**Cross-industry proposal for a**

**‘pass-on’ mechanism**

**under CSDR mandatory buy-ins**

**(for failing non-centrally cleared transaction chains)**

September 2019

**Draft**

**V2.4 09/06/2019**

**What does the industry’s ask of the regulator?**

**\*\*\* WORDING TO BE AGREED BY INDUSTRY WORKING GROUP\*\*\***

***A pass-on mechanism to be allowable under the CSDR buy-in framework***

ESMA to provide Level ‘Q&A’ guidance that where a receiving trading party has a failing settlement of the receipt and a contingent (‘linked’) onward delivery, also failing as a result of the failing receipt, it is not obliged to initiate a buy-in against the failing delivering counterparty. Rather that obligation will fall on the onward receiving counterparty. This is possible so long as the intended settlement dates for both the failing receipt and the ‘linked’ failing delivery are within the applicable extension period.

This is intended to support market efficiency and stability and is consistent with buy-in practice and pass-on mechanisms widely used in the European securities markets today.

**EXECUTIVE SUMMARY**

**\*\*\* TO BE DRAFTED FOLLOWING AGREEMENT ON MAIN TEXT OF PROPOSAL\*\*\***

**Background**

This paper outlines a market-led proposal for a standardised market mechanism for buy-in ‘pass-ons’ that is intended to enhance CSDR mandatory buy-in framework,[[1]](#footnote-1) which is expected to be applied from September 2020 (or possibly November 2020 if the implementation deadline is extended).

The mechanism was developed through a cross-industry workshop[[2]](#footnote-2) which included representative firms from the Association for Financial Markets in Europe (AFME), the Association of Global Custodians (AGC), the International Capital Market Association (ICMA), and the International Securities Lending Association (ISLA), including sell-side, buy-side, and market intermediaries. Individual participants included traders and operations experts, as well as compliance and legal experts. The proposed mechanism is based on existing pass-on mechanisms (such as that used under the ICMA Secondary Market Rules & Recommendations),[[3]](#footnote-3) as well as considerations based on the provisions of the regulation and regulatory technical standards (RTS),[[4]](#footnote-4) operational practicalities, and the liquidity profiles of different security types and markets. The proposal is intended to be fully compliant with and complementary to the CSDR regulatory requirements.

The proposed mechanism is designed for both equity and non-equity transactions[[5]](#footnote-5) not cleared by a CCP.[[6]](#footnote-6)

The mechanism is not intended to apply to settlement fails in out-of-scope securities financing transactions (SFTs), which will continue to be covered by their relevant contractual frameworks.[[7]](#footnote-7)

**Existing pass-on mechanisms**

Often the settlement of onward outright sales in non-cleared markets is 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.[[8]](#footnote-8) 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.

A ‘pass-on’ is a mechanism by which a single buy-in can be used to settle an entire chain of settlement fails. Usually, though not exclusively, the buy-in is initiated by the receiving party at the end of the chain (the ‘final purchaser’) who issues a buy-in notice to their failing seller. In turn, the failing seller (delivering trading party) is able to *pass-on* the buy-in notice to the party failing to them. In this way the buy-in can be passed along the entire chain until it reaches the start of the chain and the cause of the fails (the ‘original delivering trading party’).

In this way, the only required buy-in is initiated by the final purchasing (receiving) trading party in the chain against the final selling party in the chain. The final receiving trading party receives its securities. All settlement instructions throughout the chain are cancelled. The buy-in price becomes the reference price to settle the cash differences between each party in the chain. Every trading party in the chain is effectively restored to the position they would have been in had all the transactions settled, with any costs associated with the buy-in being borne by the original (failing) selling party at the start of the chain.

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 notification (and subsequent details of the buy-in status and execution) are 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.

Similarly, once the buy-in is executed, the initiating party (the final purchaser) 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 notification. 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.

Neither CSDR nor the RTS provides for a pass-on mechanism, however Recital (19) of the Regulation suggests ‘minimising the number of buy-ins’ where possible. It is assumed that in the interest of efficient and stable markets, a pass-on mechanism that enhances the CSDR buy-in framework is a desirable objective.

**Importance of addressing the buy-in/cash compensation differential payment asymmetry**

It is important to recognise that one of the main obstacles to the creation of an effective pass-on mechanism under the CSDR provisions is the apparent asymmetric treatment in the payment of the differential between the original transaction price and the buy-in price[[9]](#footnote-9) or cash compensation reference price.[[10]](#footnote-10) Since the regulation does not provide for this differential payment to be paid by the receiving trading party to the delivering trading party (in the event that the buy-in price or cash compensation reference price is lower than the original transaction price), it will not be possible to ensure that the buy-in process will restore the economics of the original transactions in a chain. As a result, a pass-on cannot be affected. The reason is that the profit from the price differential if the reference price is lower will be an incentive for every purchasing (receiving) party in a transaction chain to initiate a buy-in process at the earliest possible opportunity to lock in the profit (i.e. immediately following a failed receipt), regardless of any onward deliveries or the extension period.

Therefore, to make pass-ons works under CSDR, trading parties must be allowed to settle the buy-in or cash compensation differential payment in either direction. This could be facilitated under existing contractual frameworks (such as the ICMA Secondary Market Rules & Recommendations)[[11]](#footnote-11) or through new arrangements between trading parties.

**Breaking transaction chains**

There are a number of situations where a transaction could be deemed out of scope of the CSDR buy-in regime and where pass-ons would not be effective, so ‘breaking’ the transaction chain:

* **Transactions with CCPs**

The regulation does not provide for trading parties to issue buy-ins against a CCP. Under CSDR, CCPs are responsible for initiating buy-ins against any failing member. This creates a challenge to the possibility of passing-on a buy-in where a CCP is a failing onward delivering party. In the interest of efficient markets, and to minimise the number of buy-ins, it is desirable that CCPs would be considered part of a transaction chain and could apply a pass-on mechanism.

* **Transactions settling on out-of-scope CSDs**

Where a delivering trading party has a failing receipt on an EU/EEA CSD, causing an onward delivery to a non-EU/EEA CSD to fail, it is unlikely that they will be in a position to pass-on the buy-in obligation to their onward receiving party. In this case they will effectively become the end of the chain and responsible for initiating the buy-in process. The exception could be where both trading parties trade under a contractual agreement that enforces the provisions of CSDR, even in the case that the elected CSD is non-EU/EEA.

* **Failing securities financing transactions**

It is anticipated that most SFTs will be out-of-scope of the CSDR buy-in provisions (i.e. short-dated, with terms of less than 30 business days), and it would therefore not be possible to apply a pass-on mechanism in the case of a failing SFT. Furthermore, in the case of in-scope SFTs, market best practice is expected to be that the relevant contractual provisions for settlement fails (usually under a GMRA or GMSLA) are applied before the end of the extension period to avoid being subject to the CSDR buy-in provisions.[[12]](#footnote-12) So it should be assumed that in most cases, SFTs will break a transaction chain for the purpose of pass-ons.

**Benefits of a pass-on mechanism**

Buy-ins can be market distortive and destabilising, particularly where the market for underlying security is relatively illiquid, and where bids significantly above fair market value are required to flush out sellers that are also able to ensure guaranteed delivery. 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, or over a few days, could result in excessive market volatility in the underlying (as well as related) securities, compromising market efficiency and stability. 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.

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.

**Overview of pass-on mechanism proposal**

* For liquid shares (as defined by MiFIR), the scope to pass-on the buy-in obligation is limited to same intended settlement date (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 (i.e. multiple-ISD transaction chains).
* In the case of multiple-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 (i.e. they should not wait to receive a buy-in or pass-on notice from their onward purchasing party).
* 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 onward 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 can choose not to initiate their own buy-in.
* In all cases, the best practice recommendation is that 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).

**The pass-on proposal**

The following outlines and illustrates how the proposed pass-on mechanism would be applied under CSDR. Essentially there are three different scenarios for its application, depending on the underlying liquidity profile of the relevant security:

1. **Liquid shares: same-ISD**

In the case of liquid shares (as defined by MiFIR)[[13]](#footnote-13) transaction chains would be limited to matching purchases and sales in the same security for the same intended settlement date (ISD). In this instance, where a trading party has a matching receipt (purchase) and delivery (sale), that are both failing, they are able effectively to ‘pass-on the obligation’ to initiate the buy-in process at the end of the extension period (ISD+4) to the next (receiving) party in the transaction chain. In other words, it only needs to inform its failing delivering counterparty that it is not required to initiate a buy-in and that this will be initiated by an onward receiving party. In this way, the buy-in obligation (including responsibility for initiating the buy-in process, appointing the buy-in agent, etc.) for the entire chain can be passed to the final receiving (purchasing) party (i.e. the party with a failing receipt, but no onward delivery).

On successful completion of the buy-in, the securities are delivered directly to the final receiving (purchasing) trading party in the chain by the buy-in agent. All other settlement instructions in the chain are then cancelled and parties settle between each other the difference in value between their original transaction and that of the buy-in (including any associated costs to execute the buy-in). In this way, all parties are restored to the same position they would have been in had the original transactions all settled, with any costs (and buy-in premia) being borne by the original failing (delivering) party at the start of the chain.

In the case of cash compensation, which would be determined at the end of the chain (by the final receiving trading party), the same principle applies. The value derived from the cash compensation reference price is also used to settle the differences between the various parties in the chain, restoring them all to the position they would have been in had the transactions settled, leaving any costs with the original failing delivering (selling) party at the start of the chain.

In summary, the buy-in obligation can be passed along the chain in the case that:

1. The matching purchase and sale are in the same security
2. The matching purchase and sale are for the same (or a smaller sell ticket) number of shares/nominal amount [[14]](#footnote-14)
3. The matching purchase and sale are for the same ISD
4. **All other securities: multiple-ISD / end-of-chain**

In the case of securities other than liquid shares, the transaction chain is not limited to transactions with the same ISD. Rather, it is limited to matching purchases and sales in the same security with ISDs that are within the relevant extension period (i.e. no longer than seven business days apart). In this instance, where a party has a matching failing receipt (purchase) and delivery (sale) within the seven day extension period, they are able to pass-on the obligation[[15]](#footnote-15) to initiate the buy-in process at the end of the extension period for the delivery (sale) to the next receiving (purchasing) trading party in the transaction chain. In this way, the buy-in obligation for the entire chain can again be passed to the final receiving (purchasing) trading party (i.e. a failing receipt, but no onward delivery).

Again, on successful completion of the buy-in, the securities are delivered directly to the final receiving (purchasing) trading party in the chain by the buy-in agent, all other settlement instructions in the chain are then cancelled, and parties settle between each other the difference in value between their original transaction and that of the buy-in (including any associated costs to execute the buy-in).

In the case of cash compensation, the value derived from the reference price is used to settle the entire chain.

It is important to note that in this process the buy-in will be triggered at the end of the extension period of the final transaction in the chain. Where there is more than one ISD in the chain, this effectively extends the time until of the buy-in relative to the transaction at the start of the chain. Each ‘link’ in the chain has the potential to extend the overall extension period for the chain (so beyond seven business days). However, cash penalties will continue to apply until the buy-in is settled, which therefore ensures that failing parties are incentivised to settle the trade (and therefore the chain) as soon as possible.

In summary, the buy-in obligation can be passed along the chain in the case that:

1. The matching purchase and sale are in the same security
2. The matching purchase and sale are for the same (or a smaller sell ticket) number of shares/nominal amount12
3. The respective ISDs of the matching purchase and sale are within seven business days of each other
4. **All other securities: earlier in the chain**

While it is usual to pass-on the buy-in obligation to the end of transaction chain, in many circumstances it may be more efficient for a party to forgo the right to pass-on the buy-in obligation and to execute the buy-in at the start of (or earlier in) the chain and for a party to forgo the right to pass-on the buy-in obligation. This is likely to the case where the liquidity profile of the underlying security is such that it should be possible to execute a successful buy-in relatively quickly and easily, with minimum market disruption or price dislocation. The choice not to pass-on the obligation would be based on a professional market judgement by the relevant trading party, with reference to actual or perceived market liquidity of the security, as opposed to the quantitative liquidity measure applied under MiFIR.

In this instance, the trading party electing to initiate the buy-in process would need to inform the trading party to which it has an onward delivery, who would no longer be required to initiate its own buy-in; instead they would wait for the buy-in to settle which in turn would settle their receipt. Similarly, if this party had a failing onward delivery in the same security, they would need to inform the receiving trading party that a buy-in was being initiated earlier in the transaction chain, so negating their obligation to initiate a buy-in. In this way the entire transaction chain can be settled by one buy-in, but this time at the start of (or before the final purchase/receipt in) the chain.

If the buy-in is successfully executed, this should ‘unblock’ the chain and so settle all other matched transactions in the transaction chain.

In the case that the buy-in cannot be successfully executed, then this information would need to be communicated along the chain, with the possibility of using the option of the deferral period to pass-on the buy-in obligation along the chain to the final receiving party (as in scenarios (1) and (2)). In this case the initiating party would also need to communicate (in both directions) that the original buy-in attempt has been cancelled and that the buy-in obligation is being passed-on, with respect to the relevant deferral dates.

It should also be noted that where a buy-in is executed at the start of (or earlier in) a chain, there is a risk that where there are other fails or onward deliveries along the chain, the bought-in securities may be used to settle these commitments first, and so prevent the securities from reaching the final receving party (purchaser): in which case additional buy-ins along the chain may still be required and triggered.

The obligation to initiate a buy-in is negated in the case that:

1. The purchasing party is informed by the failing seller that a buy-in process has already been initiated

**Evidencing pass-on situations**

The pass-on mechanism is built on the premise of efficient and effective communication by parties and active management of their regulatory obligations. In the example of a party who has a matching purchase and sale that are both failing, and is thus entitled to pass-on the buy-in obligation, they must communicate this in a clear and timely manner to both their counterparties. Failure to do so should be considered as non-compliance with the regulatory requirements (i.e. the alternative is that the party initiate a buy-in against the failing receipt).

In all three scenarios, parties are required to document electronically their communication with their relevant counterparties. This creates an audit trail which can be used to evidence why a pass-on situation exists and/or that the regulatory buy-in obligation is negated, and hence why a buy-in may not have been initiated by every single party in a transaction chain as otherwise required by the regulation.

**Pass-on mechanism provisions and examples**

1. **Liquid shares: same-ISD**

The decision to pass-on

* In the case of liquid shares (as defined by MiFIR) the scope to pass-on a buy-in along a transaction chain is limited to transactions with the same intended settlement date (ISD).
* Where a receiving party has a failing receipt which in turn causes an onward delivery to fail, the receiving party has the ability to pass-on the obligation to initiate the buy-in process to their onward receiving party.
* The quantity/ nominal for which the possibility to pass-on exists will be based on the quantity/ nominal of the delivery (sell transaction), to the extent that this is equal to or less than the quantity/nominal of the matched receipt (purchase transaction).
* To the extent that the quantity/nominal of the failing receipt (purchase) is greater than the quantity/nominal of the matched failing onward delivery, only the buy-in obligation for the quantity/nominal of the delivery can be passed-on, and the buy-in obligation will remain for the difference.
* Two business days before the end of the extension period (ISD+2), the receiving trading party should issue a pre-advice notice to the failing delivering trading counterparty to confirm that a buy-in situation exists (noting that the selling delivering party can still deliver securities until the end of the extension period).
* Following the end of the extension period (ISD+4), where the party decides to pass-on the buy-in obligation, they must inform:
  + the failing delivering trading counterparty that a pass-on situation exists, and that they have opted to pass-on the obligation to initiate the buy-in process;
  + the failed-to receiving trading counterparty that a pass-on situation exists, and that they are passing-on the obligation to initiate the buy-in process.

Issuing the pass-on

* Following the end of the extension period (ISD+4), if the receipt has not settled, the final party in a transaction chain (i.e. a party with no onward matching delivery for the same ISD) begins the buy-in process against its failing delivering counterparty [as per sub-sections 3 and 4 of the RTS].
* Any party in a pass-on situation (and who has already notified their receiving and delivering counterparties of their intention to pass-on the buy-in obligation), on receiving a buy-in or pass-on, should ***immediately***[[16]](#footnote-16)send notice of the buy-in or pass-on details to the delivering party.
* Any party receiving a buy-in or pass-on notification should immediately confirm their acknowledgement of receipt to the issuing party.

Executing the buy-in across the chain

* On receiving notification from the buy-in agent that the buy-in has been fully or partially executed, the initiating party should ***immediately*** notify its failing delivering trading counterparty of the execution with all relevant details.
* In a pass-on situation, a party receiving confirmation of a buy-in execution should ***immediately*** pass-on all the relevant details to their failing delivering counterparty.

Settling the buy-in across the chain

* On successful settlement of the bought-in securities from the buy-in agent, the initiating party should notify its delivering trading counterparty that the buy-in has settled.
* The initiating party and failing delivering trading party should settle between themselves any cash differences arising from the difference in the buy-in price and the original transaction price, including any costs directly related to the execution of the buy-in.
* In a pass-on situation, a party receiving confirmation that the buy-in has settled should inform their delivering trading party.
* In a pass-on situation, the receiving and delivering trading parties should settle between themselves any cash differences arising from the difference in the buy-in price and **their** original transaction price, including any costs directly related to the execution of the buy-in.

Example

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

* Transaction 1:

On Trade Date (TD) January 2 2019,[[17]](#footnote-17) 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 120, 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 130, 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 125, ISD January 7 2019 (T+2)

*Scenario 1*

1,000 ABC 1,000 ABC 1,000 ABC 1,000 ABC

E

D

A

B

C

€125,000 €120,000 €130,000 €125,000

TD: 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.

* B has the option to pass-on the buy-in obligation to C
* C has the option to pass-on the buy-in obligation to D
* Since D’s onward sale to E is a different ISD to D’s matching purchase from C, D cannot pass-on the buy-in obligation (as the underlying security is a liquid share)
* Should B and C pass-on the buy-in obligation, D is responsible for initiating the buy-in process

*Instructing the pass-on notification*

* Jan 10: B notifies A that it is passing-on its buy-in obligation (i.e. it has elected not to initiate a buy-in, and so the buy-in will be initiated further along the chain by another party)
* Jan 10: B notifies C that it is passing-on its buy-in obligation to C
* Jan 10: C notifies D that it is passing-on its buy-in obligation to D
* Jan 10: D begins the buy-in process

Pass-on notification Buy-in obligation Buy-in obligation

D

D begins buy-in

C

A

B

process

VD: 1/10 1/10 1/10 1/10

*Issuing the pass-on*

* 1/10: on appointing the buy-in agent, D sends a buy-in notice to C
* 1/10: C acknowledges receipt of the buy-in and passes-on the buy-in to B
* 1/10: B acknowledges receipt of the pass-on and passes-on to A

Pass-on Pass-on Buy-in

D

C

A

B

Buy-in

agent

VD: 1/10 1/10 1/10 1/10

*Executing the buy-in across the chain*

Assume the buy-in is successfully executed on January 11 for T+2 settlement, in all 1,000 shares, at a price of €128 (including all associated costs)

* 1/14: the buy-in agent informs D that the buy-in has successfully been executed (at €128)
* 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

1,000 ABC 1,000 ABC 1,000 ABC 1,000 ABC

BIA

D

A

B

C

Px: €128 Px: €128 Px: €128 Px: €128

TD: 1/11 1/11 1/11 1/11

**ISD:** **1/15 1/15 1/15 1 /15**

*Settling the buy-in across the chains[[18]](#footnote-18)*

* 1/15: the Buy-in agent delivers 1,000 shares to D vs €128,000
* 1/15: D pays €2,000 to C ((128 – 130) x 1,000)
* 1/15: B pays €8,000 to C ((128 – 120) x 1,000)
* 1/15: A pays €3,000 to B ((128 – 125) x 1,000)

1,000 ABC

BIA

D

A

B

C

€3,000 €8,000 €2,000 €128,000

ISD (before buy-in): 1/04 1/04 1/04

**ASD (after buy-in): 1/15 1/15 1/15 1/15**

1. **All other securities: multiple-ISD / end-of-chain**

The decision to pass-on

* In the case of securities other than liquid shares, the scope to pass-on the buy-in obligation is not limited to matching transactions with the same ISD.
* Where a receiving party has a failing receipt which in turn causes an onward delivery to fail, the receiving trading party has the ability to pass-on the obligation to initiate the buy-in process to their onward receiving counterparty, so long as the respective ISDs of the transactions are within the relevant extension period (i.e. seven business days).
* The quantity/ nominal for which the possibility to pass-on exists will be based on the quantity/ nominal of the delivering transaction, to the extent that this is equal to or less than the quantity/nominal of the matched receiving transaction.
* To the extent that the quantity/nominal of the failing receipt is greater than the quantity/nominal of the matched failing onward delivery, only the buy-in obligation for the quantity/nominal of the delivery can be passed-on, and the buy-in obligation will remain for the difference.
* Two business days before the end of the extension period (ISD+4), the failed-to party must issue a pre-advice notice to their failing delivering counterparty to confirm that a buy-in situation exists. (noting that the delivering party can still deliver securities until the end of the extension period).
* Following the end of the extension period (ISD+7) related to the receipt, where the party decides to pass-on the buy-in obligation, they must inform the failing delivering counterparty that a pass-on situation exists, and that they intend to pass-on the obligation to initiate the buy-in process.
* Following the end of the extension period (ISD+7) related to the delivery, where the party decides to pass-on the buy-in obligation, they must inform their onward receiving counterparty that a pass-on situation exists, and that they have opted to pass-on the obligation to initiate the buy-in process.

Issuing the pass-on

* Following the end of the extension period (ISD+7), if the receipt has not settled, the final trading party in a transaction chain (i.e. a party with no onward matching delivery for an ISD within seven business days of the failing purchase) begins the buy-in process against its failing delivering trading counterparty [as per sub-sections 3 and 4 of the RTS].
* Any trading party in a pass-on situation (and who has already notified their purchasing and selling parties of their intention to pass-on the buy-in obligation), on receiving a buy-in or pass-on, should ***immediately*** send notice of the buy-in or pass-on details to the delivering counterparty.
* Any trading party receiving a buy-in or pass-on notification should immediately confirm their acknowledgement of receipt to the issuing counterparty.

Executing the buy-in across the chain

* On receiving notification from the buy-in agent that the buy-in has been fully or partially executed, the initiating party should ***immediately*** notify its failing delivering trading counterparty of the execution with all relevant details.
* In a pass-on situation, a party receiving confirmation of a buy-in execution should ***immediately*** pass-on all the relevant details to their failing delivering trading counterparty.

Settling the buy-in across the chain

* On successful settlement of the bought-in securities from the buy-in agent, the initiating party should notify its delivering trading counterparty that the buy-in has settled.
* The initiating party and failing delivering trading party should settle between themselves any cash differences arising from the difference in the buy-in price and the original transaction price, including any costs directly related to the execution of the buy-in.
* In a pass-on situation, a trading party receiving confirmation that the buy-in has settled should inform their delivering trading counterparty.
* In a pass-on situation, the purchaser and seller should settle between themselves any cash differences arising from the difference in the buy-in price and **their** original transaction price, including any costs directly related to the execution of the buy-in.

Example

This scenario involves four transactions between five different counterparties in the same bond (assume the bond is widely considered to be illiquid):

* Transaction 1:

On Trade Date (TD) January 2 2019, Party B buys €1,500,000 nominal of XYZ 1% 1/2024 from Party A at a price of 100.25, for intended settlement date (ISD) January 4 2019 (T+2)

* Transaction 2:

TD January 2 2019, Party B sells €1,000,000 nominal of XYZ 1% 1/2024 to Party C at a price of 100.35, ISD January 7 2019 (T+3)

* Transaction 3:
* TD January 8 2019, Party C sells €1,000,000 nominal of XYZ 1% 1/2024 to Party D at a price of 100.75, ISD January 10 2019 (T+2)
* Transaction 4:

TD January 18 2019, Party D sells €1,000,000 nominal of XYZ 1% 1/2024 to Party E at a price of 100.50, ISD January 22 2019 (T+2)

*Scenario 2*

€1.5mm XYZ €1mm XYZ €1mm XYZ €1mm XYZ

E

D

A

B

C

100.25 100.35 100.75 100.50

TD: 1/02 1/02 1/08 1/18

**ISD:** **1/04 1/07 1/10 1/22**

Assume that A fails to deliver the €1.5mm bonds to B on ISD 1/04 and continues to fail. In turn this causes: B to fail its delivery of bonds (€1mm) to C (on 1/07); C to fail its delivery of bonds to D (also on 1/10); and, in time, D to fail its delivery of bonds to E (on 1/22).

* B has the option to pass-on the buy-in obligation to C (since its purchase and sale are within seven business days), but only for the amount of €1mm
* B still has an obligation to buy-in A for the remaining €0.5mm on ISD+7 (Jan 15)
* C has the option to pass-on the buy-in obligation to D (since its purchase and sale are within seven business days)
* Since the ISD for D’s onward sale to E is more than seven business days after its matching purchase from C, it does not have the option to pass-on the buy-in obligation.
* Should B and C pass-on the buy-in obligation, D is responsible for initiating the buy-in process

*Instructing the pass-on notification*

* Jan 15: B notifies A that it is passing-on its buy-in obligation for €1mm (i.e. it has elected not to initiate a buy-in, and so the buy-in will be initiated further along the chain by another party, possibly at a future, unspecified date)
* Jan 15: B also issues A with a buy-in notification for €0.5mm [not illustrated below]
* Jan 16: B notifies C that it is passing-on its buy-in obligation to C
* Jan 21: C notifies D that it is passing-on its buy-in obligation to D
* Jan 21: D begins the buy-in process

Pass-on notification Buy-in obligation Buy-in obligation

D

D begins buy-in

C

A

B

process

VD: 1/21 1/21 1/21 1/21

*Issuing the pass-on*

* 1/21: on appointing the buy-in agent, D sends a buy-in notice to C
* 1/21: C acknowledges receipt of the buy-in and passes-on the buy-in to B
* 1/21: B acknowledges receipt of the pass-on and passes-on to A

Pass-on Pass-on Buy-in

D

C

A

B

Buy-in

agent

VD: 1/21 1/21 1/21 1/21

*Executing the buy-in across the chain*

Assume the buy-in is successfully executed on January 21 for T+2 settlement, in all €1mm bonds, at a price of €100.50 (including all associated costs)

* 1/21: the buy-in agent informs D that the buy-in has successfully been executed (at 100.50)
* 1/21: D immediately informs C of the buy-in execution and relevant details
* 1/21: C immediately informs B of the buy-in execution and relevant details
* 1/21: B immediately informs A of the buy-in execution and relevant details

€1mm XYZ €1mm XYZ €1mm XYZ €1mm XYZ

BIA

D

A

B

C

100.50 100.50 100.50 100.50

TD: 1/21 1/21 1/21 1/21

**ISD:** **1/23 1/23 1/23 1 /23**

*Settling the buy-in across the chain*

* 1/23: the Buy-in agent delivers €1mm XYZ to D vs 100.50 + accrued interest
* 1/23: D pays €2,500 to C ((100.50 – 100.75) x €1mm)
* 1/23: B pays €1,500 to C ((100.50 – 100.35) x €1mm)
* 1/23: A pays €2,500 to B ((100.50 – 100.25) x €1mm)

10,000 ABC

BIA

D

A

B

C

€2,500 €1,500 €2,500 €1,005,000 +AI

ISD (before buy-in): 1/04 1/07 1/10

**ASD (after buy-in): 1/23 1/23 1/23 1/23**

*(Note that in this example a single buy-in process to settle the chain is triggered on Jan 21, 11 business days after the ISD of the first transaction in the chain. Without the pass-on mechanism, the regulation would require three separate buy-ins, with the processes being triggered on Jan 11, 15, and 18 respectively.)*

1. **All other securities: start of chain**

The decision to buy-in or pass-on

* Two business days before the end of the extension period (ISD+4), the failed-to party must issue a pre-advice notice to their failing delivering counterparty to confirm that a buy-in situation exists. (noting that the delivering party can still deliver securities until the end of the extension period).
* In a potential pass-on situation, where a trading party takes the view that the liquidity profile of the failing security is such that a buy-in could be quickly and effectively executed, it is considered best practice for them to initiate the buy-in process rather than to utilise the option to pass-on the buy-in obligation.
* Where a party opts to initiate the buy-in process rather than to pass-on the buy-in obligation, they should notify their onward receiving counterparty.
* Where a receiving trading party is informed by their delivering counterparty that they, or another trading party in the transaction chain, is initiating the buy-in, the receiving trading party should notify any onward receiving counterparty.
* Where a receiving trading party is informed by their delivering counterparty that they, or another party in the transaction chain, is initiating the buy-in, the receiving trading party no longer has an obligation to initiate a buy-in process.[[19]](#footnote-19)

Example

Re-applying scenario 2: four transactions between five different counterparties in the same bond :

* Transaction 1:

On Trade Date (TD) January 2 2019, Party B buys €1,000,000 nominal of XYZ 1% 1/2024 from Party A at a price of 100.25, for settlement date (ISD) January 4 2019 (T+2)

* Transaction 2:

TD January 2 2019, Party B sells €1,000,000 nominal of XYZ 1% 1/2024 to Party C at a price of 100.35, ISD January 7 2019 (T+3)

* Transaction 3:

TD January 8 2019, Party C sells €1,000,000 nominal of XYZ 1% 1/2024 to Party D at a price of 100.75, ISD January 10 2019 (T+2)

* Transaction 4:

TD January 18 2019, Party D sells €1,000,000 nominal of XYZ 1% 1/2024 to Party E at a price of 100.50, ISD January 22 2019 (T+2)

*Scenario 2*

€1mm XYZ €1mm XYZ €1mm XYZ €1mm XYZ

E

D

A

B

C

100.25 100.35 100.75 100.50

TD: 1/02 1/02 1/08 1/18

**ISD:** **1/04 1/07 1/10 1/22**

Assume that A fails to deliver the €1mm bonds to B on ISD 1/04 and continues to fail. In turn this causes: B to fail its delivery of bonds to C (on 1/07); C to fail its delivery of bonds to D (on 1/10); and, in time, D to fail its delivery of bonds to E (on 1/22).

*The decision to buy-in or pass-on*

In this instance, B decides that the underlying security is relatively liquid and can be bought in relatively easily and quickly with minimal market impact.

1/11: B initiates buy-in process against A

1/11: B informs C that a buy-in is being initiated

1/11: C informs D that a buy-in is being initiated

*Executing the buy-in*

* 1/15: the buy-in agent informs B that the buy-in has successfully been executed (at 100.50) for T+2
* 1/15: B immediately informs A of the buy-in execution and relevant details
* 1/17: the buy-in agent delivers €1mm XYZ bonds to B vs 100.50 + accrued interest
* 1/17: A pays the buy-in differential to B

€1mm XYZ

BIA

A

B

€2,500 100.50

TD: 1/15 1/15

**ISD:** **1/17 1/17**

*Settling the chain*

* 1/17: the Buy-in agent delivers €1mm XYZ to B vs 100.50 + accrued interest
* 1/17: B settles the sale to C
* 1/17: C settles the sale D
* 1/22: D settles the sale to E ,

€1mm XYZ €1mm XYZ €1mm XYZ

E

D

B

C

100.35 100.75 100.50

ISD (before buy-in): 1/07 1/10 1/22

**ASD (after buy-in):**  **1/17 1/17 1/22**

1. Article 7 of [REGULATION (EU) No 909/2014](https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0909&from=EN) OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 [↑](#footnote-ref-1)
2. The workshop was hosted by ICMA in London in July 2019 [↑](#footnote-ref-2)
3. See: [www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/ICMA-Rule-Book/](http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/ICMA-Rule-Book/) [↑](#footnote-ref-3)
4. [COMMISSION DELEGATED REGULATION (EU) 2018/1229](https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018R1229&from=EN) of 25 May 2018 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on settlement discipline [↑](#footnote-ref-4)
5. This is irrespective of whether traded on a trading venue or not [↑](#footnote-ref-5)
6. For overall market efficiency, including CCPs in the ‘transaction chain’ from the perspective of buy-ins and pass-ons would be highly desirable [↑](#footnote-ref-6)
7. It should also be noted that recommended best practice by the ICMA European Repo and Collateral Council (ERCC) and ISLA is that in the case of SFTs that are in scope of CSDR buy-ins, the relevant contractual remedies should be applied before the end of the extension period. [↑](#footnote-ref-7)
8. 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. [↑](#footnote-ref-8)
9. See Article 35(2) of the RTS [↑](#footnote-ref-9)
10. See Article 33(2) & 33(3) [↑](#footnote-ref-10)
11. The ICMA Secondary Market Rules & Recommendations include the ICMA ‘Buy-in Rules’ which automatically apply between ICMA members transacting in international securities (usually applied to cross-border bond transactions). [↑](#footnote-ref-11)
12. The CSDR buy-in provisions are generally considered to be unsuitable for SFTs [↑](#footnote-ref-12)
13. [REGULATION (EU) No 600/2014](https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN) OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 [↑](#footnote-ref-13)
14. The pass-on will be based on the sale nominal/quantity, to the extent that the sale nominal is ≤ purchase nominal [↑](#footnote-ref-14)
15. Note that passing-on the buy-in obligation is different from passing-on a buy-in notice. Passing on the buy-in obligation constitutes informing the counterparties to your respective purchase and sell trades that you have elected not to initiate the buy-in process: this will now become the responsibility of the counterparty to your onward sale (or another onward party in the transaction chain). [↑](#footnote-ref-15)
16. It may be that market best practice establish suitable deadlines for the communication and acknowledgment of key notifications in the buy-in and pass-on process [↑](#footnote-ref-16)
17. For consistency, the examples and illustrations utilise the ‘month-day’ format [↑](#footnote-ref-17)
18. 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 [↑](#footnote-ref-18)
19. Subject to the sale and purchase having the same ISD in the case of liquid shares, or being within seven business days in the case of all other securities [↑](#footnote-ref-19)