

**Cross-industry proposal for a
'pass-on' mechanism
under CSDR mandatory buy-ins
(for failing non-centrally cleared transaction chains)**

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What does the industry ask of the regulator?***A pass-on mechanism to be allowable under the CSDR buy-in framework (for non-centrally cleared transactions)***

ESMA to provide Level 3 'Q&A' guidance that where a receiving trading party has a failing settlement of the receipt of securities and a contingent ('linked') failing onward delivery of the same securities, the receiving trading party may 'pass-on' the buy-in notice to its failing delivering trading party. This pass-on should be considered as equivalent to and complying with the regulatory obligation to execute a buy-in against the failing delivering party.

This is intended to reduce the number of buy-ins required to remedy settlement fails, particularly where multiple settlements are contingent on a single (failing) settlement. This is consistent with Recital (19) of the Regulation and Recital (34) of the Regulatory Technical Standards.

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

EXECUTIVE SUMMARY

- This paper outlines a market-led proposal for a standardised market mechanism for buy-in 'pass-ons' that is intended to enhance the CSDR mandatory buy-in framework.
- Buy-ins can be market distortive and destabilising, particularly where the market for the underlying security is relatively illiquid. 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.
- Recital (19) of the Regulation and Recital (34) of the RTS suggest '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.
- The proposed mechanism would allow for trading parties with linked receipts (purchases) and deliveries (sales) of the same securities effectively to 'elect' to be bought in, via receipt of the buy-in notice from the onward receiving (purchasing) counterparty, and pass-on this notice to their failing delivering counterparty. This would be the equivalent of appointing a buy-in agent, since the responsibility for this would move to the onward receiving (purchasing) counterparty.
- The proposal puts forward a two-approach model for pass-ons:
 - i. Approach 1: Pass-on chains that are limited to linked transactions with the same Intended settlement date (ISD): more suited to liquid shares
 - ii. Approach 2: Pass-on chains that consist of linked transactions with different ISDs (more suited for securities other than liquid shares, and important for less liquid securities and asset classes)
- In the case of Approach 2, the transaction chain is extended to settlement instructions with ISDs within the seven-business day buy-in period of the failing receipt, as per Article 37 of the RTS.
- However, trading parties with linked failing transactions are not obliged to elect to pass-on a buy-in notice, and can instead elect to appoint the buy-in agent, should they feel that it is more efficient not to delay the buy-in. In this situation, the trading party should inform its onward receiving counterparty that it is taking responsibility to appoint the buy-in agent.¹
- In both Approach-1 and Approach-2, contractual arrangements between trading parties will ensure that the final receiving (purchasing) trading party in the chain is responsible for appointing the buy-in agent (as per Article 25 of the RTS).

¹ This is in addition to the information to be sent to the failing delivering trading party required by Article 31(1) of the RTS

- The pass-on mechanism is built on the premise of efficient and effective communication by parties and active management of their regulatory obligations. Where a trading party has a linked failing receipt (purchase) and delivery (sale) that are both failing, and is thus intends to pass-on a buy-in notice rather than appoint the buy-in agent, they must communicate this in a clear and timely manner to both their counterparties.
- The proposed mechanism is designed for both equity and non-equity transactions not cleared by a CCP.
- 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.

Introduction

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,² 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,³ and subsequent follow-up meetings, which has 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),⁴ as well as considerations based on the provisions of the regulation and regulatory technical standards (RTS),⁵ 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 transactions⁶ not cleared by a CCP.

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

Benefits of a pass-on mechanism

Buy-ins can be market distortive and destabilising, particularly where the market for the 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. In the same way that a buy-in (or 'cash compensation') is

² Article 7 of [REGULATION \(EU\) No 909/2014](#) 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

³ The workshop was hosted by ICMA in London in July 2019

⁴ See: www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/ICMA-Rule-Book/

⁵ [COMMISSION DELEGATED REGULATION \(EU\) 2018/1229](#) 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

⁶ This is irrespective of whether traded on a trading venue or not

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.

intended to restore the trading parties to a transaction to the economic position they would have been in had the transaction settled on the intended settlement date, so a pass-on restores all trading parties in a transaction chain to the same position.

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.

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.

As described above, 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 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 notice (and subsequent buy-in confirmation, detailing 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

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.

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 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.

Neither CSDR nor the RTS provides for a pass-on mechanism, however Recital (19) of the Regulation and Recital (34) of the RTS suggest '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.

The proposed pass-on mechanism:

Approach 1: same ISD

Intended for fails in liquid shares

Overview

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

- Where a trading party has a failing inward receipt of 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 a trading party has a failing inward receipt of securities and a contingent ('linked') onward delivery of the same securities, it can meet its buy-in obligations by notifying both its failing delivering counterparty (the seller) and its onward receiving counterparty (the buyer) that a 'chain' exists. It should do this at (or before) the end of the extension period related to the failing receipt.⁹
- The responsibility to appoint a buy-in agent at the end of the relevant extension period will then move to the onward receiving counterparty (the buyer).
- It is proposed that for liquid securities (in particular liquid shares, as defined by MiFIR) the scope for a chain situation to exist is limited to linked transactions with the same intended settlement date (ISD) (i.e. same-ISD transaction chains).
- For a chain to exist, the linked receipt and deliveries must be for the same security (ISIN). The trade sizes/nominal amounts may be different, in which case each pass-on would apply to the smaller amount of the linked transactions. Since receipts and deliveries can be of different sizes (such as in the case of sub-account allocations), pass-ons can effectively be split and 'partialed' based on trade sizes¹⁰ [see Example 2 further on].
- Trading parties with linked failing transactions are not obliged to pass-on a buy-in notice from its onward receiving trading counterparty, and can instead elect to preempt this by appointing the buy-in agent, should they feel that it is more efficient not to delay the buy-in. In this situation, the trading party should inform its onward receiving counterparty that it is taking responsibility to appoint the buy-in agent.

⁹ There is discussion about the possibility of market best practice to be that trading parties confirm that a potential buy-in situation exists before the end of the extension period by means of a 'pre-advise notification'

¹⁰ For example, a trading party has two purchases of 40mm, a borrow of 10mm, and an onward sale of 100mm. If all the settlements fail, the party will receive a buy-in notification for 100mm, they can pass-on for 40mm to their two counterparties and will accept the buy-in for 10mm (since they cannot pass-on against the borrow).

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

- In a chain situation, the final receiving trading party (buyer) will be responsible for appointing the buy-in agent. They will know that they are the final receiving party because they will not have a linked onward delivery.
- On appointing the buy-in agent the receiving trading party should issue its failing delivering counterparty (seller) with a buy-in notice.
- A trading party in a chain, on receiving a buy-in notice (or a pass-on notice), should immediately pass that notice on to its failing delivering counterparty (seller), stating that this is a 'pass-on situation'.
- The original failing delivering trading party (seller) in the chain will not be able to pass-on the buy-in notice to another counterparty (see Annex II – Breaking transaction chains). They will be the trading party that is ultimately bought-in.
- On receiving a buy-in or pass-on notice, parties should put their deliveries on hold.

Executing the buy-in

- On successful execution of the buy-in (or any part of the buy-in), the buy-in agent should inform the appointing trading party immediately. The buy-in agent should communicate size, price, and value date of any successful execution.
- The appointing party (the final receiving trading party – or buyer- in the chain), on being informed of the size, price, and value date of any successful execution, should immediately communicate this information to the failing delivering trading party (seller).
- Any (delivering) trading party in a chain, on being informed of the size, price, and value date of any successful execution, should immediately communicate this information to their failing delivering trading party (seller). In this way the relevant information of the buy-in execution should pass along the chain to the original failing delivering party as quickly as possible so that they are able to take the necessary steps to manage their market risk.

Settling the buy-in

- On successful settlement of the buy-in (or any part of the buy-in), the receiving trading party (buyer) responsible for appointing the buy-in agent should notify its delivering counterparty (the seller) that the buy-in (or part of it) has settled. The trading parties should then settle between themselves any difference in the price/value of the buy-in execution and the price/value of their original transaction, including any associated costs related to the buy-in.

- Similarly, the delivering trading party should notify its counterparty that the buy-in (or part of it) has settled, and they should settle between themselves any difference in the price/value of the buy-in execution and the price/value of their original transaction, including any associated costs related to the buy-in.
- 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.
- This will ensure that all trading parties in the chain are ‘made whole’ with respect to their original transactions, with any costs associated with the buy-in being borne solely by the original delivering party (seller) in the chain.
- It is important to note that this can only work if the differential payments can be paid in either direction between the various delivering (selling) and receiving (purchasing) trading parties in the chain, depending on whether the price/value of the buy-in execution (including any associated costs) is higher or lower than that of each original transaction in the chain. This is discussed and illustrated in Annex I.

Deferrals

- Where the buy-in cannot be executed successfully within the appropriate timeline, the appointing party (the final receiving trading party – or buyer- in the chain), can elect whether to attempt the buy-in one more time (deferral), or to go to cash compensation.
- Where the appointing party (the final receiving trading party – or buyer- in the chain) elects to defer the buy-in for one more attempt, they should immediately notify their failing delivering trading party (seller).
- Any (delivering) trading party in a chain, on being informed of a deferral of the buy-in, should immediately communicate this information to their failing delivering trading party (seller). In this way, notice of deferral should pass along the chain to the original failing delivering party as quickly as possible.

Cash compensation

- In the event of cash compensation, the appointing party (the final receiving trading party – or buyer- in the chain), should immediately communicate this information to the failing delivering trading party (seller) including the cash compensation reference price.
- The cash compensation reference price will be determined between the appointing (the final receiving trading party – or buyer- in the chain) and its failing inward delivering counterparty (as

per Article 32 of the RTS). This reference price is then used to settle the entire transaction chain, in the same way as buy-in price.

- Any (delivering) trading party in a chain, on being informed of cash compensation and the cash compensation reference price, should immediately communicate this information to their failing delivering trading party (seller). In this way the relevant information should pass along the chain to the original failing delivering party as quickly as possible so that they are able to take the necessary steps to manage their market risk.
- The process for settling the cash compensation through the chain should be similar to that of settling the buy-in differential, with each trading party in the chain making payments with their respective counterparties based on the cash compensation reference price/value and their original transaction price/value, to ensure that all trading parties are 'made whole' with respect to their original transactions. As with settling the buy-in differential, it will need to be possible for these payments to be made in either direction between delivering (selling) and receiving (purchasing) parties to ensure that no trading party in the chain is unduly penalised or rewarded.

Ensuring that the buy-in takes place

- In the case of transaction chains, there is a theoretical possibility that the buy-in is delayed across the chain if the final receiving trading party does not initiate the buy-in process and appoint the buy-in agent as required. This possibility may increase with longer transaction chains.
- To ensure that the appointment of the buy-in agent is not delayed unreasonably due to the length of some chains, it is proposed that where a trading party identifies a pass-on situation, and notifies both its counterparties accordingly, if it does not subsequently receive a buy-in (or pass-on) notice from its onward receiving counterparty (buyer) by the end of the first day of the buy-in period, it will be required to appoint a buy-in agent and issue its failing delivering counterparty (seller) with a buy-in notice the following business day.

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. Where a trading party has a linked failing receipt (purchase) and delivery (sale) that are both failing, and is thus entitled to pass-on the buy-in notice rather than appoint the buy-in agent, they must communicate this in a clear and timely manner to both their counterparties at (or before) the end of the relevant extension period related to the receipt (purchase).

As standard operational best practice, trading parties are required to 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, as would otherwise be required by the regulation.

An example of Approach 1 is provided on page 16

The roles of the trading counterparties

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

Approach 1 (same ISD)



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



Approach 2: different ISDs

Intended for fails in securities other than liquid shares

Differences to approach 1

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

- It is usual for transaction chains to be made up of linked trades with different ISDs. From a market efficiency and stability perspective, it is important that these chains do not result in multiple buy-ins (i.e. one being triggered for each ISD in the chain), particularly for less liquid securities and asset classes (such as corporate bonds).
- Pass-ons used in the non-cleared bond markets today (such as the ICMA Buy-in Rules) are not restricted by the ISDs of linked transactions.
- To be consistent with the regulation, it is proposed that for the purpose of a pass-on, matching receipts and deliveries can be linked so long as their respective ISDs are within seven business days of each other (i.e. within the relevant extension period).

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

- As with Approach 1, the final receiving trading party (buyer) in the chain will be responsible for appointing the buy-in agent. They will know that they are the final receiving party because they will not have a linked onward delivery within seven business days of the ISD of their failing receipt.
- On receiving a buy-in or pass-on notice, parties should put their deliveries on hold. Until this time, it remains possible to make good on their deliveries, which could potentially happen before the final receiving trading party in the chain is required to appoint the buy-in agent and serve its failing counterparty with the buy-in notice.

Ensuring that the buy-in takes place

- Given the ability to link matching transactions with different ISDs (within a seven business day limitation), this is likely to extend the overall extension period for the entire chain beyond the seven business day extension period of the original transaction in the chain.
- To ensure that the appointment of the buy-in agent is not delayed unreasonably due to the length of some chains, it is proposed that where a trading party identifies a pass-on situation, and notifies both its counterparties accordingly, if it does not subsequently receive a buy-in (or pass-on) notice from its onward receiving counterparty (buyer) by the end of the seventh (final) business day of the buy-in period, it will be required to appoint a buy-in agent and issue its failing delivering counterparty (seller) with a buy-in notice the following business day.
- This would ensure that a buy-in would never be delayed beyond the deferral period outlined in the regulation.

An example of Approach 2 is provided on page 19

The roles of the trading counterparties

Approach 2 (different ISDs)



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 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	At the end of the extension period for trade with B, 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)	At the end of the extension period for trade with C, 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



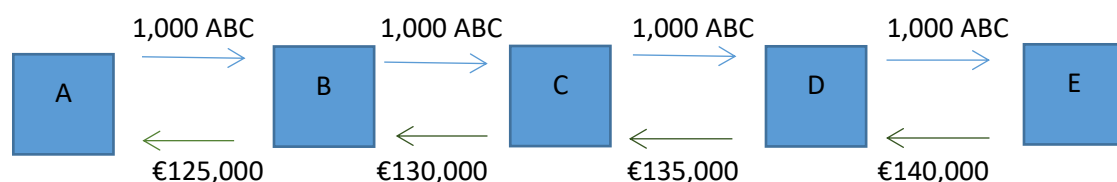
Pass-on mechanism examples

Approach 1 (same ISD)

Example 1

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

- **Transaction 1:**
On Trade Date (TD) January 2 2019,¹¹ 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)



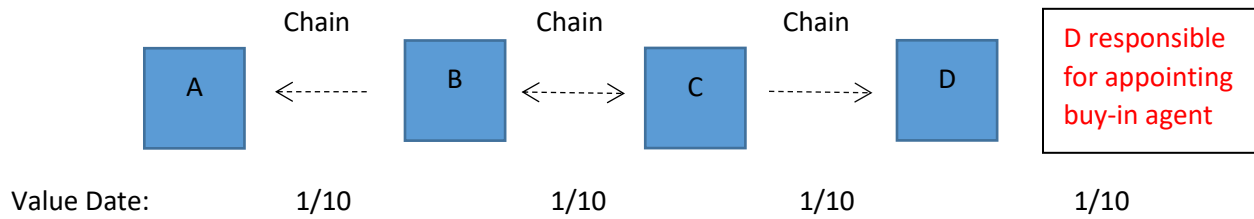
Trade Date:	1/02	1/02	1/02	1/03
ISD:	1/04	1/04	1/04	1/07

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

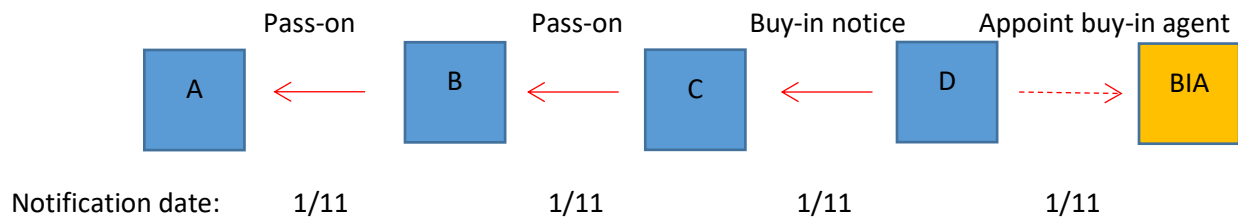
- Since B has a linked failing purchase (receipt) and sale (delivery), for the same ISD, it can inform its counterparties, A and C, that there is a chain. C will be responsible for appointing the buy-in agent.
- Since C has a linked failing purchase (receipt) and sale (delivery), for the same ISD, it 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).

¹¹ For consistency, the examples and illustrations utilise the 'month-day' format



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

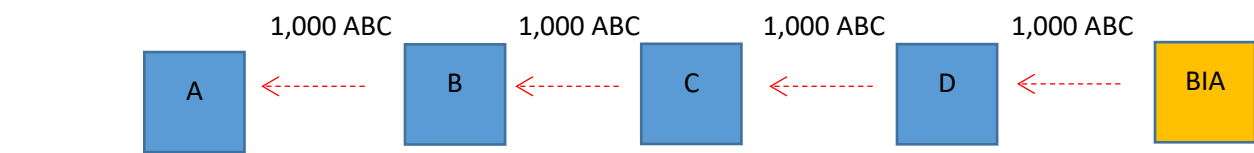
- 1/11: on appointing the buy-in agent, D sends a buy-in notice to C¹²
- 1/11: C acknowledges receipt of the buy-in and passes-on the buy-in to B
- 1/11: B acknowledges receipt of the pass-on and passes-on to A
- 1/11: A, B, and C must put their respective deliveries on hold



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

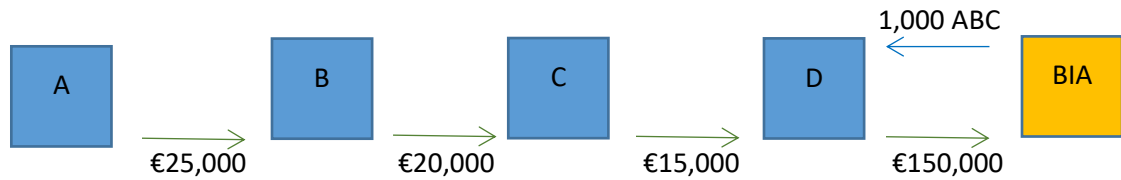


¹² The extension period ends on ISD+4, with the buy-in process beginning on ISD+5

	Px: €150	Px: €150	Px: €150	Px: €150
TD:	1/14	1/14	1/14	1/14
ISD:	1/16	1/16	1/16	1/16

Settling the buy-in¹³

- 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 $((150 - 125) \times 1,000)$



ISD (before buy-in):	1/04	1/04	1/04	
SD (after buy-in):	1/16	1/16	1/16	1/16

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).

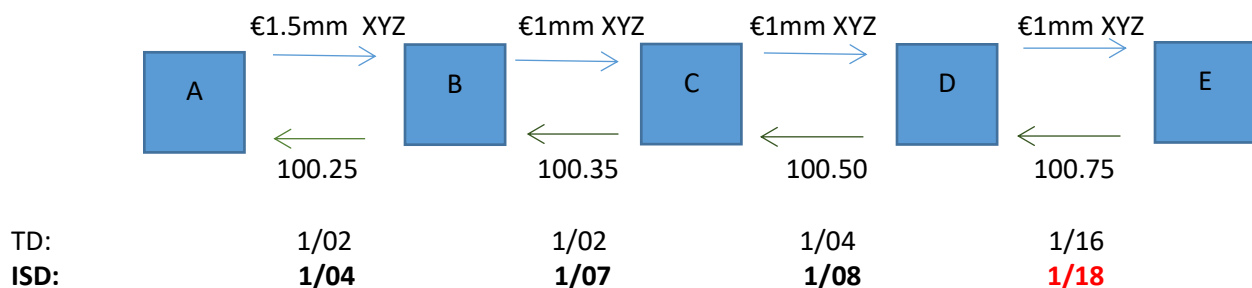
¹³ Here it is assumed that parties settle the buy-in differential payments on the same day that the buy-in is settled, however the RTS specifies that this should be within 2 business days of the buy-in settlement

Approach 2 (different ISDs)

Example 2

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

- 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 4 2019, Party C sells €1,000,000 nominal of XYZ 1% 1/2024 to Party D at a price of 100.50, ISD January 8 2019 (T+2)
- Transaction 4:
TD January 16 2019, Party D sells €1,000,000 nominal of XYZ 1% 1/2024 to Party E at a price of 100.75, ISD January 18 2019 (T+2)

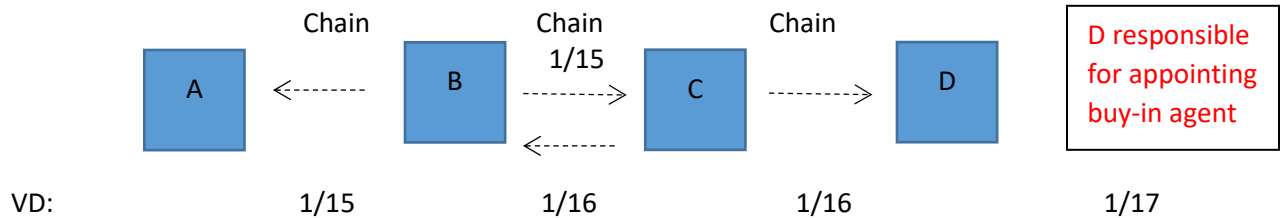


Assume that A fails to deliver the €1.5mm bonds to B on ISD 1/04 and continues to fail. In turn this causes: B to fail its delivery of bonds (€1mm) to C (on 1/07); C to fail its delivery of bonds to D (on 1/08); and, in time, D to fail its delivery of bonds to E (on 1/18).

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

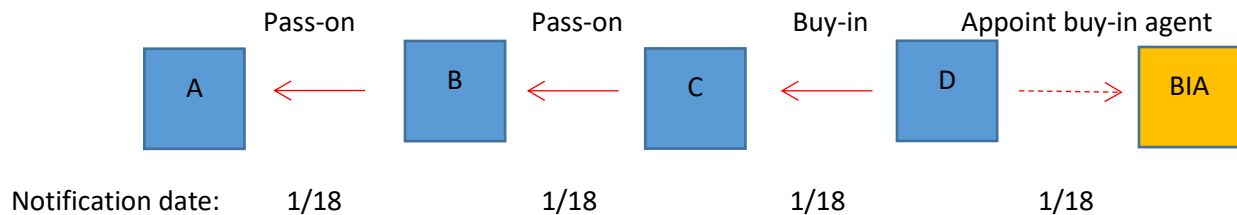
- Since B has a linked failing purchase (receipt) and sale (delivery), for ISDs within the 7 days extension period, it can inform its counterparties, A and C, that there is a chain. However, this will only be for the smaller of B's purchase and sale (€1mm). C will be responsible for appointing the buy-in agent.
- B still has an obligation to buy-in A for the remaining €0.5mm after ISD+7 (Jan 16)
- Since C has a linked failing purchase (receipt) and sale (delivery), for ISDs within the 7 days extension period, 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 the ISD for D’s onward sale to E is more than seven business days after its linked purchase from C, it does not have the option to pass-on the buy-in obligation. D is at the end of the chain and is responsible for appointing the buy-in agent.



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

- 1/18: on appointing the buy-in agent, D sends a buy-in notice to C¹⁴
- 1/18: C acknowledges receipt of the buy-in and passes-on the buy-in to B
- 1/18: B acknowledges receipt of the pass-on and passes-on to A
- 1/18: A, B, and C must put their respective deliveries on hold

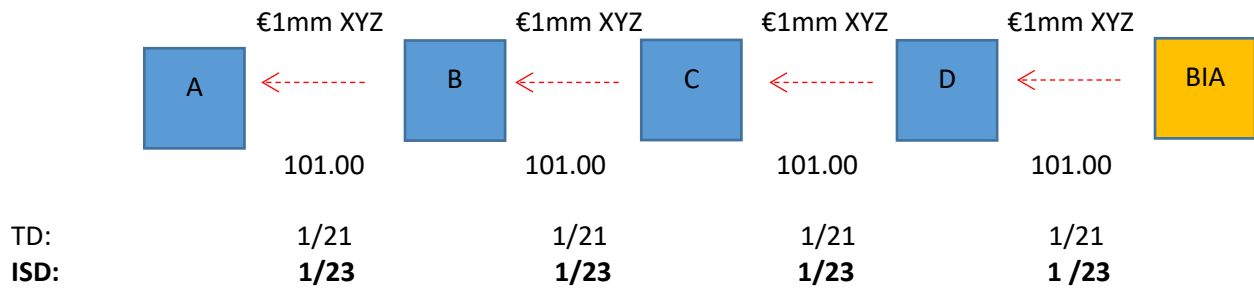


Executing the buy-in

Assume the buy-in is successfully executed on January 21 (the following business day after the buy-in agent is appointed) for T+2 settlement (January 23), in all €1mm bonds, at a price of €101.00 (including all associated costs)

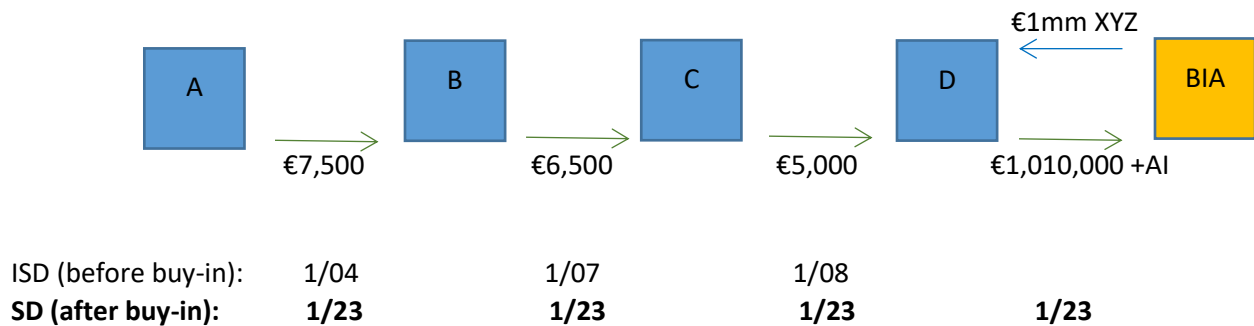
- 1/21: the buy-in agent informs D that the buy-in has successfully been executed (at 101.00)
- 1/21: D immediately informs C of the buy-in execution and relevant details
- 1/21: C immediately informs B of the buy-in execution and relevant details
- 1/21: B immediately informs A of the buy-in execution and relevant details

¹⁴ This is the day following the end of the extension period for D’s purchase from C



Settling the buy-in

- 1/23: the Buy-in agent delivers €1mm XYZ to D vs 101.00 + accrued interest
- 1/23: C pays €5,000 to D $((101.00 - 100.50) \times \text{€1mm})$
- 1/23: B pays €6,500 to C $((101.00 - 100.35) \times \text{€1mm})$
- 1/23: A pays €7,500 to B $((101.00 - 100.25) \times \text{€1mm})$



(Note that in this example a single buy-in process to settle the chain is triggered on Jan 18, 10 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 16, 17, and 18 respectively.)

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 101.00).

Annex I

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 price¹⁵ or cash compensation reference price.¹⁶

The purpose of a buy-in is to restore the parties to a transaction to the economic position they would have been in had the original transaction settled on the intended settlement date. The fallback remedy of cash settlement (called 'cash compensation' in CSDR) is intended to achieve the same outcome where a buy-in is not possible. Pass-ons facilitate the same remedy (whether through a buy-in or cash compensation) through the entire transaction chain. This requires the ability to make payments between parties in either direction, depending on whether the price/value of the original transaction is higher or lower than the buy-in price/value or the cash compensation reference value.

Since the regulation does not seem to 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/value or cash compensation reference price/value is lower than the original transaction price), it will not be possible to ensure that the buy-in process will restore all parties in the chain to the position they would have been in had the original transactions settled.

In the case where the buy-in price/value or cash compensation price/value is lower than an intermediary's original transactions (purchase and sale), CSDR seems to suggest that both transactions would effectively be canceled, and the differential related to these transactions would be "deemed paid". This creates a significant risk to trading parties in a chain, who could be economically disadvantaged as a result of settlement fails that are beyond their control. In this case a pass-on mechanism cannot be relied upon to make them 'whole'. From the intermediaries perspective, a CSDR buy-in will inadvertently penalize them. The safest option to protect the economics of their original position would therefore be to initiate a contractual buy-in at the earliest possible opportunity (ISD+1).¹⁷ All other intermediary parties in the chain will have the same incentive.

Hence a CSDR pass-on mechanism will not work unless the buy-in and cash compensation differentials can be paid symmetrically (in either direction) between trading parties, as is the usual process for contractual buy-ins and pass-ons.

This is illustrated in the below example.

¹⁵ See Article 35(2) of the RTS

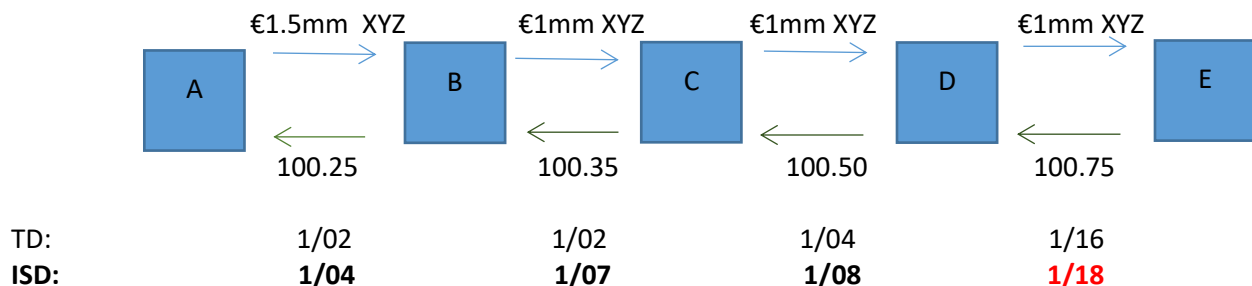
¹⁶ See Article 33(2) & 33(3)

¹⁷ It is important to remember that while CSDR specifies extension periods after which a buy-in must take place, contractually firms can issue buy-ins any time from ISD+1

Example 3

Revisiting Example 2, involving four transactions between five different counterparties in the same bond (assume the bond is widely considered to be illiquid):

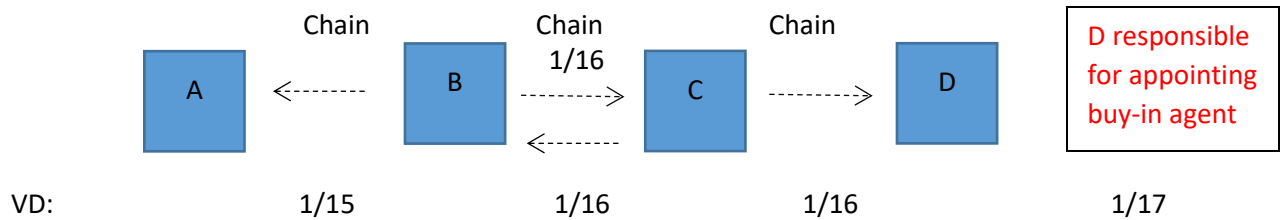
- Transaction 1:
On Trade Date (TD) January 2 2019, Party B buys €1,500,000 nominal of XYZ 1% 1/2024 from Party A at a price of 100.25, for intended settlement date (ISD) January 4 2019 (T+2)
- Transaction 2:
TD January 2 2019, Party B sells €1,000,000 nominal of XYZ 1% 1/2024 to Party C at a price of 100.35, ISD January 7 2019 (T+3)
- Transaction 3:
TD January 4 2019, Party C sells €1,000,000 nominal of XYZ 1% 1/2024 to Party D at a price of 100.75, ISD January 8 2019 (T+2)
- Transaction 4:
TD January 16 2019, Party D sells €1,000,000 nominal of XYZ 1% 1/2024 to Party E at a price of 100.50, ISD January 18 2019 (T+2)



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 (on 1/08); and, in time, D to fail its delivery of bonds to E (on 1/18).

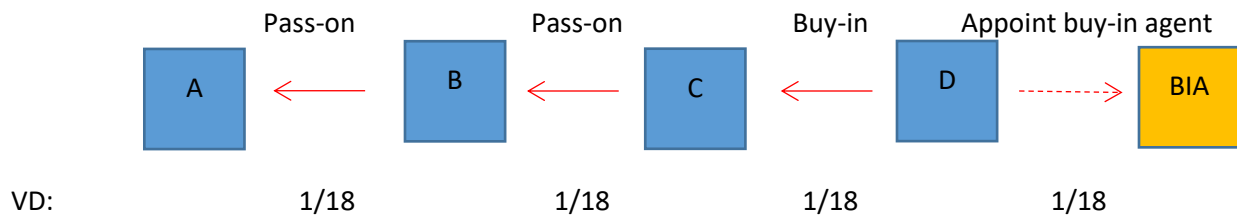
Identifying a pass-on situation and creating the chain

- Since B has a linked failing purchase (receipt) and sale (delivery), for ISDs within the 7 days extension period, it can inform its counterparties, A and C, that there is a chain. However, this will only be for the smaller of B's purchase and sale (€1mm). C will be responsible for appointing the buy-in agent.
- B still has an obligation to buy-in A for the remaining €0.5mm on ISD+7 (Jan 15)
- Since C has a linked failing purchase (receipt) and sale (delivery), for ISDs within the 7 days extension period, it can inform its counterparties, B and D, that there is a chain. D will be responsible for appointing the buy-in agent.
- Since the ISD for D's onward sale to E is more than seven business days after its linked purchase from C, it does not have the option to pass-on the buy-in obligation. D is at the end of the chain and is responsible for appointing the buy-in agent.



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

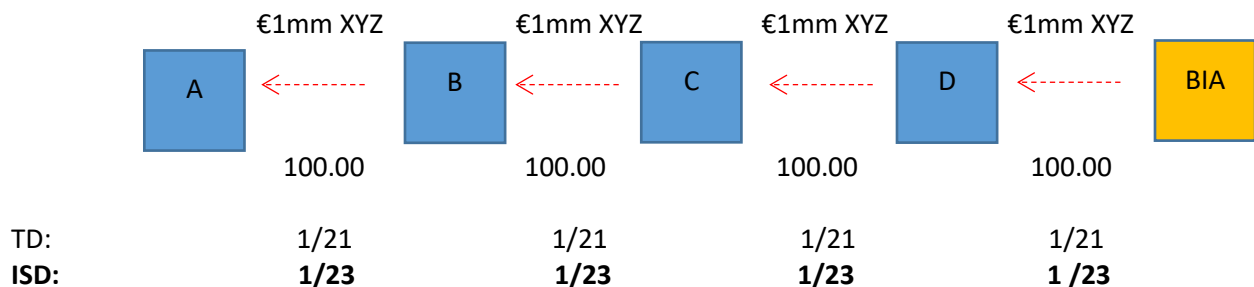
- 1/18: on appointing the buy-in agent, D sends a buy-in notice to C
- 1/18: C acknowledges receipt of the buy-in and passes-on the buy-in to B
- 1/18: B acknowledges receipt of the pass-on and passes-on to A
- 1/18: A, B, and C must put their respective deliveries on hold



Executing the buy-in

Assume the buy-in is successfully executed on January 21 for T+2 settlement (January 23), in all €1mm bonds, at a price of €100.00 (including all associated costs)

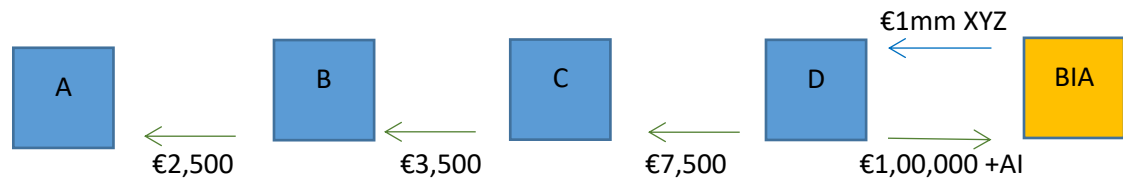
- 1/21: the buy-in agent informs D that the buy-in has successfully been executed (at 100.00)
- 1/21: D immediately informs C of the buy-in execution and relevant details
- 1/21: C immediately informs B of the buy-in execution and relevant details
- 1/21: B immediately informs A of the buy-in execution and relevant details



Settling the buy-in

- 1/23: the Buy-in agent delivers €1mm XYZ to D vs 100.00 + accrued interest
- 1/23: D pays €7,500 to C ((100.00 – 100.75) x €1mm)

- 1/23: C pays €3,500 to B $((100.00 - 100.35) \times \text{€1mm})$
- 1/23: B pays €2,500 to A $((100.00 - 100.25) \times \text{€1mm})$



ISD (before buy-in):	1/04	1/07	1/08	
SD (after buy-in):	1/23	1/23	1/23	1/23

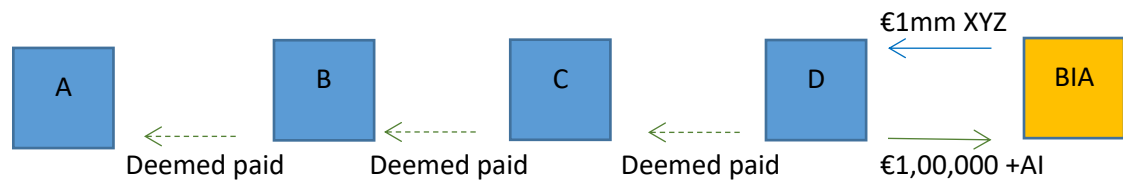
All parties are restored to the position they would have been had all the original trades settled.

The same process would apply in the case of cash compensation (with reference price 100.00).

Applying the CSDR asymmetry

Settling the buy-in

- 1/23: the Buy-in agent delivers €1mm XYZ to D vs 100.00 + accrued interest
- Since the buy-in price is lower than all the other transactions in the chain, these are all “deemed paid”



ISD (before buy-in):	1/04	1/07	1/08	
SD (after buy-in):	1/23	1/23	1/23	1/23

None of the parties are restored to the position they would have been had all the original trades settled.

D is €7,500 better off; C is €4,000 worse off; B is €1,000 worse off; and A is €2,500 worse off.

The pass-on mechanism will not work as a consequence of the asymmetry.

Annex II

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.

- **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.¹⁸ So it should be assumed that in most cases, SFTs will break a transaction chain for the purpose of pass-ons.

In the case where a transaction chain is broken by an out-of-scope trade, the receiving (purchasing) trading party to the last in-scope transaction will be responsible for appointing the buy-in agent.

¹⁸ The CSDR buy-in provisions are generally considered to be unsuitable for SFTs