

ESMA'S QUESTION & ANSWER (Q&A) TOOL

QUESTION SUBMISSION FORM

| IDENTIFICATION | |
|--|---|
| 1. | <i>Name of entity</i> |
| International Capital Market Association (ICMA) | |
| 2. | <i>Country of incorporation / Residence</i> |
| « Other - please specify below » | |
| Switzerland | |
| 3. | <i>E-mail address / Other contact details</i> |
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| 4. | <i>Sector</i> |
| « Other » | |
| LEGISLATIVE REFERENCE | |
| 5. | <i>Level 1</i> |
| « Central Securities Depositories Regulation (CSDR) Regulation (EU) No 909/2014 » | |
| 6. | <i>Article/s of Level 1 Legislative Act</i> |
| Article 7 | |
| 7. | <i>Other relevant Act/s or Guidance</i> |
| Central Securities Depositories Regulation (CSDR) Regulation (EU) No 909/2014: Recital 19 Delegated Regulation (EU) 2018/1229 supplementing Regulation (EU) No 909/2014: Recital 34 | |
| QUESTION | |
| 8. | <i>Subject matter</i> |
| A contractual buy-in pass-on mechanism for trading parties in a settlement chain, which satisfies the objectives of the buy-in regime and avoids market disruption by limiting the number of buy-ins required to resolve settlement fails in the same security. | |
| 9. | <i>Question</i> |
| In the case of transactions not cleared by a CCP, where a receiving trading party does not receive the relevant financial instruments on the intended settlement date, it may as a result be unable to settle its own onward ('linked' or 'contingent') delivery of the same securities (a "settlement chain") | |
| Where a settlement chain exists, can a trading party (or parties) discharge its (or their) own obligation to initiate a buy-in by passing on the relevant buy-in notice to its failing trading counterparty? | |

10. *Proposed answer*

Yes. Where a settlement fail results in the failure of a 'linked' onward delivery of the same securities, the most efficient and secure method of achieving the objective of the buy-in rules (to preserve the economic position of the parties by the compulsory enforcement of the original agreement¹) is a 'pass-on' mechanism under which trading counterparties in a settlement chain are able to pass on the buy-in notification (typically received from the final receiving party in the chain) until it reaches the original failing party, rather than requiring multiple buy-ins in respect of the same security throughout the chain.

Such a coordinated approach among the parties is supported by Recital 34 of the Settlement Discipline RTS which provides that "*parties involved in the buy-in process could also limit the number of buy-ins by coordinating their actions amongst themselves, and informing the CSD thereof, where a transaction is part of a chain of transactions and may result in different settlement instructions*".

11. *Relevant background*

This mechanism, described in more detail below and represented by the table and diagrams in the Annex to this document, achieves the objective of the buy-in rules in a manner which preserves market stability and avoids unnecessary volatility. This assumes that the linked transactions are all for the same intended settlement date (ISD).

Pass-on mechanism in detail

Where a trading party has a failing inward receipt of in-scope securities and a contingent ('linked') onward delivery of the same securities, a potential pass-on situation exists. The trading party will need to confirm that both of the linked transactions are within scope of the mandatory buy-in obligation. Where the intended settlement date for both receipt and onward delivery is the same, the trading party can satisfy its buy-in obligations by notifying both its failing delivering counterparty and its onward receiving counterparty that a pass-on chain exists. It should do this at (or before) the end of the extension period related to the failing receipt. In this way, a pass-on chain is created.

For a pass-on chain to exist, the linked receipts and deliveries must be for the same security (ISIN). The trade sizes or nominal amounts may be different, in which case each pass-on would apply to the smaller amount of the linked transactions.

Where these requirements are met, the responsibility to appoint a buy-in agent at the end of the relevant extension period will move to the onward receiving counterparty.

In a chain situation, the final receiving trading party will be responsible for appointing the buy-in agent. They will identify themselves as the final receiving party in the chain as they will not have a linked onward delivery that would be considered in scope of the buy-in obligation.

¹ Recital 15 of CSDR

The buy-in process will be the equivalent of that outlined in Articles 28, 29, 30, and 31 of the Delegated Regulation (EU) 2018/1229, with each party in the pass-on chain responsible for passing the relevant information between their respective receiving and delivering parties.

On successful settlement of the buy-in (or any part of the buy-in), the receiving trading party responsible for appointing the buy-in agent should notify its failing counterparty that the buy-in (or part of it) has settled. The trading parties should then settle between themselves any difference in the value of the buy-in execution and value of their original transaction, including any associated costs related to the buy-in (as per Articles 34 and 35 of the Delegated Regulation (EU) 2018/1229).

This process of confirmation and settlement of the differential should be replicated along the chain, in each case calculating the difference to be paid between parties based on the buy-in execution price (plus any associated costs) and that of each respective original transaction in the chain.

Where the buy-in cannot be executed successfully within the appropriate timeline, the appointing party (the final receiving trading party in the chain), can elect whether to attempt the buy-in one more time (the 'deferral'), or to go to cash compensation (as per Article 38 of the Delegated Regulation (EU) 2018/1229).

Where the appointing party (the final receiving trading party in the chain) elects to defer the buy-in for one more attempt, they should notify their failing delivering trading party. Any trading party in a chain, on being informed of a deferral of the buy-in, should communicate, in writing, this information to their failing delivering trading party.

In the event of cash compensation, the appointing party (the final receiving trading party in the chain), should communicate, in writing, this information to the failing delivering trading party including the cash compensation market value.

The market value for calculating the cash compensation should be determined by the final receiving party in the chain (or the buy-in agent), as outlined in Article 32 of the Delegated Regulation (EU) 2018/1229. This market value should be used to settle the entire transaction chain, in the same way as a buy-in price.

To ensure the successful application of such a pass-on mechanism, all trading parties in the chain should document electronically their communication with their relevant counterparties for all stages of the buy-in/pass-on process. This creates an audit trail which can be used to evidence why a pass-on situation exists, that trading parties have met their regulatory obligations, and hence why a buy-in may not have been initiated by every single trading party in a transaction chain.

Buy-ins and market volatility

The settlement of onward outright sales in non-cleared markets is often contingent on the settlement of an outright purchase of the same securities. In active markets this can create entire chains of transactions with dependent inward and onward settlements.

Accordingly, a single settlement fail (at the start of the chain) can cause a sequence of settlement fails throughout the entire chain.

Buy-ins create additional risk, since they involve a new market transaction. Furthermore, they can be market distortive, since they are usually executed at an off-market price.²

In the case of transaction chains where a single failing settlement is the cause of multiple market fails, executing multiple buy-ins at the same time, could result in excessive market volatility in the underlying (as well as related) securities, compromising market efficiency and stability.

From a market efficiency and stability perspective, it is therefore undesirable to have multiple buy-ins being attempted in the same security at the same time.

Benefits of a pass-on mechanism

Pass-on mechanisms are an effective means to avoid this, by ensuring that only one buy-in is executed (usually by the final receiving trading party in a chain) to settle the entire transaction chain. In the same way that a buy-in (or 'cash compensation') is intended to restore the trading parties to a transaction to the economic position they would have been in had the original transaction settled on the intended settlement date, so a pass-on restores all trading parties in a transaction chain to the same position.

Existing pass-on mechanisms

Pass-on mechanisms are a well-established and broadly understood risk mitigation tool used in the OTC (non-cleared) securities markets in the case of multiple fails in the same security.

In terms of the flow of trading party responsibilities through the transaction chain, the incentive (or obligation) to initiate the buy-in process is passed from the purchasing party at the start of the chain to the final purchasing party. The buy-in notice (and subsequent buy-in confirmation, detailing the buy-in status and execution) is passed from the final receiving trading party (the purchaser) in the chain to the original failing delivering trading party (the seller) at the start.

The main advantage of the buy-in being executed at the end of a transaction chain is that (if successfully executed) it ensures that the final receiving trading party in the transaction chain receives their securities. If the buy-in is executed earlier in the chain, other onward deliveries or further fails along the chain could mean that the buy-in only settles part of the chain and the final receiving trading party is still left with a failing receipt. In the case of transaction chains with multiple intended settlement dates this also allows more time for the chain to settle naturally, before a buy-in is necessitated. Furthermore, it prevents contingent parties in the chain from making decisions, such as electing to extend the buy-in

² This is the result of the 'buy-in premia' for guaranteed delivery. Also, buy-ins are often a signalling mechanism of a 'distressed buyer' which can temporarily drive prices higher.

or going to cash compensation, that will be beyond the control (and potentially not in the interest) of the final receiving (purchasing) party.

Once the buy-in is executed, the initiating party (the final purchaser), via the buy-in confirmation, will pass the buy-in details on to their failing seller, who in turn will pass this on to their failing seller, and so on along the chain, with respect to each individual transaction, until the details reach the original seller. As the details are passed between parties, so they will cancel their original settlement instructions and instead settle between them the differential between the buy-in price (including any associated costs) and the original agreed trade price. Any final costs associated with the buy-in (primarily the buy-in premia - i.e. the difference between the buy-in price, or the cash compensation reference price, and the current market price for non-guaranteed delivery) are ultimately borne by the original delivering trading party (the seller). Everybody else in the chain, including the final receiving trading party, is restored economically to the position they would have been in had the original trade(s) settled.

Importantly, there does not need to be a holistic view of the entire settlement chain, and trading parties do not need to know where they are in the chain: trading parties merely need to know that they have a failing inward receipt and a dependent onward delivery to be able to pass-on any buy-in notice. Furthermore, pass-ons are not CSD-specific, and can be used to settle transaction chains that involve multiple CSDs, and, in theory, across different jurisdictions.

Recital 34 of the RTS states “parties involved in the buy-in process could also limit the number of buy-ins by coordinating their actions amongst themselves.... where a transaction is part of a chain of transactions.” The intention of the proposed pass-on mechanism is to fulfil this objective, in the interest of efficiency and stable markets.

In most respects, a pass-on is identical to a buy-in notification. The notable exception is that where there is the possibility to pass-on the buy-in (against a matching failing receipt of securities), there is no requirement to appoint additional buy-in agents, since this is effected at the end of chain by the final receiving party. In terms of the timing of the buy-in notifications, communications, possible deferral, and eventual settlement or cash compensation, this is fully aligned between the parties in the pass-on chain and determined by the final receiving party and the buy-in agent. Thus, in the case of CSDR, the buy-in process for the entire chain would be consistent with the timings and provisions of the regulation.

Annex

The roles of the trading counterparties

The below tables outline the roles and obligations of the various parties in the buy-in chain.

The arrows illustrate the direction of communications between trading parties in the transaction chain.



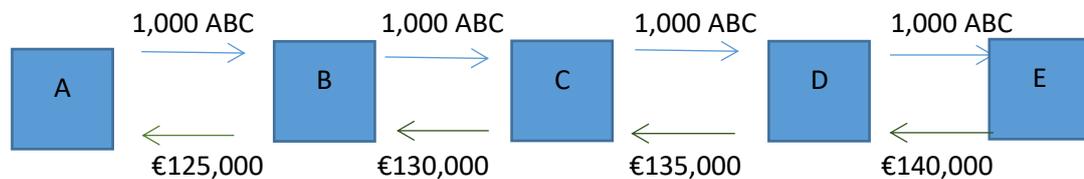
| Trading parties | | Identifying a pass-on situation and 'linking' the chain | Appointing the buy-in agent and passing-on the buy-in notice | Executing the buy-in | Settling the buy-in |
|-----------------|--|---|--|--|---|
| A | Original delivering trading party (seller) | | Receives pass-on notice | Receives confirmation of buy-in details (manages risk accordingly) | Settles buy-in differential with B |
| B | Intermediary trading party | At the end of the extension period for the trade with A, notifies A and C that a chain exists | Passes-on pass-on notice from C to A | Notifies A of buy-in details (buy-in confirmation) | Settles buy-in differentials with C and A |
| C | Intermediary trading party | Notifies B and D that a chain exists | Passes-on buy-in notice from D to B | Notifies B of buy-in details (buy-in confirmation) | Settles buy-in differentials with D and B |
| D | Final receiving trading party (buyer) | Appoints the buy-in agent | Appoints the buy-in agent and issues C with a buy-in notice | Notifies C of buy-in details (buy-in confirmation) | Settles buy-in differential with C |



Example of a pass-on (same ISD)

This scenario involves four transactions between five different counterparties in the same liquid equity:

- Transaction 1:
On Trade Date (TD) January 2 2019,³ Party B buys 1,000 of ABC stock from Party A at a price of 125, for intended settlement date (ISD) January 4 2019 (T+2)
- Transaction 2:
TD January 2 2019, Party B sells 1,000 of ABC stock to Party C at a price of 130, ISD January 4 2019 (T+2)
- Transaction 3:
TD January 2 2019, Party C sells 1,000 of ABC stock to Party D at a price of 135, ISD January 4 2019 (T+2)
- Transaction 4:
TD January 3 2019, Party D sells 1,000 of ABC stock to Party E at a price of 140, ISD January 7 2019 (T+2)



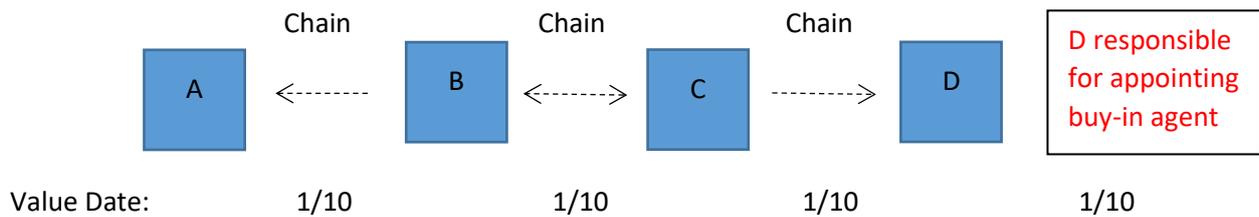
| | | | | |
|-------------|-------------|-------------|-------------|-------------|
| Trade Date: | 1/02 | 1/02 | 1/02 | 1/03 |
| ISD: | 1/04 | 1/04 | 1/04 | 1/07 |

Assume that A fails to deliver the 1,000 shares to B on ISD 1/04 and continues to fail. In turn this causes: B to fail its delivery of 1,000 shares to C (also on 1/04); C to fail its delivery of 1,000 shares to D (also on 1/04); and D to fail its delivery of 10,000 shares to E on 1/07.

Identifying a pass-on situation and 'linking' the chain

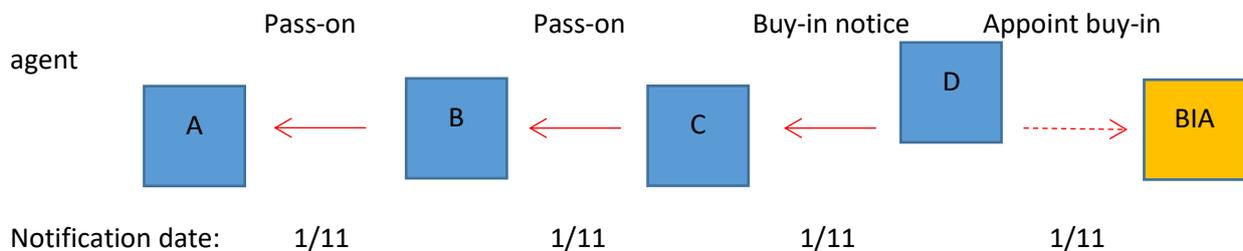
- Since B has a linked failing purchase (receipt) and sale (delivery), for the same ISD, it can inform its counterparties, A and C, that there is a chain. C will be responsible for appointing the buy-in agent.
- Since C has a linked failing purchase (receipt) and sale (delivery), for the same ISD, it can inform its counterparties, B and D, that there is a chain. D will now be responsible for appointing the buy-in agent.
- Since D's onward sale to E is for a different ISD to D's purchase from C, D will be the last party in the chain and is responsible for appointing the buy-in agent (as the underlying security is a liquid share).

³ For consistency, the examples and illustrations utilise the 'month-day' format



Appointing the buy-in agent and passing-on the buy-in notice

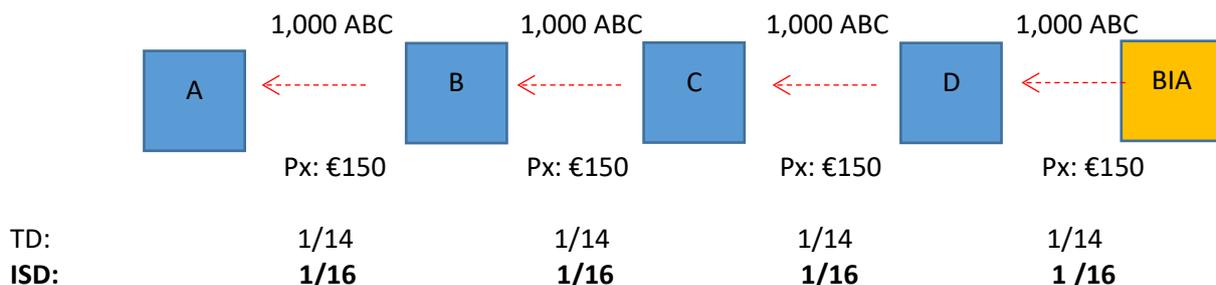
- 1/11: on appointing the buy-in agent, D sends a buy-in notice to C⁴
- 1/11: C acknowledges receipt of the buy-in and passes-on the buy-in to B
- 1/11: B acknowledges receipt of the pass-on and passes-on to A
- 1/11: A, B, and C must put their respective deliveries on hold



Executing the buy-in

Assume the buy-in is successfully executed on January 14 (the following business day after the buy-in agent is appointed) for T+2 settlement, in all 1,000 shares, at a price of €150 (including all associated costs).

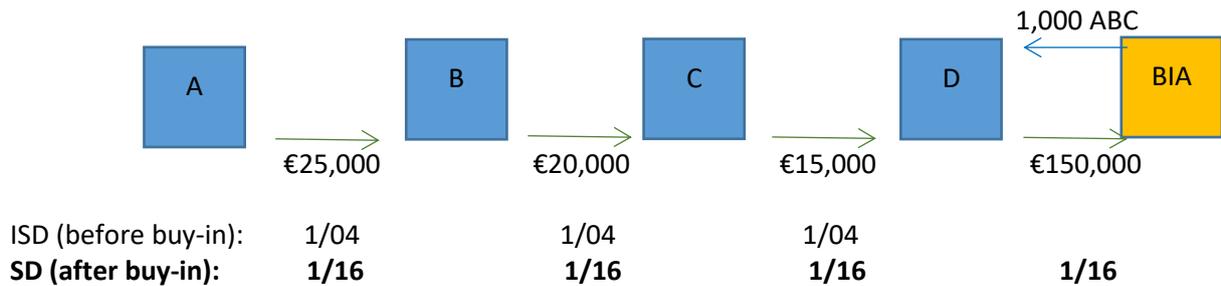
- 1/14: the buy-in agent informs D that the buy-in has successfully been executed (at €150)
- 1/14: D immediately informs C of the buy-in execution and relevant details
- 1/14: C immediately informs B of the buy-in execution and relevant details
- 1/14: B immediately informs A of the buy-in execution and relevant details



⁴ The extension period ends on ISD+4, with the buy-in process beginning on ISD+5

Settling the buy-in⁵

- 1/16: the Buy-in agent delivers 1,000 shares to D vs €150,000
- 1/16: C pays €15,000 to D $((150 - 135) \times 1,000)$
- 1/16: B pays €20,000 to C $((150 - 130) \times 1,000)$
- 1/16: A pays €25,000 to B $((150 - 125) \times 1,000)$



All parties are restored to the position they would have been had all the original trades settled.

The same process would apply in the case of cash compensation (with reference price €150).

⁵ Here it is assumed that parties settle the buy-in differential payments on the same day that the buy-in is settled, however the RTS specifies that this should be within 2 business days of the buy-in settlement
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