meanwhile, intermediaries for SFTs (such as repo desks) will need to adjust their prices if they are to continue lending securities for fixed terms that are in-scope of buy-ins (the impact of this is illustrated later in this response).

3) Bifurcation of the repo market

As ESMA will be aware, fixed-term SFTs are common in the €5.8 trillion European repo market, with only 7% of repos transacted on an open basis. Around 45% of the outstanding market is termed for over a week, and more than 20% is termed for more than a month².

The introduction of mandatory buy-ins as proposed will have a significant impact on reshaping the repo market, driving participants to very shorter-dated and open SFTs, while crushing liquidity in the term market.

It would be interesting to hear whether ESMA and the European Commission had considered this impact in light of the Basel III Net Stable Funding Ratio, which seeks to reduce financial institutions' reliance on short-term funding and to encourage the use of longer term sources of finance (such as term repos).

4) Open and callable SFTs

It should be made clear in the RTS that the first-leg of open-ended SFTs should be exempt from mandatory buy-ins with reference to Article 7.4(b) in the Level 1 text. 'Open' SFTs, which have no specified second-leg, can be closed by either counterparty to the transaction (borrower or lender of securities), usually with one day's notice (or maximum two days' notice). The same applies to 'callable' SFTs, which are normally traded as fixed term SFTs (with a specified second-leg), but both counterparties have the right to close the transaction early, with one, or possibly two days' notice. In the event of a failing first-leg it is highly unlikely that these types of transactions would not be closed by the failing counterparty before the end of the relevant extension period.

² The term profile, size, and other data related to the European repo market can be found in the semi-annual [ICMA European Repo Market Survey](#).

It is not clear from Article 14.3 of the draft RTS whether the dynamic of open (or callable) SFTs and the logic of exempting their first-legs is fully grasped.

5) Analysis: impact of mandatory buy-ins on the European repo market

The ICMA CSDR Mandatory Buy-ins Impact Study, which is discussed in the response to Q7, and which will be provided to ESMA separately, illustrates the detrimental impact on term repo market prices of introducing the mandatory buy-in regime. Given, that virtually all the underlying bonds of the repo market would be considered liquid under the MiFID II/R post-trade transparency liquidity calibrations (see responses to Q7 and Q8), around 45% of the current European repo market would be in-scope of mandatory buy-ins.

However, this impact could be greatly reduced while still complying with the Level 1 text of CSDR. If all fixed income securities are to be afforded the maximum extension period in keeping with Article 7.4(a) of CSDR (see responses to Q7 and Q8), and Article 7.4(b) of CSDR is interpreted to include both the buy-in timeframe (as per Article 13.1 of the draft RTS) and the possibility for deferral (as per Article 11.7 of the draft RTS), then this would effectively take the exemption threshold for SFTs to 21 business days. This would equate to more-or-less one calendar month as the exemption threshold for SFTs, and so reduce the size of the impacted market from 45% (as per the draft RTS) to a little over 20%. In terms of ICMA's cost analysis of mandatory buy-ins, applying a 7 day extension period to all fixed income securities, and so a 21 day exemption threshold for SFTs, could reduce the cost of the regulation to repo market users by at least €2 billion per annum (based on current market size and structure).

6) Complications of managing buy-ins for SFTs

The current RTS provide that the first-leg of an SFT will be in-scope of mandatory buy-ins depending on the term of the SFT, which in turn is contingent on the liquidity calibration of the underlying security (as defined by MiFID II/R). This will require the initiator of the buy-in (be it the CSD, CCP, trading venue, or receiving participant) to be able to identify:

- (i) Whether the trade is an SFT
- (ii) Whether the fail relates to the first-leg or the second-leg of the SFT
- (iii) The term of the SFT (this also requires being able to identify open or callable SFTs, which will need to be exempt)
- (iv) The appropriate liquidity calibration of the underlying security

Currently CSDs are unable to do this, and this will require some major investment, as well as a market-wide change in trade matching and confirmation practices, to ensure that this can be successfully implemented. It should also be noted that Target2-Securites would not support in this since it does not provide for SFT identification. A repo specific message to feed CSDs is recommended in order for them to differentiate between outright transactions and SFTs, and so identify and segregate ineligible buy-ins. This will also allow market practices to develop to standardize upstream matching and confirmation processes. Additionally, a suite of buy-in messages should be developed to provide statuses of impacted trades and identify inventory. These could be introduced into a new or existing ISO standard (SWIFT and

other messaging communities can use these for adoption regionally) with a view to broader market adoption as a global standard. This is on the basis that inventory flows are extraterritorial and it will be necessary to harmonize market practice and inventory to identify impact transaction types and message statuses.

A further complication of partial exemption of SFTs will relate to the netting processes of CCPs. CCPs will be required to differentiate between SFTs that are subject to mandatory buy-ins and those that are exempt, and apply different netting treatments. This will also serve to reduce the netting efficiency of the CCP.

7) Existing contractual frameworks for SFTs

As ESMA will be aware, the vast majority of SFTs transacted in the European markets (and beyond) are under the legal framework of either the Global Master Repurchase Agreement (GMRA) or the Global Master Securities Lending Agreement (GMSLA). Both contracts provide legal remedies for counterparties to an SFT where the settlement of securities fails (known as a 'mini close-out'). In the case of the second-leg of the SFT failing, the disappointed counterparty has the right to cancel the second-leg, to pass-on to the failing counterparties any associated costs with replacing (or selling) the underlying securities. This is in effect the same as exercising a buy-in (or sell-out). In the case of a failing first-leg, the disappointed counterparty has the right to cancel the trade and to claim any due interest up to the point of cancellation had the trade settled. The disappointed counterparty, however, does not have the right to issue the equivalent of a buy-in (or sell-out) since this would be the wrong remedy to settle what is a loan of securities as opposed to an outright sale of securities. It would also disincentivize lending securities for the reasons previously outlined.

GMRA and GMSLA will need to be updated to reflect any change in the rights and obligations of counterparties in light of CSDR. As ESMA will be aware, these are bilateral contracts that exist between counterparties transacting in SFTs (large institutions may have tens of thousands of these in place). Furthermore, they are the governing framework for SFTs in over 50 jurisdictions, most of which are outside of the EEA. If mandatory buy-ins under CSDR is to be implemented with respect to SFTs, this will require significant legal work to update the provisions of the agreements, which will most likely take three-to-five years, if not longer. (See also response to Q14.)

8) The RTS for in-scope SFTs

The Consultation Paper provides a very confusing example of where SFTs would be out of scope (Paragraph 100) related to Article 14 in the draft RTS. It does not help that there is an apparent error in example 2 which is described as a '9 day-repo on a liquid share' followed by an illustration of an 8-day repo.

The inference from Article 14 of the RTS and paragraph 100 of the Consultation Paper is that the first-leg of an SFT would be exempted where the second-leg of the SFT falls before the appropriate extension period (as defined in Article 13) plus the appropriate timeframe of the buy-in (as defined in Article 12 of the RTS). Based on the current RTS, this would suggest that the maximum fixed term of an SFT that

would be deemed out of scope would be 8 business days where the underlying security is deemed 'liquid' and 14 business days where the underlying security is deemed 'illiquid'. However, this does not allow for the possibility to defer the buy-in in the event that it is unsuccessful or only partially successful (as specified in Article 11.8 of the RTS). For consistency with the provisions for buy-ins related to outright sales, in particular where an SFT and an outright sale may be interdependent trades (i.e. part of a chain), it is necessary to include the possibility for deferral when considering whether the second-leg of an SFT would render a buy-in ineffective. Therefore, applying the RTS as drafted, the maximum fixed term of an SFT that would be deemed out of scope has to be 12 business days where the underlying security is deemed 'liquid' and 21 business days where the underlying security is deemed 'illiquid' (i.e. the extension period plus the timeframe plus the allowance of another timeframe in the event of deferral). It would be helpful if this was clarified in the final RTS (see also point 5 above).

Furthermore, while it is largely implied, it may also be helpful for ESMA to clarify in the RTS that the appropriate extension periods and timeframes (including deferrals) that apply to SFTs are the same as those that would apply to the underlying security in the case of outright transactions. This is to ensure that there is consistency in the event of interdependent transactions (chains) and to avoid multiple buy-ins related to a single fail.

9) Recommendations

ICMA and its members well understand the limitations and inflexibility of the Level 1 text that put SFTs in scope of mandatory buy-ins. From the perspective of the RTS, it is strongly recommended that the provisions for buy-ins for SFTs, including extension periods and timeframes, are consistent with those applied to the underlying security for outright trades. This, at least, will help ensure consistency in unravelling fails-chains and avoiding multiple buy-ins. Similarly, ESMA may also wish to think about the provisions for deferring a buy-in as this relates to the term of an in-scope SFT, again, particularly where the SFT is part of a chain. This necessitates that the term of an SFT that is to be considered in-scope of mandatory buy-ins also allow for the possibility of deferral of the buy-in.

However, the primary concern of ICMA and its members relates more to the market impact of imposing mandatory buy-ins on the first-leg of SFTs, as well as to the operational and legal complexity of its implementation. As argued above, the implementation of mandatory buy-ins for SFTs will damage both funding and bond markets while providing no discernable contribution to improving settlement efficiency, and quite possibly having the counterproductive effect of worsening it. Accordingly, the longstanding recommendation of ICMA's members that a buy-in on the first-leg of any SFT should be considered 'ineffective' still holds.

b) Other types of operations that could render a buy-in ineffective

ICMA agrees that there are a number of circumstances where a buy-in may be possible, but would be the inappropriate remedy. This could include: (i) collateral movements/margining; (ii) transfers of

securities between different accounts of the same underlying client; (iii) allocation of securities across different funds; (iv) settlement as the result of a corporate action.

Triparty

A further consideration relates to triparty repo, which is notably unaddressed in both the Level 1 text and the draft RTS. As ESMA will be aware, the triparty product (such as that provided by Euroclear Bank, Clearstream Frankfurt, Clearstream International, among many others) is substantially different to standard DVP transactions, with the triparty agent providing collateral management, daily mark-to-market on the underlying securities, and automatic return of securities at the end of the trade. Subjecting these types of operations to the possibility of mandatory buy-ins would only serve to undermine the efficiency of triparty management and settlement. ESMA should clarify in the RTS that triparty transactions are not subject to mandatory buy-ins.

Where a buy-in is not possible

There are also circumstances where a buy-in may not be possible. This could include where a security no longer exists, such as following redemption (whether on maturity or if called), or where it is converted into another security. With this in mind, securities close to redemption, call dates, or conversion/exercise dates should be excluded.

Further scenarios where a buy-in may not be possible relate to where liquidity is severely limited. This could be due to: (i) concentrated holdings of securities restricting supply (including central bank or sovereign wealth fund holdings); (ii) temporary demand-supply imbalances (possibly due to futures deliveries or index composition changes); or (iii) movement of securities being blocked (possibly due to corporate actions or sanctions).

Finally, where a transaction is failing due to a failing interdependent trade on a non-EU CSD (and so out of scope of CSDR), it will not be possible to initiate or pass-on a buy-in against the counterparty delivering on the non-EU CSD.

Recommendation

ICMA believes that detailing an exhaustive list in the RTS of such potential circumstances where a buy-in is neither appropriate nor possible is not advisable, and may inadvertently exclude unforeseen circumstances. ICMA feels that rather it would be pertinent to acknowledge in the RTS that such circumstances can and will exist, and that the decision that a buy-in would be inappropriate or not possible should be left to the discretion of the involved trading level counterparties. Where an operation is determined to render a buy-in ineffective, the relevant participants should inform the CSD of their reason for not initiating a buy-in (see response to Q7).

Recommended enhancements for the RTS

Article 14

1. The following operations shall be deemed an operation composed of several transactions:

(a) Operations whereby a first counterparty sells financial instruments against cash to another counterparty with the commitment of that counterparty to sell the same quantity of those financial instruments to the first counterparty for a price that is determined or determinable;

(b) Operations whereby a first counterparty lends financial instruments, against collateral or not, to another counterparty with the commitment of that counterparty to return the same quantity of those financial instruments to the first counterparty, against the collateral when it has received it.

2. Where an operation is composed of several transactions, the buy-in shall be ineffective when the intended settlement date of the second transaction of the operation is set before or on the date when the delivery the financial instruments following the buy-in process for the first leg of the operation would be expected to take place. In allowing for the delivery of the financial instruments following the buy-in process, the relevant extension period and timeframe to deliver the financial instruments should be taken into consideration, as well as the possibility of a deferral of the buy-in.

3. ~~Paragraph 2 shall not apply where no intended settlement date is set for the second transaction of the operation or where the fail relates to the second transaction of the operation.~~
Where there is no intended settlement date of the second transaction of the operation, the buy-in shall be considered ineffective.

Q10: What are your views on the proposed draft RTS related to the calculation of the cash compensation?

ICMA's members, in principle, agree that there should be the possibility for a cash compensation remedy in the case where a buy-in is unsuccessfully executed, or only partially executed. However, feedback from members suggests that while there is a need to achieve certainty in terms of resolving a fail, this also needs to be balanced with the rights of the purchasing (disappointed) counterparty who wants to retain the right to the economic exposure of the original purchase and so may wish to defer the buy-in at their discretion. The provision for the disappointed counterparty, at their discretion, to defer the buy-in for one more attempt may be seen as an acceptable compromise in this respect, although some investors may feel that cash compensation as a mandatory remedy could unfairly disadvantage them.

Perhaps the most difficult aspect of providing for cash compensations is agreeing the appropriate reference price. While Article 15 of the draft RTS attempts to offer possible solutions for a range of circumstances, ICMA feels that it is not comprehensive or robust enough, and needs to address a number of potential issues:

- 1) The fact that a buy-in is not possible (or fails) suggests that there is not a 'deliverable' price (i.e. a price for 'guaranteed delivery') as opposed to an 'executable' price (i.e. a price that may exist on an ATS or with a broker, but does not guarantee delivery). Guaranteed delivery prices are generally at a premium to standard market prices, and this may not be reflected in the cash compensation if a non-guaranteed delivery price is used as the reference price. In other words, where a buy-in is unsuccessful, cash compensation is likely to be referenced to a much lower price than where a buy-in would be possible.
- 2) Using the closing price of the previous day, in many cases, will not be appropriate. Firstly, the closing price will not necessarily be a 'deliverable' price, but also it does not take account of the fact that the market may have moved since the previous day's close.
- 3) The use of a dealer poll, where a number of market-makers provide indicative prices for guaranteed delivery, which are then averaged, is one possible solution. However, this is potentially time consuming for the buy-in agent, and still only provides a theoretical as opposed to a deliverable reference price.
- 4) The fact that a buy-in cannot be successfully executed, or fails, suggests that a buy-in may not be possible. This could be due to circumstances discussed in the response to Q9, and could therefore be where a buy-in should be rendered ineffective, rather than being remedied through cash compensation.
- 5) The RTS needs to specify what should happen in the event where securities are bought-in, but the settlement of the buy-in subsequently fails. Should the buy-in transaction be cancelled? Or should the counterparty failing into the buy-in now be subject to settlement discipline measures, including cash penalties and mandatory buy-ins? ICMA would recommend the former, but this should be specified in the RTS. (This point is also discussed in the response to Q7.)

- 6) It is very likely that the mandatory implementation of cash settlement, which will be mainly employed in the case of the least liquid securities (otherwise it is assumed that a buy-in would have been possible), will lead to a number of disputes. This could be driven either by the failing counterparty who may feel that the reference price is much higher than fair market value of the securities, or by the disappointed counterparty, who may feel that the reference price is too low and not representative of the fair guaranteed delivery price of the securities. As recommended in the response to Q7, ICMA believes that ESMA should outline a centralized buy-in disputes mechanism to hear and resolve such disputes as they arise, including those related to cash settlement.

Finally, but very importantly, ICMA takes objection to Article 15(b), which specifies that cash compensation should only be paid where the reference price is higher than the original transacted price. This is deeply flawed and seems to reflect the weakness of the whole mandatory buy-in RTS in that there is no definition of what a buy-in is, or its role in remedying a contractual breach between counterparties. Under ICMA Secondary Market Rules and Recommendations, the purpose of a buy-in is to restore both counterparties in a financial transaction to the economic position they would have been in had the transaction settled on the intended settlement date. It is not intended to penalize the failing counterparty or to compensate the disappointed counterparty. Therefore, in the buy-in process, the difference between the buy-in price and the original trade price is passed from the failing counterparty to the disappointed counterparty in the case where the former is higher than the latter, and is passed from the disappointed counterparty to the failing counterparty in the event that the buy-in price is lower. (See also the response to Q7 where this is explained in more detail, as well as highlighting the potential for arbitrage or market abuse if the proposed approach of CSDR is applied). This same logic should be applied to the RTS for cash compensation.

Recommended enhancements to the RTS

Article 15(d)

(d) Where under point (a) to (c) the price of the settlement instruction is equal or higher than the price determined by the buy-in agent or the pre-agreed price, the cash compensation shall be ~~not~~ paid by the receiving participant to the failing participant.

Q11: What are your views on the proposed draft RTS related to the conditions for a participant to consistently and systematically fail?

While ICMA and its members support all measures that are likely to have a beneficial impact on settlement efficiency, there are a number of concerns related to the ‘Conditions under which a participant is deemed to consistently and systematically fail’ (Article 16 in the draft RTS).

Clearing banks acting as settlement agent

Firstly, and as noted in paragraph 108 of the Consultation Paper, many of the larger participants act as clearing banks for their clients, and in such capacity the successful settlement of a transaction will often be beyond their control. ICMA would argue that inclusion of settlement efficiency rates of the client accounts (which in many cases will be omnibus accounts, rather than segregated client accounts) of clearing banks would therefore be highly misleading in identifying consistent and systemic fails, and could lead to undue penalization (and even suspension) of a clearing bank. In turn, this could lead to clearing banks holding back settlement instructions until it is certain that a client has sufficient securities or cash, which is likely to reduce settlement efficiency. In certain cases it is possible that clearing banks may turn away clients with low settlement efficiency performance, which will merely cause these clients to find alternate clearing banks rather than addressing the root problem.

ICMA therefore recommends that Article 16 include a provision that settlements on behalf of client accounts of agent banks be excluded when assessing the overall settlement efficiency of a participant.

Market-making and interdependent trades

ICMA is concerned that inclusion of settlement efficiency rates of participants related to market-making could have negative impacts for secondary-market liquidity. As ESMA will be aware, banks and broker-dealers that provide market-making services in securities are required to show two-way pricing to clients in securities that, in most cases, they do not hold in inventory. Where they are ‘lifted’ (and so short-sell securities), their ability to deliver the securities on the intended settlement date will be largely dependent on their ability to cover these securities for the same day, whether through an outright purchase or through a reverse repo or securities lending transaction, and for this covering trade to also settle. In the case of less liquid asset classes, or where securities are trading as ‘special’, providing a market-making service will result in lower than normal settlement efficiency rates, as sourcing securities to cover the sale may become more difficult, or will have a higher probability of failing.

Including settlement efficiency rates from market-making activity in the monitoring of consistent and systemic fails could have the detrimental impact of market-makers retrenching from providing offer-side liquidity in securities that they do not hold in inventory. As highlighted by an ICMA study, this will already be an unintended consequence of mandatory buy-ins (see response to Q7), and is likely to be compounded if fails related to market-making are included in the methodology outlined in Article 16 of the RTS.

ICMA therefore recommends that Article 16 include a provision that settlement fails related to market-making activity, at least in the case where the fail is due to an interdependent trade, be excluded from the methodology for calculating consistent and systemic fails.

The calculation

Another concern relates to the calculation, in particular the CSD reference rate (i.e. ‘the rate determined for the securities settlement system’), which will be used to determine whether a participant consistently and systemically fails. It is not clear how this reference rate will be determined, and whether it should relate to a specific efficiency target that ESMA may have in mind, or rather it is determined at the discretion of the individual CSD or the relevant NCA. Clearly, if this rate is arbitrarily set too high it could exaggerate the perception of systemic settlement risk, whereas if it is arbitrarily set too low it will no longer serve as an effective deterrent.

It might be useful if Article 16 of the draft RTS include a guideline of how this reference rate should be determined and by whom? It should also clarify whether it is subject to review, or even discontinuation, particularly during periods of unusual market stress.

Suspension

ICMA notes that Article 7.9 of CSDR provides for the suspension of participants that consistently and systemically fail with the involvement of the NCA and with the opportunity for the participant to ‘submit its observations’. ICMA agrees that this is appropriate, and would welcome RTS that provide for:

- (i) A ‘warning’ notification process for participants who are approaching the settlement efficiency threshold.
- (ii) A timeframe following breach of the settlement efficiency threshold in which the participant can provide evidence related to fails that were beyond its control, to be reviewed by the CSD and the relevant NCA.
- (iii) Assurance that the identity of the participant will not be made public until a decision to suspend the participant has been finalized by the CSD and the relevant NCA informed.

ICMA would like to stress the point that the suspension of a participant from a CSD will impair its ability to finance itself, effectively excluding it from access to the repo and funding markets. This will have implications for the participant’s creditors and counterparties which could pose systemic risks for the entire financial markets. Not only should suspension of a participant therefore be a last resort, but should not be undertaken without due consideration to the likely market and systemic impacts.

Furthermore, if the market is made aware of the possibility of a participant being suspended (due to public disclosure of a participant being close to or in potential breach of the settlement efficiency threshold) this could trigger a preemptive response by the participant’s counterparties and creditors which would have the same market and systemic impacts of an actual suspension. Thus the importance of confidentiality of information relating to participants that are deemed to consistently and systemically fail should be included in the RTS.

Q12: What are your views on the proposed draft RTS related to the settlement information for CCPs and trading venues?

ICMA questions the rationale of the CSD providing settlement information to trading venues in the case of non-cleared fixed income transactions. As explained in the response to Q7, for non-cleared transactions, the trading venue offers no added value in the implementation of settlement discipline (this can only be done effectively at the trading counterparty and CSD levels), and from this perspective Article 17 of the RTS offers no useful purpose.

ICMA strongly recommends that the wording of Article 17 be redrafted to specify that the information should only be provided to trading venues in the event that they request it.

Recommended enhancements to the RTS

Article 17.1

1. The CSD shall provide to ~~each of~~ the relevant CCP and, if requested, the relevant trading venue, the information that relates to the status of the failed settlement of the transactions included in the list of instructions that the CCP or the trading venue sent for settlement to the CSD. The information shall include:

Anti-avoidance rules

Q13: What are your views on the proposed draft RTS related to anti-avoidance rules for cash penalties and buy-in?

ICMA agrees that standardized and consistent mechanisms for both cash penalties and mandatory buy-ins be applied across the whole market where in scope of CSDR Level 1. However, it is important to consider the differences in business models and market structure relating to different security or transaction types, including cleared and non-cleared trades, and equity and fixed income products. ICMA therefore recommends that an overly granular and prescriptive approach to 'one-size-fits-all' mechanisms for both buy-ins and cash penalties be avoided due to the risk of such an approach being counterproductive to the intent of the regulation.

Phase-in for Settlement Discipline

Q14: Do you agree that 18 months would be an appropriate timeframe for the implementation of the settlement discipline regime under CSDR? If not, what would be an appropriate timeframe in your opinion? Please provide concrete data and evidence justifying a phase-in for the settlement discipline measures and supporting your proposals.

ICMA welcomes the fact that ESMA recognizes the imperative of an extended timeframe for the implementation and phasing-in of settlement discipline if it is to stand any chance of being effective. However, given the significant market-wide investment and operational and technological development that settlement discipline requires, particularly in parallel with the ongoing roll-out of Target2-Securities (T2S), ICMA is concerned that even 18 months may be inadequate.

ICMA sees 5 key stages in the successful implementation of settlement discipline, some of which are largely contingent on each other.

1) Target2-Securities

T2S, as a centralized settlement platform for most of Europe's CSDs, is likely to be the most effective and cost-efficient common infrastructure to support harmonized settlement discipline mechanisms. Furthermore, T2S is likely to have an even greater positive impact on settlement efficiency than CSDR. ICMA would therefore suggest that the successful implementation of T2S should be an overarching priority from a settlement efficiency perspective, and should precede the implementation of CSDR settlement discipline. ICMA accordingly recommends that Article 20 of the RTS be revised to specify that the successful implementation of T2S (including suitable time for testing) be the determinant for the implementation of CSDR settlement discipline.

2) CSD and participant operational and technological development

In order to support effective and efficient mechanisms for both cash penalties and mandatory buy-ins, this will require significant investment and operational and technological development, in particular by

the CSDs but also by participants. Both cash penalty and mandatory buy-in mechanisms will be reliant on highly automated processes and real-time messaging linking participants (both sell-side and buy-side) and CSDs across the entire market. The necessary systems and processes that need to be developed to support this will also need to be rigorously tested. While CSDs, CCPs, and participants should begin to specify the required builds and necessary investment even before the RTS are published in the Official Journal, and with operational requirements being developed in parallel to the roll-out of T2S, it would be optimistic at best to assume that the market will be in a position to be fully compliant with the regulation before the full implementation of T2S.

ICMA would also cite the CSDR Impact Survey conducted by AFME, and referenced in their response to this consultation. The survey reveals that 54% of market respondents (CSD participants) require an estimated timeframe of between 18 months and 3 years to implement in-house solutions in order to be compliant with the regulation as outlined in the draft RTS.

3) Calibrating the cash penalty mechanism

As discussed in the response to Q3 of the Consultation Paper on Technical Advice to be provided to the EC, given the relative simplicity of the proposed cash penalty mechanism, it would seem likely that a period of review after implementation will be required to establish the appropriate penalty rate calibrations to optimize the impact on settlement efficiency.

It is further explained in the response to Q3 of the CP on Technical Advice that for a meaningful review and successful re-calibration of the penalty mechanism, other, less predictable, impacts on settlement efficiency will need to be excluded. It would therefore seem logical that the cash penalty mechanism be implemented at least a full 18 months before mandatory buy-ins, allowing sufficient time to optimize the mechanism without the distortive (and possibly counterproductive) impacts that mandatory buy-ins will produce.

4) Legal work

Given the changes to existing rules and remedies that exist across the European markets for settlement fails that CSDR will necessitate, in many cases this may require the updating or redrafting of existing contractual agreements. Such contracts could be between participants and CSDs, CCPs, and trading venues, as well bilateral contracts between counterparties. The scale of this requirement should be assessed, and enough time allowed to ensure that contracts underpinning the European capital markets are compliant with the regulation. As noted in the response to Q7, bringing the first-leg of SFTs into scope of a buy-in will require the updating of many hundreds of thousands of bilaterally negotiated GMRA and GMSLA contracts. Based on previous updates to these contracts, this is likely to take a minimum of three years to complete, and, most probably, much longer.

5) Impact assessment of mandatory buy-ins

As highlighted in the responses to Q7 and Q9, with reference to the ICMA CSDR Mandatory Buy-in Impact Study (February 2015), the introduction of mandatory buy-ins will have a significant and detrimental impact on European secondary bond and repo market pricing and liquidity. Apart from increasing costs and risks to investors and market users, this is also likely to have a negative impact on settlement efficiency. ICMA believes that in the interests of both efficient and liquid capital markets, and settlement risk and efficiency, the EC needs to conduct a full and rigorous impact assessment of introducing mandatory buy-ins, including a detailed cost-benefit analysis. This study should be conducted in full consultation with market users, including market-makers, investors, and issuers, and the results should be publicly disclosed. Only if the Commission is confident that mandatory buy-ins will provide a useful and cost-effective contribution to settlement efficiency, should the regulation be implemented (in sequence with the above stages). On the other hand, there may be a case for the Commission and the Parliament revisiting the Level 1 legislation.

Thus the recommended sequence for the successful and effective implementation of CSDR mandatory buy-ins should be:

- (i) The successful roll-out and projected migration to T2S, including a suitable testing period (in parallel with the necessary operational and legal work required by participants to ensure compliance with the regulation)
- (ii) The introduction of a cash penalty mechanism
- (iii) The review, recalibration, and further review of the cash penalty mechanism (minimum 18 months)
- (iv) The introduction of mandatory buy-ins (based on a thorough impact assessment)

Consultation Paper on Technical Advice

Cash Penalties

Q1: What are your views on the proposed basis for the cash penalty calculation?

ICMA agrees that penalties should be charged with respect to an appropriate reference price for the underlying security, regardless of the price used in the individual failing transaction. This will ensure consistency across the market and CSDs, and will provide fairness in the case of interdependent transactions (chains) where counterparties in the middle of such chains would otherwise be exposed to a possible mismatch between the penalty charged and the redistribution received.

However, to ensure this level of consistency and fairness, the appropriate reference price will need to conform to the following criteria:

- (i) Reference prices will need to be available for all financial securities that fall into scope of the mechanism (note that many of these will not be securities issued within the EU).
- (ii) It will need to be the same reference price for all in-scope CSDs conforming to the penalty mechanism, and should therefore be determined and communicated centrally.
- (iii) It should be adjusted daily to reflect market movements.
- (iv) It should represent an accurate and fair market price. It should be noted that this may prove difficult in the case of less liquid securities that are seldom quoted on a trading venue, or which do not trade on a daily basis. A means of establishing a fair price for such securities will need to be established to avoid disputes.

It may be necessary for ESMA, or another delegated independent body, to take responsibility for publishing a daily list of all in-scope securities as well as the appropriate reference price to be applied by all in-scope CSDs.

ICMA also agrees that where the disappointed receiving counterparty does not accept a partial delivery from the failing counterparty, the penalty should only apply to the missing financial instruments or the missing part of the cash.

Q2: What are your views on the proposed approach regarding the categories of financial instruments and the penalty rates? In particular, do you consider that these penalty rates could dis-incentivise trading in small caps? Please provide evidence to support your views.

ICMA appreciates that in drafting the proposed approach regarding categories of financial instruments and the penalty rates, ESMA needed to consider a simple, easily implementable, cost effective approach, while balancing the sufficient incentives and deterrents to cure fails. From this perspective, it is very difficult to design a mechanism that will be appropriate for every security under every market condition.

Categories of financial instruments and penalty rates

ICMA's members are largely agnostic both to the proposed categories of instrument and penalty rates, at least from the perspective of fixed income securities. It is broadly felt that until the mechanism is implemented, it is difficult to assess what the impact could be on settlement efficiency, or for any potential increases in market-making spreads that may need to be passed on to investors. It has been noted by some members that if the rates are set too low, then this may have no impact on improving settlement efficiency. Conversely, if they are set too high, this could have a negative impact on liquidity in the securities lending and repo markets, which could have a detrimental impact not only for market liquidity and pricing for certain securities or asset classes, but could also reduce settlement efficiency (this point is discussed in more detail in the following section). Therefore, the general view of ICMA members is that there may need to be a period of review and impact assessment after the introduction of the penalty mechanism that could result in the revision of the applied penalty rates, and possibly a broadening of the categories of instrument (this is discussed more in the response to Q3).

Securities lending

An important consideration in building a penalty mechanism is the likely impact on the securities lending market. AS ESMA will be aware, institutional lenders of financial securities, either lending directly or via their custodian banks or agency lenders, play an important role in enhancing settlement efficiency, primarily by facilitating the short covering of market-maker sales, or allowing counterparties in chains of interconnected transaction fails to 'break the chain' and cure the fail. A key component of the overall efforts to improve settlement efficiency will be the need to support and encourage a conducive market environment for securities lending (including repo) by holders of securities.

These lenders generally provide securities to the market for relatively small spreads (often less than 10bps annualized in the case of 'easy' or 'general collateral' securities), which in turn, across a portfolio of securities will only add a small incremental enhancement to their returns. Given the relatively low risks and administration costs associated with securities lending, many holders of securities therefore elect to lend, but this is, relative to their general investment business, a marginal decision.

Cash penalties will create an additional risk to the lending of securities. Even where the probability of failing on the first-leg of a lending transaction is relatively small, if the penalty rate is considered too high, even the most negligible possibility of a one-day fail (say due to an administrative error), could

render the transaction uneconomically viable. For example, consider the case of a lender of an 'easy' liquid stock for 10bps, who runs the risk of failing for one day and being charged with an equivalent fine of 360bps. This risk-to-cost consideration may mean that a significant number of lenders reconsider their willingness to lend securities, which in turn could be counterproductive in terms of achieving the objective of improved settlement efficiency. ICMA notes that this point is highlighted and discussed in more detail the ISLA response, and would support many of the concerns outlined by their members.

Therefore, in setting the appropriate cash penalty rates, ESMA will not only need to balance the appropriate incentives to cure fails and provide deterrents to failing, but in turn will need to ensure that the securities lending market is not severely impaired.

Q3: What are your views on the proposed approach regarding the increase and reduction of the basic penalty amount?

ICMA appreciates ESMA's approach to calibrating a penalty rate that is consistent with, and possibly higher, than the cost of borrowing the failed financial instrument. However, as ESMA notes in the Consultation Paper, the financing rates for financial instruments are not only security specific (rather than asset specific), but are also dynamic and therefore unpredictable. As discussed, the impact on securities lending also needs to be considered in this context.

Given the need for a simple, security-type based, relatively static model, it is inevitable that there will be security specific situations where the applied penalty rate will be less than the market repo or lending rate, thereby providing a perverse incentive to fail. In evaluating the overall calibration of the mechanism, it will be important for ESMA to identify and monitor such incidents. Similarly, it will be important to monitor the impact of cash penalties on the securities lending market, and where this may be detrimental to the supply of certain securities or asset types. This would warrant the case for a periodic review of the applied rates (and possibly categories of instruments) and a possible recalibration of the model to improve the overall impact on settlement efficiency.

ICMA would certainly advocate a review of the penalty rates before the first twelve months of the implementation of cash penalties. To assess better the impact of rates, and to exclude other, less predictable influences on settlement discipline or securities lending and repo liquidity, ICMA would further recommend that during this first review period mandatory buy-ins not be implemented. This would allow for the development and calibration of an effective cash penalty system without the additional market stresses and liquidity impacts of a mandatory buy-in regime (see response to Q7 in the Consultation Paper on Technical Standards).

Q4: What are your views on the proposed approach regarding the cash penalties in the context of chains of interdependent transactions?

ICMA fully agrees with the principle that in the case of interconnected transactions the amount of the penalty charged should be equal to the amount redistributed. To do otherwise would subject counterparties in the middle of a chain to the risk of being charged and credited different amounts, despite being effectively 'flat'.

As discussed in the response to Q1, this will require a harmonized and consistent approach to establishing daily reference prices as the basis for the penalties to be applied across all CSDs.