CSDR Industry Working Group

Workshop on designing a buy-in pass-on mechanism

Meeting note from July 1, 2019

Participating firms: *BAML, Barclays, BGC Partners, BlackRock, BNP Paribas, Broadridge, Credit Suisse, Deutsche Bank, Deutsche Boerse, Erste Bank, Euroclear, Goldman Sachs, HSBC, Jane Street, LCH, Market Axess, Morgan Stanley, NAB Group, Northern Trust, Pershing, Société Générale, TD Securities,*
Participating associations: *AFME, AGC (BBH), ICMA, ISLA*

Objective

To bring trading and operations experts together from across the industry (primarily representing sell-side, buy-side, and market intermediaries) to identify the potential challenges and discuss possible solutions with respect to the creation of a potential buy-in pass-on mechanism (or mechanisms) that could be relied upon in non-cleared markets under the CSDR mandatory buy-in regime. Pass-on mechanisms are viewed as essential not only for creating operational efficiencies in managing the buy-in process, but also for minimizing market instability and preserving market liquidity.[1]

The expectation was that in the interest of market efficiency and stability, the regulatory authorities would welcome the possibility for reducing the number of buy-ins through the means of pass-on mechanisms. While there was no provision for pass-ons in the regulation, the recitals of the RTS do allude to the desirability of such a mechanism.

An intended output of the workshop would be a consensual industry basis to formulate a concrete proposal for a pass-on framework to complement and enhance the CSDR buy-in process with a view to regulatory endorsement through ESMA Level 3 guidance.

[1] A pass-on mechanism allows for a single buy-in to be executed to settle a chain of 'linked' failing transactions, thus avoiding multiple buy-ins being executed at the same time for the same security.

Overview of possible 'optimal' pass-on model

- For liquid shares (as defined by MiFIR), the scope to pass-on the buy-in obligation is limited to same ISD for linked transactions.
- For all other securities, the scope to pass-on the buy-in obligation for linked transactions is subject to the sale and purchase being within the seven-day extension period.
- In the case of flexible-ISD pass-ons, the best practice recommendation should be that firms consider whether a buy-in could be executed quickly and efficiently, in which case, in the interest of market efficiency, this should be the preferred option, rather than passing-on the buy-in obligation.
- Where firms elect to pass-on the buy-in obligation, they should notify both their selling and purchasing counterparties.
- Where firms elect to initiate the buy-in, rather than pass-on the obligation (and wait for the buy-in to be initiated along the chain), they should notify their purchasing party. In this way, this information can be passed-along the chain to inform all parties in the chain that a buy-in is being initiated and that they are not obligated to initiate their own buy-in.
- In all cases, the purchasing party should issue their failing selling counterparty with a pre-advice notice of the requirement to start the buy-in process (two days before the end of the extension period).

Summary of workshop discussions

1. The challenge of the CSDR buy-in asymmetry

- The session began with a quick recap of how buy-ins and pass-ons work from the perspective of the non-cleared fixed income markets (largely with reference to the ICMA Buy-in Rules).[2]
- The importance of the symmetry in the settlement of the buy-in price differential between parties was noted and discussed, comparing this to the asymmetrical payment provisions outlined in the RTS (stemming from the original error in the Level 1 regulation). It was understood that unless the regulation was amended, or Level 3 guidance provided for it, the current asymmetry in the payment provisions in CSDR (for both buy-ins and cash compensation) would make an effective pass-on mechanism unfeasible.
- ICMA updated the group that it has been involved in detailed discussions with ESMA regarding the possibility of a contractual solution, whereby transacting firms could agree that in the case of a buy-in (or cash compensation), the differential (less any associated costs) would be paid symmetrically. This could be through existing contractual frameworks, such as the ICMA SMR&Rs, or alternative arrangements. ICMA explained that they were hopeful that ESMA 'Q&A' confirming this possibility would be imminent.

[2] The ICMA Buy-in (and Sell-out) Rules form part of the ICMA Secondary Market Rules & Recommendations, which automatically apply to ICMA members transacting in international securities (usually applied as meaning bonds that can be settled cross-border or on ICSDs).

- The point was raised that for CCP buy-ins for equities, this asymmetry is an established practice. It was explained that equity traders understood this risk, however the economics associated with this 'short option' are very different for equities and bonds. In the case of the latter, underlying values of transactions are significantly higher, and potential losses caused by an asymmetrical differential treatment could put a trading desk out of business.
- It was suggested that while non-cleared (mostly fixed income) buy-ins were designed to remedy fails, CCP buy-ins (mostly equities) appeared to be designed to penalize fails. However, the asymmetry makes the extent of the 'penalty' wholly unpredictable and open-ended. From this perspective, the existing asymmetrical differential payment model applied by CCPs in the equity markets seems difficult to rationalize.
- It was further recognized and broadly agreed by the group that for pass-ons to work in the equity space, CCPs would also need to apply a symmetrical differential payment treatment to their buy-ins and cash compensation mechanisms.

2. Same-ISD vs multiple-ISD pass-on models

- The group discussed the merits and challenges of applying pass-ons to transaction chains which are defined by having the same intended settlement date (ISD) and those with multiple ISDS.
- It was noted that the multiple-ISD model, as applied under the ICMA Rules, works well for certain fixed income markets, such as credit or EM, in light of the inherent lack of liquidity and immediacy. While any party in the chain could chose to execute a buy-in at any point, it was usual for the right to initiate the buy-in process to pass along the transaction chain to the final buyer.
- For more liquid instruments, in particular exchange traded equities, where liquidity was relatively deeper and turnover much higher, the group felt that there was less reason to delay the buy-in process, and early execution could be more efficient.
- The group largely felt that there was a case for applying a multiple-ISD model in the case of less liquid instruments or securities, and a same-ISD model in the case of more liquid instruments.
- In the interest of simplicity and consistency with the regulation, it was agreed that a dual-model approach would be optimal, applying the MiFIR 'liquidity' definition used in CSDR.[3] Pass-ons for liquid shares should be limited to same-day ISD transaction chains, while pass-ons for all other instruments should allow some flexibility with respect to multiple-ISDs.[4]
- It was further suggested that in the case of instruments that fell outside of the MiFIR/CSDR 'liquid' definition, any best practice should recommend that where parties in a chain felt that a buy-in could be executed relatively swiftly and efficiently, they should not pass-on their buy-in obligation, but should endeavor to initiate the buy-in process (although this would require good communication through the chain).

[3] The group noted that the 'golden source' for this information is the ESMA FITRS database

[4] In other words, where a four-day extension period applies, pass-ons are limited to same ISD, and where a seven-day extension period applies, there could be more flexibility with respect to different ISDs.

3. Extending the buy-in time

- The group discussed the ICMA multiple-ISD proposal which provides that the buy-in obligation can be passed along the chain so long as the matching purchase and sale were within the relevant extension period (i.e. seven business days). There was a concern that passing-on the buy-in obligation in this way effectively extended the time until the eventual buy-in took place beyond that envisaged by the regulation, which may be difficult for the regulators to approve.
- ICMA explained that they had discussed the proposal with ESMA in principle, and had provided illustrations of how it could work, including example timelines. While it would, in many cases, extend the extension period across a chain well beyond the original seven days, it would be more efficient than the alternative of multiple, simultaneous buy-ins in the same security to settle the same fail.

4. Communications through the chain

- It was agreed that currently it is impossible to have overall visibility of a transaction chain (even if same-ISD and same CSD). If that were not complicated enough, it was also noted that in practice transaction chains are not so much chains as trees, with multiple, complex transaction 'branches', some of which fold back in on themselves. It was recognized that for pass-ons to work in the CSDR world, efficient bilateral communication through the chain would be essential.
- Based on the current ICMA model, it was agreed that the two critical pieces of information to communicate along the transaction chain were: (i) the buy-in notice; and (ii) the buy-in execution (including price). These needed to be passed-along the chain 'immediately'.
- It was proposed that in the wake of CSDR, there was also a lot of value in the purchasing party also issuing a 'pre-advice' notification to the failing seller. This had the advantage of ensuring that both parties recognized and agreed that a valid buy-in situation existed before initiating the buy-in process, as well as opening a window for settlement before the end of the extension period. The AFME group had discussed this and proposed that a pre-advice notice two days before the end of the extension period would be appropriate, since this allowed for a settlement cycle before triggering the mandatory buy-in (ie ISD+2 or ISD+5).
- The group deliberated on whether in the case of a CSDR pass-on whether more communication was helpful. It was broadly agreed that where a party in a chain (i.e. matching purchase and sale) opted to pass-on the buy-in obligation (as allowed under any regulatory guidance), it would be helpful, and even important, that they communicated this to both their selling and purchasing counterparties. This would not only help manage expectations of the failing seller, and the potential responsibility of the failed-to buyer(s), but it would also create an audit trail for the relevant regulator (NCA) to evidence why they did not start a buy-in process at the end of the extension period.
- The case of a party in a chain opting to issue a buy-in, rather than pass-on the obligation, was also considered (with reference to the earlier discussion regarding a best practice recommendation in the case of more liquid securities that could fall under the seven-day/flexible-ISD extension period). It was agreed that in this case, apart from issuing a pre-advice and subsequent buy-in notice to the failing seller, it would also be important to notify the

onward purchasing party that a buy-in was being executed (which in turn would need to be passed along the chain). In this case, it would be important to prevent the buy-in being executed further along the chain (suggesting that a 'reverse pass-on' mechanism was also necessary). It was also agreed that this eventuality would need to be addressed and codified into any best practice proposal.

- It was agreed that in the case of pre-advice notifications, all purchasing parties should issue a pre-advice notice to their failing seller, regardless of whether they are in a chain or have the possibility to pass-on the buy-in obligation. This would help ensure that a valid buy-in situation existed (in-scope transaction recognized by both parties) and may also help prompt settlement before the end of the extension period/buy-in process being triggered.

5. Chain visibility solutions

- It was suggested that there are some potential technology solutions that are exploring the possibility to have visibility of an overall transaction chain.
- This could be achieved by transactions, and settlement status, being instructed to a central repository (or a number of interoperable repositories). It would then be possible for independent agents to identify transaction chains, and within the allowable parameters of the regulation/best practice, identify the optimal point in the chain for the buy-in to take place. This could also be CSD agnostic and (within what is allowable) ISD agnostic.
- It was discussed that (I)CSDs currently have transaction visibility, not so much to identify chains, but to identify where a fail may be causing a settlement 'blockage'. Autoborrow facilities generally do a good job in unblocking these settlements, and it was suggested that in 80% of cases the autoborrow is reimbursed the same day (it was noted that often this seems to unblock chains that go beyond the relevant (I)CSD).

6. Custody chains

- The issue of custody chains and failed transactions in client omnibus accounts was raised.
- It was felt that ultimately the responsibility for the buy-in (or pass-on) should fall on the end client (as per the regulation), and that while custodians may need to tighten up information flows, ultimately it is the end purchaser who is best placed to know whether a buy-in should take place, and against whom, as well as whether a pass-on situation exists.
- It was argued that even where settlement is internalized, the regulatory requirements applied to the ultimate purchasing and selling entities and not the custodian (with the exceptional case of the buy-in differential not being paid by the selling party, when it will become the liability of the delivering CSD 'participant').
- The group discussed the provisions in Article 25 of the RTS which are intended to ensure that all parties in the settlement chain are brought into scope of the regulatory requirements, noting that AGC is currently exploring the practicalities and complexities related to this.
- The group further discussed briefly the potentially significant extraterritorial impacts of this, the challenges with respect to end investors that are domiciled or regulated outside of the EU, and the huge educational effort that this will require.

7. Breaking the transaction chain

- The group identified three main ways in which a transaction chain can potentially be broken: (i) SFTs; (ii) transacting on an out-of-scope CSD; and (iii) transacting with a CCP.
- It was noted that in the case of the first two ‘breaks’, these risks exist today for market participants and liquidity providers. These risks will clearly increase significantly under CSDR, but they are not new, even if they do become more challenging to manage.
- The lack of harmonization in the buy-in process between CCPs and the non-cleared market, however, creates risks that should not exist.
- The group agreed that it would be critical that CCPs not only have consistent buy-in frameworks with each other, but also with that adopted by the non-cleared markets (in particular timings and symmetrical differential payments).
- AFME and ICMA agreed to further this discussion with EACH.

8. Other issues

- It was noted that a previous issue raised in the ICMA CSDR-SD working group related to the importance of NCAs/ESMA being able to suspend the CSDR buy-in obligation in situations of extreme market stress, whether ISIN specific or across instruments. ICMA confirmed that they had not yet raised this with ESMA but understood it to be an important consideration with respect to market stability and investor protection and would certainly raise it, most likely in conjunction with AFME and other representative bodies.
- The question was raised as to the requirement in the RTS to appoint a buy-in agent (for non-cleared trades), the fact that ICMA had removed the requirement to appoint a third-party buy-in agent in 2017, and whether this suggested that there could be potential problems with respect to finding a buy-in agent. ICMA confirmed that the decision was in response to feedback from members that they were struggling to find willing buy-in agents (traditionally market-makers in the relevant security), and that the change had seemed to be have been a success, making the buy-in process more efficient with no apparent issues related to conflicts of interest. ICMA also updated the group that they had discussed this with ESMA, who seemed interested in the idea as a potential ‘fall-back’ option but were also conscious of the limitations set by the RTS. However, ICMA had not made a formal proposal and would want to consult with AFME and the broader market before doing so.
- Finally, participants were asked about the practicalities and business impacts of applying the CSDR buy-in provisions. The group suggested that investment firms would need to create ‘buy-in teams’, which would have to sit between the front and back offices, given the implications and interdependence of both. Significant investment in people and technology seemed inevitable.

Next steps

The group agreed that while the basis of a possible pass-on model had been outlined, it would require more detailed discussion and work, led by AFME and ICMA, to construct a proposal to share with ESMA. While no timeline was set, it was agreed that this should be done as quickly as possible to allow for regulatory approval/guidance well ahead of the November 2020 'go live'.

Prepared by: Andy Hill, ICMA, July 2019