Proposal for pass-on mechanism under CSDR mandatory buy-ins
(for failing non-centrally cleared transaction chains)
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Draft (v1)

- This paper has been prepared for the ICMA CSDR-SD WG
- It is intended to be circulated more broadly, including with other associations
- Ideally this should become a joint industry proposal to ESMA
Overview

Buy-ins are a long established and well utilized settlement risk management tool that have existed in ‘cash’ markets for decades. In the event of a settlement fail, they are means (usually contractual in nature) by which the purchaser can effectively ‘enforce’ settlement of the transaction. Pass-ons are a mechanism within buy-in processes that provide for the efficient settlement of chains of dependent transactions by means of a single buy-in, rather than triggering multiple buy-ins across the entire chain. From September 2020, the CSD-Regulation will introduce a new and standardized approach to buy-ins for transactions intended to be settled on EU/EEA (I)CSDs, including a mandatory requirement for purchasers to initiate a buy-in process against their selling counterparty in the case of a settlement fail. The CSDR buy-in framework, however, does not provide for a pass-on mechanism.

This proposal, which has been developed by a broad range of market participants, lays out a model for a possible pass-on mechanism that could function under CSDR with respect to non-centrally cleared markets. It is based on existing pass-on models (such as the ICMA Buy-in Rules) and is intended to provide for many of the benefits and efficiencies of established practice, while operating within the regulatory requirements of CSDR.

What is a pass-on and how do they work?

Often the settlement of onward outright sales in non-cleared markets are contingent on the settlement of a 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.

A ‘pass-on’ is a mechanism by which a single buy-in can be used to settle an entire chain of settlement fails. The buy-in is initiated by the 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 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 seller’).

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 until the details reach the original seller. As the details are passed between parties, so they will cancel their original trades and settle between them the differential between the buy-in price (including any associated costs) and the original trade price. Any final costs associated with the buy-in (primarily the buy-in premia - i.e. the difference between the buy-in price and the current market price) are ultimately borne by the original seller. Everybody else in the chain, including the final purchaser, is restored economically to the position they would have been in had the original trade settled.

Importantly, there does not need to be a holistic view of the entire settlement chain, and parties do not need to know where they are in the chain: parties merely need to know that they have a failing inward purchase and a dependent onward sale 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.
The ICMA Buy-in Rules\(^1\) have provided for a pass-on mechanism since their inception some decades ago, and the process is generally considered to work effectively and efficiently.

It should also be noted that a pass-on mechanism can work in exactly the same way in the case of cash compensation.

**Context: CSDR**

CSDR introduces a mandatory buy-in framework, including for non-centrally cleared trades, whereby purchasing parties are obliged to initiate a buy-in process in the case that their purchase fails to settle for a prescribed period of time (known as the ‘extension period’). Other than in the case of liquid equities, the extension period is 7 business days.\(^2\) The regulation then allows the same timeframe (7 business days, other than in the case of liquid equities) for the buy-in to be completed (i.e. the buy-in notice to be served, the buy-in agent appointed, and the buy-in executed and settled). In the event that the buy-in is unsuccessful, the purchasing party may elect to attempt the buy-in one more time, subject to the same timeframe (known as the ‘deferral period’), otherwise the buy-in will be cash settled (called ‘cash compensation’ in the regulation) based on a market reference price or by applying a pre-agreed methodology. In the case that the purchaser unsuccessfully attempts the buy-in one more time, this will automatically result in cash compensation at the end of the deferral period.

CSDR does not provide for a pass-on mechanism, nor does it preclude one. From a market efficiency and stability perspective, a pass-on mechanism under CSDR would be highly desirable. However, the CSDR framework presents a number of challenges to applying a pass-on mechanism.

**Challenges to a pass-on mechanism under CSDR**

For a buy-in mechanism to work efficient and effectively, and with a high degree of reliability, there are two main pre-requisites:

1. **There is no incentive for any party in the chain, other than the final purchaser, to initiate a buy-in process**
   Since parties in a chain are not economically disadvantaged by the pass-on process, there is no incentive for them to start a buy-in process; rather it is easier to rely on the final purchaser to start the process and wait for the pass-on.

2. **There is no requirement for any party in the chain, other than the final purchaser, to initiate a buy-in process**
   This is important since often the transactions in a chain will not be for the same value date. The discretionary nature of the buy-in process means that parties in the chain will not be

\(^{1}\) The ICMA Buy-in Rules apply to transactions in international securities and automatically apply to trades between ICMA members. (Note that they do not apply to repo or other SFTs.)

\(^{2}\) In this proposal we will assume a 7-day extension period, although the principal applies equally to the shorter 4-day extension period for liquid equities.
obligated to start a buy-in process, and so the discretion to do so will ultimately fall to the final party in the chain (the final purchaser).

Proposal

The incentive for parties in a chain to buy-in: addressing the potential CSDR asymmetry

Parties in a buy-in chain (other than the final purchaser) will generally have no inclination to initiate a buy-in since there is no economic incentive to do so. Since they have a matching purchase and sale, it is far more efficient to wait for a buy-in or a pass-on to be issued to them and in turn pass it on to their failing seller (and along the chain). So long as the buy-in (or cash settlement/compensation) framework allows for payments to be passed in either direction between failing sellers and buyers, depending on whether the buy-in/reference price is higher or lower than the original transaction prices, parties in the chain will not be economically disadvantaged. If for any reason the differential payments between parties could not go in either direction, then this would potentially change the economics of the original transactions, putting matched sellers and buyers at risk. In this case there would be an incentive not to wait for a pass-on and instead to initiate a buy-in against their failing seller as quickly as possible (ideally on ISD+1).

While there is an apparent asymmetry in the buy-in and cash compensation payment provisions in CSDR (which has been widely flagged and discussed), it is assumed that this can be resolved by means of a contractual arrangement between parties to settle the differential payments symmetrically. Thus it is important that for the proposed pass-on mechanism to function effectively, this will require that parties are able to settle buy-in and cash compensation differential payments symmetrically throughout the transaction chain.

The obligation for parties in a chain to buy-in: working within the mandatory requirement

Transactions in a transaction chain will rarely share the same ISD. Parties who buy and sell securities may not do so on the same day or for the same value date. Where the buy-in mechanism is discretionary (such as the ICMA Buy-in Rules), different ISDs within a transaction chain do no pose a problem since there is neither an incentive, nor requirement, for any party in the chain to initiate a buy-in process: this incentive will always sit with the final purchaser in the chain. Hence different ISDs do not ‘break the chain’ and a pass-on mechanism can be used to settle the entire chain with a single buy-in.

Since CSDR requires that a buy-in process be initiated immediately following the extension period, this gives rise to the risk that each new ISD in a transaction chain will trigger its own buy-in process, leading to multiple buy-ins. This proposal therefore seeks to address this particular challenge by proposing that the obligation to initiate the buy-in passes along a transaction chain until it reaches the final purchaser.

The obligation would only pass along the chain in the case that:

3 For example, it is expected that the ICMA Buy-in Rules, which are used widely in the international bond markets, will be revised to align with the CSDR provisions whilst also providing for symmetrical buy-in and cash compensation differential payments.
(i) The matching purchase and sale are in the same security
(ii) The matching purchase and sale are for the same nominal amount\(^4\)
(iii) The matching purchase and sale are within the extension period

**Example**

This scenario involves 4 transactions in the same security and 5 different counterparties:

- 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 €500,000 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 10 2019, Party D sells €500,000 nominal of XYZ 1% 1/2024 to Party E at a price of 100.50, ISD January 14 2019 (T+2)

\[\begin{align*}
\text{A} & \xrightarrow{100.25} \text{B} \xrightarrow{100.35} \text{C} \xleftarrow{100.75} \text{D} \xleftarrow{100.50} \text{E} \\
\text{TD:} & \quad 1/02 \quad 1/02 \quad 1/08 \quad 1/09 \\
\text{ISD:} & \quad 1/04 \quad 1/07 \quad 1/10 \quad 1/11
\end{align*}\]

We will assume that A fails to deliver the €1mm securities to B on ISD 1/04 and continues to fail. In turn this causes: B to fail its delivery of €1mm to C on 1/07; C to fail its delivery of €0.5mm to D on 1/10; and D to fail its delivery of €0.5mm to E on 1/14.

**No pass-on mechanism**

In the case of there being no pass-on mechanism, each transaction could potentially trigger a buy-in process:

- On 1/15, B is required to initiate the buy-in process against A (to be completed by 1/23) for €1mm
- On 1/16, C is required to initiate the buy-in process against B (to be completed by 1/24) for €1mm
- On 1/18, D is required to initiate the buy-in process against C (to be completed by 1/28) for €0.5mm

\(^4\) The pass-on will be based on the sale nominal, to the extent that the sale nominal is ≤ purchase nominal
- On 1/21, D is required to initiate the buy-in process against E (to be completed by 1/29) for €0.5mm

![Buy-in Process Diagram]

Notice date: 1/15 1/16 1/18 1/21
Completion date: 1/23 1/24 1/28 1/29

Summary: 4 buy-ins initiated over 5 days for a total nominal value of €3mm

Proposed pass-on mechanism

- On 1/15, B is not required to initiate the buy-in process against A, since it has a matching sale to C (also for €1mm) within the extension period (ISD 1/07)
- On 1/16, C is required to initiate a buy-in process against B, but only for €0.5mm, since it has a part-matching sale to D (of €0.5mm) also within the extension period (ISD 1/10)
- On 1/18, D is not required to initiate the buy-in process against C, since it has a matching sale to E (€0.5mm) within the extension period (ISD 1/11)
- On 1/21, E is required to initiate the buy-in process against D, for €0.5mm, since it has no matching onward sale

Buy-in 1: C issues a buy-in against B for €0.5mm, and B passes-on to A

Notice date: 1/16 1/16
Completion date: 1/24 1/24

Buy-in 2: E issues a buy-in against D for €0.5mm, D passes-on to C, C passes-on to B, B passes-no to A

Notice date: 1/21 1/21 1/21 1/21
Completion date: 1/29  1/29  1/29  1/29

Summary: 2 buy-ins initiated over 4 days for a total nominal value of €1mm

Settling the buy-in

Buy-in 1: Assume C successfully executes the buy-in at 100.00 on 1/22 (for T+2)

- On 1/22, C immediately informs B of the successful execution and execution price, and B immediately informs A
- On 1/24, C receives the bonds (€0.5mm) from the buy-in agent (Price 100.00)
- On 1/28, C makes a payment to B of 0.35c (100.00-100.35)
- On 1/28, B makes a payment to A of 0.25c (100.00-100.25)

Settlement date: 1/24  1/24
Payment date: 1/28  1/28

Buy-in 2: Assume E successfully executes the buy-in at 101.00 on 1/25 (for T+2)

- On 1/25, E immediately informs of the successful execution and execution price. D immediately informs C, and this information is immediately passed along the chain until it reaches A
- On 1/29, E receives the bonds (€0.5mm) from the buy-in agent (Price 101.00)
- On 1/31, D makes a payment to E of 0.50c (101.00-100.50)
- On 1/31, C makes a payment to D of 0.25c (101.00-100.75)
- On 1/31, B makes a payment to A of 0.65c (101.00-100.35)
- On 1/31, A makes a payment to B of 0.75c (101.00-100.25)

Settlement date: 1/29  1/29  1/29  1/29
Payment date: 1/31  1/31  1/31  1/31

Summary: All parties are restored to the economic position they would have been had all the original transactions settled. Any costs associated with the buy-ins (including the buy-in premia) are incurred by the original failing party (A).
Pros & cons

Pros:

- Does not require overall visibility of the transaction chain
- Is not CSD specific (can work across multiple CSDs)
- Could work across other jurisdictions (where mandatory buy-ins do not apply)
- Works for different ISDs in the transaction chain (to the extent that each matching buy and sell in the chain fall within their respective extension period)
- Is based on a well-established and widely used mechanism in the non-cleared bond markets
- Avoids additional risks (and potential costs) for all parties in the chain, except for the original failing seller
- Will also work in the case of cash compensation
- Will reduce the overall number of buy-ins and increase market efficiency

Cons:

- Each link in the transaction chain potentially extends the time between the original fail and the eventual buy-in
- To work successfully, all parties in the chain must pass-on the original notification and eventual buy-in execution details immediately [this challenge exists today]

Other considerations

How do parties know that they can pass-on the obligation to buy-in?

In many respects this would be similar to how pass-on in the non-cleared markets work today. Where parties have a matching purchase and sale (same security, same nominal value), they would not be obliged to initiate the buy-in process against the failing purchase. They would need to ensure, however, that the time between the ISDs for the purchase and sale are no longer than the applicable extension period.

How do parties evidence that they can pass-on the obligation to buy-in?

Where a party has a failing purchase that reaches the end of the extension period, they should be able to evidence to the relevant CSD that they have a matching sale within the relevant extension period (noting that this sale may not necessarily be intended to settle on the same CSD).

Could parties at the end of a chain execute a matching sale to avoid the buy-in obligation?

While theoretically possible, it seems highly unlikely in practice. The final purchaser in a transaction chain has a vested interest in receiving their securities, and so would benefit from a successfully executed buy-in. In most cases, the final purchaser is an end investor, rather than a market-maker or
other liquidity provider. Furthermore, becoming a ‘forced seller’ to avoid the buy-in responsibility is likely to be economically disadvantageous compared with receiving the securities. 

*How does information pass along transaction chains quickly and efficiently?*

Firms today currently have processes in place in the case of buy-ins and pass-ons, both for passing on notifications as well as the eventual buy-in confirmation and execution details.⁵ In most cases (at least from the perspective of ICMA buy-in experience) the process works relatively well, even across long chains. However, buy-ins are relatively seldom, so the manual processing of buy-ins, while time consuming, is generally manageable. It would therefore seem that in a post-CSDR environment, where buy-ins are likely to be more frequent, there may be a need to enhance current market practice and potentially introduce some level of automation to ensure greater efficiency in the pass-on process.

**Conclusion**

Pass-ons are a critical component of buy-in mechanisms, providing for greater efficiency in the buy-in process and reducing the risk of market volatility and instability that can be caused by multiple buy-ins in the same security within relatively short timeframes. The CSDR mandatory buy-in regime is expected to increase the number of buy-ins currently experienced in the non-cleared bond and equity markets, making an effective pass-on mechanism even more important.

This proposal attempts to adapt existing pass-on mechanisms and practices to complement the CSDR framework and, hopefully, to support the objectives of the CSDR Settlement Discipline regime.

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⁵ The ICMA Buy-in Rules require that pass-on notifications and buy-in execution details are passed between relevant parties “*immediately*”