International Capital Market Association
Dreikönigstrasse 8
CH-8002 Zurich

http://www.icmagroup.org/

European Securities and Markets Authorities
103 Rue de Grenelle
75345 Paris
France

Submitted online: www.esma.europa.eu

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ESMA Consultation Paper

Regulatory Technical Standards on the CSD Regulation
The Operation of the Buy-in Process

ICMA response

About ICMA

The International Capital Market Association ("ICMA") is committed to serving the needs of its members through its activities as a trade association and as a self regulatory organisation. The membership of ICMA includes issuers, primary and secondary market intermediaries, asset managers, investors and capital market infrastructure providers. Working actively with its members in all segments of the wholesale and retail markets, buy and sell side, ICMA focuses on a comprehensive range of regulatory, market and other relevant issues which impact market practices and the functioning of the international debt capital markets. ICMA serves the needs of more than 480 members across almost 60 countries.

The mission of ICMA is to promote resilient and well functioning international debt capital markets. Such markets are necessary for economic growth, and benefit market participants and their clients alike. ICMA seeks to achieve this through:

- helping to build trust in the industry by promoting best market practice through the development of appropriate, industry accepted, guidelines, rules, recommendations and standard documentation, thereby maintaining and enhancing the framework of cross border issuing, trading and investing in debt instruments;

- bringing all segments of the industry together and encouraging dialogue between the industry and governments, regulators and central banks - at national and international level - with the aim that financial regulation supports, in a balanced and proportionate way, the resilience, efficiency and cost effectiveness of international debt capital markets;
- representing its buy side members, both asset managers and investors, in their interactions with capital markets and regulators;
- promoting networking and information flow amongst market participants and between market participants and the authorities, by organising market conferences, seminars, roundtables and meetings;
- offering market focussed high quality education, thereby promoting high professional standards for market participants.

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Acknowledgments

ICMA would like to acknowledge the guidance and input of its membership in drafting and approving this response, in particular the members of the following ICMA Committees or Working Groups:

Secondary Market Practices Committee (SMPC)
European Repo Committee (ERC)
ERC Operations Group
Asset Management and Investors Council (AMIC)
Regulatory Policy Committee (RPC)

ICMA would also like to acknowledge the input of the Association for Financial Markets in Europe (AFME), in particular its Post Trade CSDR Task Force. ICMA and AFME not only share a number of members, but also share concern over the market impacts of the mandatory buy-in provision. Accordingly, the two associations collaborated closely in preparing their respective responses.

Introduction

The International Capital Market Association welcomes the opportunity to respond to the Consultation Paper published by ESMA on June 30 2015, related to the proposed regulatory technical standards for the operation of the mandatory buy-in process under the CSD-Regulation (CSDR) regime.

As ESMA will be aware, ICMA has been a longstanding advocator and standard setter for settlement efficiency in the European capital markets, and has pushed tirelessly for improvements in CSD interoperability and harmonized cut-off times for the settlement in central bank and commercial bank money. Currently, the ICMA European Repo Council Operations Group is leading an initiative to harmonize and standardize industry-wide trade matching and affirmation processes for securities financing transactions. ICMA also sets best practice for both secondary bond and repo markets, which includes provisions for good settlement behaviour and rights to recourse in the case of settlement fails. The ICMA 'buy-in rules' are the established market practice for remedying failing settlements related to non-cleared, cross-border fixed income transactions, and provide an established right for both the purchasing and selling counterparties to enforce settlement of a transaction. Independently of CSDR, ICMA is currently consulting with its members to revise the buy-in rules to improve the efficiency and transparency of the buy-in process, to reduce reliance on buy-in agents, and to better facilitate the possibility for a buy-in auction process[1].

This commitment to improving and maintaining efficient and stable markets has led ICMA to argue against the imposition of a mandatory buy-in regime. ICMA has maintained that even with a well-designed and easily implementable legal framework for a mandatory buy-in process, **the negative impacts for market pricing and liquidity that would result would far outweigh the potential benefits** of any expected improvement in settlement efficiency rates. This is highlighted very clearly in the ICMA Impact Study for CSDR Mandatory Buy-ins (February 2015)[2], which illustrates how European fixed income market-makers will adjust their pricing (and propensity to provide offer-side liquidity) under a mandatory buy-in regime. The study shows that even for the most liquid government bonds, bid-ask spreads will have to double, while for less liquid sovereign, public, and particularly corporate bonds, in many instances, dealers will retrench from showing offers altogether. **The cost of this market-wide loss of liquidity[3] is of course a direct cost to investors, and, potentially, to capital raisers**, and not to the intermediating banks.

A further consideration is that **European CSDs (and in particular ICSDs) will be put at a relative disadvantage to non-EU based CSDs** that are not in scope of buy-in regulation. For securities that can be settled on both EU and non-EU CSDs (such as USD global issues), mandatory buy-ins will create a two-tier pricing system, with liquidity migrating to the non-EU CSD. This will not only drive investment decisions, but could also drive issuance decisions for corporates, emerging markets, and multi-nationals.

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[1] See ICMA Quarterly Report, Issue 38, Third Quarter 2015, *Review of the ICMA Buy-in Rules, pp.33-34*

[2] http://www.icmagroup.org/assets/documents/Regulatory/Secondary-markets/CSDR-Settlement-Regulation/ICMA--CSDR-Mandatory-Buy-ins-Impact-Study_Final-240215.pdf

[3] A conservative estimate based on available market data puts this cost at more than €20 billion per annum, in terms of wider bid-ask spreads

ICMA's position is that any initiative where the primary outcome is to make European capital markets less attractive to global investors and capital raisers, from a risk, cost, stability, or liquidity perspective, flies in complete contradiction to the objectives of Capital Markets Union**. CSDR 'mandatory buy-ins' is such an initiative, and its potential negative impacts cannot be understated**.

However, ICMA accepts that a provision for mandatory buy-ins is now enshrined in the CSDR, as passed into law in August 2014. While regrettable, the focus of ICMA and its members, in the best interest of maintaining stable and efficient markets, is to work with ESMA and other stakeholders to help ensure that the regulatory technical standards for the CSDR buy-in process are as implementable and workable as possible, and that they are aligned with the spirit of the Regulation. It is with this in mind that ICMA, on behalf of its members, is grateful for the opportunity to respond to this ESMA Consultation Paper.

<u>Conclusion on the available options</u>

Having carefully analyzed and discussed the three options put forward by ESMA for a possible buy-in process, ICMA and its members have concluded that all three, to varying degrees, have weaknesses, and will create significant challenges, risks, and costs from an implementation perspective. **However, given that Option 1 ('trading level execution') resembles most closely how existing, established buy-in processes work, this is the 'default' option for ICMA and its members**.

As will be explained and more clearly illustrated in the responses to the questions laid out in the Consultation Paper, Option 2 ('trading level with fall-back option execution') would not only create additional risk to both the selling and purchasing counterparties in the event that it results in cash compensation, but it also creates risk for the delivering settlement participant which would require some form of mitigation, most likely in the form of collateralization of many client deliveries.

Meanwhile, Option 3 not only creates the same risks for trading counterparties and the delivering settlement participants as Option 2, but, as ESMA recognizes, will also create substantial risks for receiving settlement participants, and could therefore require collateralization in the case of 100% of client receipts. Furthermore, there may also be a legal risk related to settlement participants instructing buy-ins (at least in some jurisdictions), which could require **full** collateralization of pending receipts (effectively the equivalent of client purchases being pre-funded on trade date).

Summary of additional risks created by CSDR mandatory buy-ins

Addressing the problems in Level 1

As ESMA will appreciate better than anyone, designing or analyzing a 'Level 2' buy-in process is extremely difficult in light of the Level 1 text, which contains a number of critical shortcomings. Most notably, the main challenges presented by the Level 1 regulation are:

(i) The 'buy-in' is not defined, nor is the purpose of the buy-in explained.

(ii) The buy-in process seems to apply to CSD participants, which in most instances will not be the same as the trading counterparties to the transaction. This creates market risk for, and places trading responsibility on, non-trading entities.

(iii) The provision for the payment of the price differential between the buy-in price and the original transaction price is reversed, compared to standard buy-in processes.

(iv) The regulation seems to apply to trading counterparties that are subject to the regulation of a non-EU jurisdiction. This extraterritorial scope raises questions of enforceability.

Whatever option, or alternative variation on these options, is eventually put forward in the Level 2 RTS, it is impossible to envisage how this could be successfully implemented without addressing these key challenges in the Level 1 Regulation.

It is with this in mind, and acknowledging that the Level 1 cannot be easily amended, that ICMA requests that ESMA help clarify in the revised draft technical standards:

1) *The definition of a buy-in*. Is it the trading-level contractual remedy that currently exists and is broadly used today, and which is designed to enforce the settlement of the transaction while restoring both trading counterparties to the economic position they would have been in had the original transaction settled? Or, is it a very different structure, designed to penalize failing counterparties, or even their settlement agents? This need for definition and clarity of purpose

applies equally to the cash compensation mechanism. This is critical in understanding the intent of the provision, and so designing a consistent process, particularly where the existing construct and understanding of a buy-in is being redefined. However, it should be noted that ICMA's understanding is that the Level 1 does not imply that the buy-in mechanism is intended to be a penalty (it outlines a separate penalty mechanism to serve as '*an effective deterrent*').

2) *Greater consistency in the RTS concerning the various actors*, including transaction (or trading) counterparties, CSD 'participants' (including custodian banks, settlement agents, and other CSDs), CCPs and CCP members, trading venue 'members', transaction (or trading) chains, settlement chains, trading intermediaries, and settlement intermediaries. It is important that trading level counterparties (whether OTC or on venue, cleared or un-cleared) are unambiguously distinguishable from settlement participants, particularly where these different entities are intended to assume market risk or execute market transactions as part of the buy-in process. (This is acknowledged in Recital (2) of the Draft RTS.)

3) *Clarity on the buy-in and cash compensation cash flows between the buy-in actors*. Article 7(6) in CSDR appears to be unintentionally mis-drafted[4]. This is discussed in greater detail in the response to Question 5, as well as in Annex II of this response. Applying Article 7(6) to any Level 2 process will create potentially absurd and highly unpredictable buy-in outcomes. Such outcomes may be difficult to enforce at both a trading counterparty and a settlement participant level, and lead to legal disputes. It is therefore critical that ESMA specify **unambiguously** how the price differential between the original transaction price and the buy-in price is expected to flow between the purchasing trading counterparty (or receiving participant) and the selling trading counterparty (or delivering participant), in both scenarios where: (i) the original transaction price is lower than the buy-in price; and (ii) where the original transaction price is higher than the buy-in price. ESMA should also specify the same flows in the case of cash compensation (with reference to Article 7(7)[5]), where again, the reference price can be higher or lower than the original transaction price. At the very least, ESMA should seek clarity from the European Commission on the intended meaning of Articles 7(6) and 7(7), and corresponding amendments if they are indeed drafting errors.

While the focus of this Consultation Paper, and ICMA's response, is very much on the Level 2 RTS and the three options presented by ESMA, it is difficult to discuss the strengths, weaknesses, challenges, risks, and costs of the various options (or alternatives) without due consideration of the limitations and flaws of the Level 1 Regulation.

[4] Article 7(6) states: '*…where the price of the shares agreed at the time of the trade is higher than the price paid for the execution of the buy-in, the corresponding difference shall be paid to the receiving participant by the failing participant no later than on the second business day after the financial instruments have been delivered following the buy-in*.' This is the opposite direction to how the price differential is settled in existing buy-in processes.

[5] Article 7(7) states: '*Cash compensation shall be paid to the receiving participant…*' This seems to preclude the possibility that cash compensation could be paid to the delivering participant (or selling counterparty) in the event that the reference price is lower than the original transaction price.

Summary of response and recommendations

Preferred option

ICMA does not believe that without changes to the Level 1 Regulation any of the options can be successfully implemented. However, **Option 1**, given its resemblance to existing buy-in processes, is **by far** the least challenging in terms of implementation, trading counterparty and settlement participant risks, and overall costs.

Regulatory technical standards on the operation of the buy-in process

Regardless of which option ESMA chooses to recommend, it is essential that ESMA provide clarity on the following issues in the Level 2 RTS related to the buy-in process:

- The definition of the buy-in and its purpose with respect to a financial transaction.
- The scope of the buy-in process, in terms of the different entities (trading level, settlement level, and other), transaction types (such as posting margin, portfolio transfers, or account realignments), and extraterritoriality, as well as the case where the settlement fail is caused by the purchasing (receiving) counterparty due to insufficient funds.
- The direction of payment of the price differential between the buy-in price and the original transaction price between trading counterparties (or settlement participants, if/where relevant) in the case where:
    (i) the buy-in price is higher than the original transaction price; and
    (ii) the buy-in price is lower than the original transaction price.
- How the reference price for cash compensation is to be established in a consistent and efficient way.
- The direction of payment of the price differential between the cash compensation price and the original transaction price between trading counterparties (or settlement participants, if/where relevant) in the case where:
    (i) the reference price is higher than the original transaction price; and
    (ii) the reference price is lower than the original transaction price.
- Clarity that a trading venue cannot be expected to know when a buy-in should be executed and to which trading counterparties (or settlement participants) it should apply.

Other related outstanding RTS issues and recommendations

In its response to the previous ESMA CSDR RTS Consultation Paper[6], ICMA recommended that the following be provided for in the RTS:

- MiFID II/R pre- and post-trade liquidity calibrations not be used to determine the appropriate extension periods, and that all fixed income securities be afforded the maximum possible extension period of 7 business days.

[6] See: ICMA Response to ESMA CSD Regulation Level 2 Consultation Papers, February 2015

- An appropriate and relatively flexible buy-in timeframe be allowed following the end of the extension period, with the buy-in execution itself being defined as a discrete event in the process.
- Defining buy-in execution as a discrete event would allow the delivery of securities by the failing counterparty beyond the end of the extension period, up until the buy-in execution, thus helping to reduce the number of buy-ins. This would also better enable the trading parties to manage the market risks arising out of the buy-in (and cash compensation) process.
- The determination for the exemption cut-off point for the first-leg of termed securities financing transactions not only allow for the appropriate extension period and buy-in timeframe of the underlying security, but also the possibility for deferral of the buy-in.
- Clarity on scope of buy-ins in terms of (i) treatment of transfers between CSD accounts which do not represent an underlying trade; and (ii) the exemption in Article 7(13) in CSDR related to the principal trading venue being in a third country.
- A centralized mechanism be established to hear and resolve buy-in (and cash compensation) related disputes.

Implementation timeline

ICMA would like to re-affirm its support for ESMA's proposal in the December 2014 Consultation Paper to make a recommendation for an appropriate postponement in the implementation of settlement discipline provisions under CSDR. ICMA and its members believe that a mandatory buy-in regime, even a workable one, should not be implemented before the successful completion of the TARGET2-Securities project, and that any attempt to do so would be counterproductive to the intent of both initiatives. **Accordingly, and in line with other stakeholder responses, ICMA recommends a delay of at least 24 months before attempting to implement CSDR mandatory buy-ins**.

Q1: Please provide evidence of how placing the responsibility for the buy-in on the trading party will ensure the buy-in requirements are effectively applied.
Please provide quantitative cost-benefit elements to sustain your arguments.

While not without significant flaws, Option 1 is the closest process to how buy-ins currently work, and therefore ICMA and its members deem it to be the least worst of the three options, and the least problematic in terms of costs and risks to implement. EU trading parties, being subject to the mandatory buy-in regime themselves, would be incentivized to ensure that they have contractual agreements in place with their trading counterparties to enforce buy-ins (which could also be achieved by means of a market-wide protocol), or would simply adjust their pricing or trading decisions to reflect any additional risk where they cannot.

However, the starting point for Option 1, and any other options for a buy-in process to be considered, should be to compare it to how the buy-in remedy is currently defined and applied in the financial markets.

<u>What is a buy-in?</u>

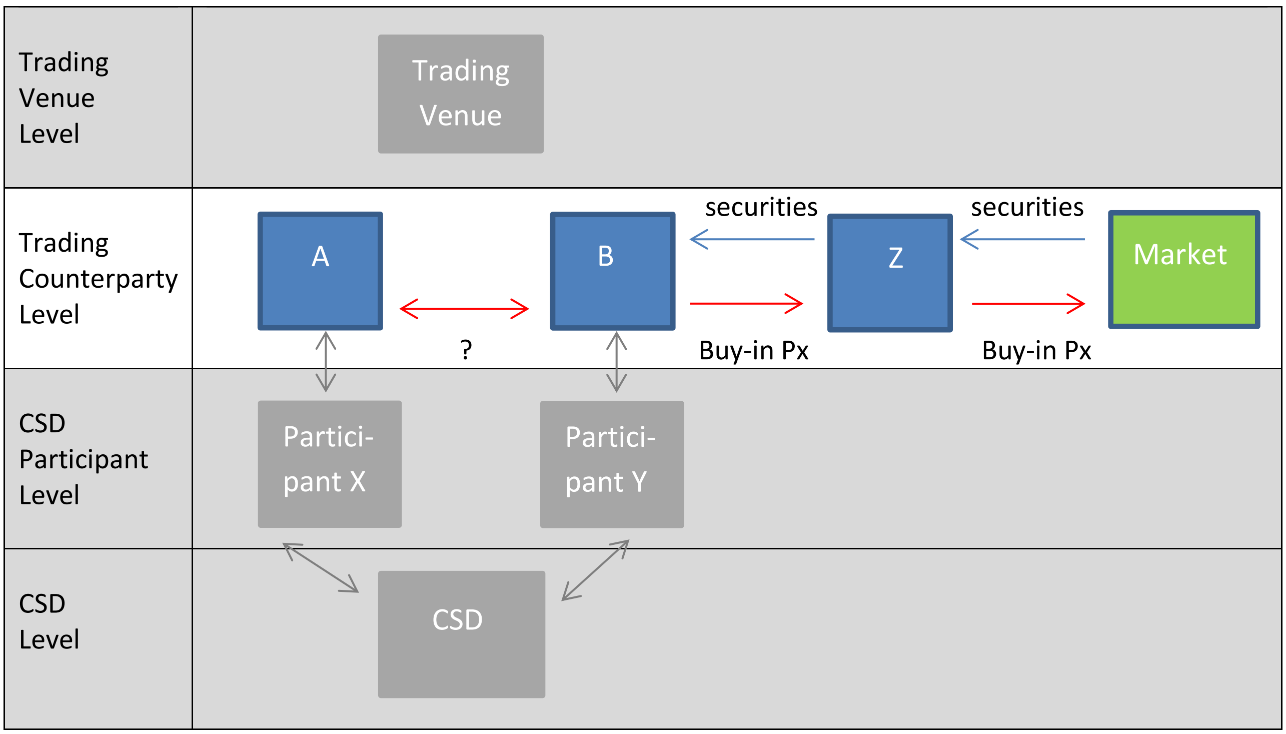
Neither the Level 1 text not the draft RTS (both December 2014 and June 2015), define what a buy-in is, or what is the purpose of the mechanism. The Level 1 text merely provides that in the event of financial instruments not being delivered 'to the receiving participant', a '*buy-in process shall be initiated whereby those instruments shall be available for settlement and delivered to the receiving participant within an appropriate time-frame*' (Article 7(3)).

Buy-ins are a long-standing and well established contractual remedy available to trading counterparties in the event that the transaction does not settle due to reasons caused by the selling counterparty[7]. The existing and broadly recognized buy-in process is explained, in detail, in Part 1 Annex II to this response. As the underlying contract is concluded between trading level counterparties, the buy-in process is a trading level process, involving a market transaction, with cost, market risk, and contractual implications for the trading counterparties involved. Most significantly, it can be seen that the purpose of the buy-in remedy is to restore the trading counterparties to a transaction to the economic position they would have been in had the original transaction settled. This process is also in line with contractual remedies under the civil law that exists in various Member States. To recreate a buy-in process that did not directly involve the trading counterparties to the original transaction would create economic risk and contractual uncertainty for both counterparties that would be beyond their control. While the Level 1 text may be inadequately, and even erroneously, worded, ICMA is relatively confident that the intent of the co-legislators is not to increase risk and uncertainty for trading counterparties (something discussed in more detail in answering Questions 3 to 5).

[7] A 'sell-out' is the equivalent remedy available in the event that the purchasing counterparty causes the fail. Inexplicably, this is not included in the CSDR.

Option 1 ('trading level execution'), as outlined in the Consultation Paper, and illustrated below (see Figure 1), very much resembles the established and broadly understood buy-in process. The primary advantage of a trading level buy-in process is that the counterparties to the original transaction are fully aware of their contractual obligations and market risks, even where there are a large number of counterparties involved in a transaction chain.

Figure 1: the buy-in under CSDR Option 1



Reasons why a buy-in does not happen or fails

While buy-ins are a recognized and widely available right of a purchasing counterparty, as ESMA recognizes, not every failing transaction results in a buy-in being executed. This could be for a variety of reasons:

(i) The purchasing counterparty chooses not to initiate the buy-in process. This could be for relationship reasons, or, in the event that the buy-in process may result in cash compensation, this could be for economic and risk management reasons (see section on cash compensation below).

(ii) The counterparty being bought-in may not legally recognize the right of the purchasing counterparty to execute a buy-in (say if the selling counterparty falls under a different legal jurisdiction).

(iii) A buy-in agent cannot be found. There is no legal requirement to act as a buy-in agent, and they may simply refuse, particularly given that it is a time-consuming, and potentially risky, operation[8].

(iv) The securities being bought-in are unavailable for guaranteed delivery. This is particularly likely for less liquid securities, or where the timeframe to execute the buy-in is relatively short.

(v) One of the trading counterparties could become insolvent during the buy-in process.

Buy-in auctions

The CSDR does not preclude the possibility for a buy-in auction mechanism, which could conceivably be hosted on an electronic trading venue[9]. This could help provide a degree of efficiency and transparency to the buy-in process, while also reducing the administrative burden and potential risks to the appointed buy-in agent. However, such a process is still likely to require a non-affiliated buy-in agent (that is also a member of the venue hosting the auction) that can act impartially and in the best interest of the trading counterparties. Similarly, any parties looking to sell into the auction may also require agents, who are also members of the venue. Furthermore, an auction process does not guarantee that the securities will be available to purchase.

Enforcing the buy-in

Since the Regulation provides that a buy-in process must be initiated (although not concluded), and so the right of the purchasing counterparty be replaced by an obligation, this will need to be reflected in the contractual agreements between trading counterparties (as well as in the rules of CCPs, CSDs, and trading venues, where appropriate). In the case of two EU trading counterparties that are both subject to EU law, enforcement should not be a problem, given that the trading parties will be supervised entities. However, there are extraterritorial implementation challenges in the case where at least one of the trading counterparties is subject to a non-EU jurisdiction. Addressing these challenges is clearly beyond the scope of the Level 2 RTS, however one possible market solution could be the establishment of an internationally recognized protocol (as has been used to implement similar legal frameworks, such as resolution stays under BRRD). This may take some considerable time to agree and implement, but it is ICMA's view that trading level contractual agreements are the only conceivable way to enforce a mandatory buy-in regime in a consistent way, without putting uninvolved third parties (primarily CSD participants) at major risk. Furthermore, given the significant increase in the economic risks of trading

[8] The risks to the buy-in agent are twofold. Firstly, the buy-in agent has counterparty risk to the purchasing counterparty (or receiving participant) instructing the buy-in. Secondly, the buy-in agent has legal risk in the event that a buy-in execution price is deemed to be far away from fair market value, and where the bought-in counterparty could claim against the buy-in agent for not exercising due diligence in the buy-in process.

[9] ICMA is currently consulting with its members to revise its 'buy-in rules' to facilitate such an auction process in the non-cleared, cross-border bond markets.

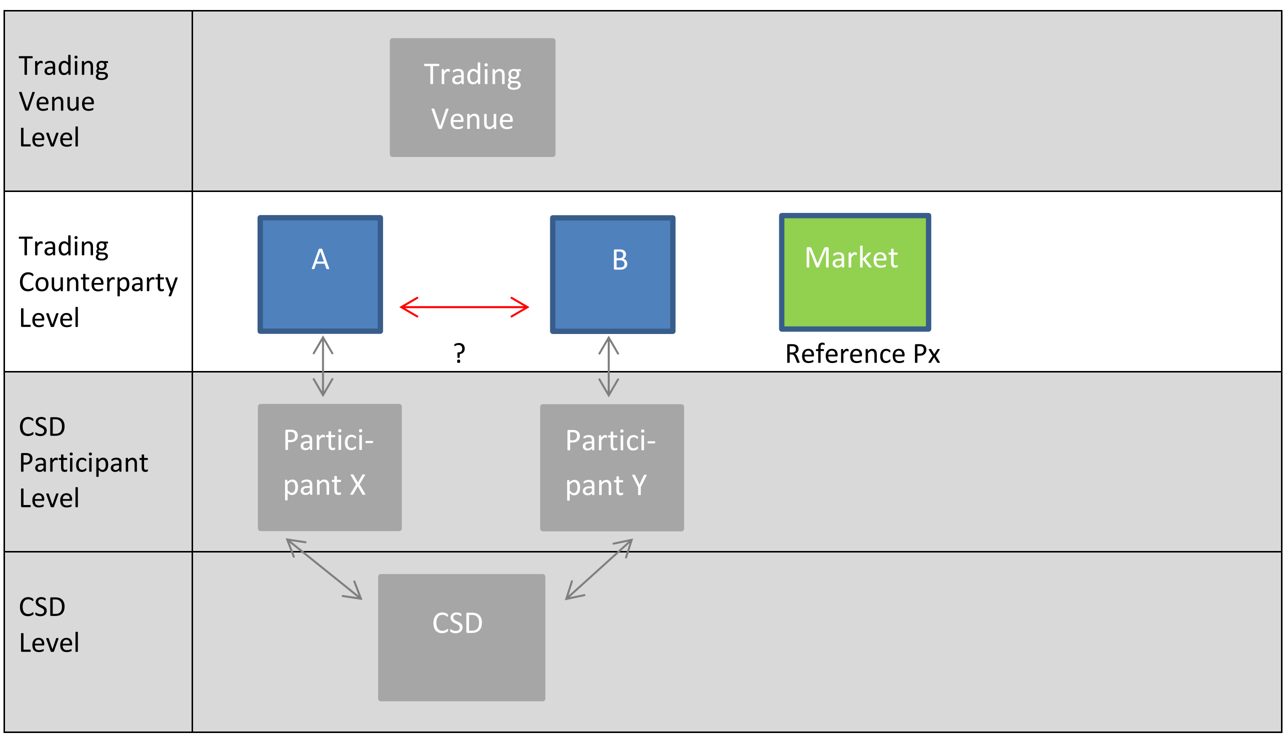
that a mandatory buy-in regime will create, EU investment firms, being subject to mandatory buy-in themselves, would have a clear incentivize to ensure that buy-ins are legally enforceable against their trading counterparties, regardless of jurisdiction or settlement system. Where they are not, the investment firm will need to exercise judgement in its choice of trading counterparty, or reflect the risk in its transaction price with such counterparties.

However, in most cases the reason for a buy-in being unsuccessful is likely to be due to reasons beyond the control of the trading counterparties (or the settlement participants).

<u>When a buy-in is unsuccessful: cash compensation and risks to the purchasing (receiving) counterparty</u>

While the initiation of the buy-in process can be enforced through making it a legal obligation of the purchasing counterparty, the successful execution of a buy-in cannot be guaranteed. CSDR provides for a cash compensation mechanism in such cases, and Option 1 provides that this happen at the trading level (illustrated in Figure 2 below). Just as with buy-ins, **it is critical that the cash compensation process take place at the trading counterparty level**.

Figure 2: cash compensation under CSDR Option 1



The cash compensation process is explained in more detail in Part 1 of Annex II to this paper. Just as with a buy-in, the cash compensation remedy seeks to restore the counterparties to a financial transaction to the economic position they would have been in had the original transaction settled. It is not the intention of cash compensation to unfairly penalize or enrich the counterparties. Accordingly, as with buy-ins, in the cash compensation remedy the difference between the reference price and the original transaction price (i.e. the cash compensation) can be passed in either direction between the original trading counterparties, depending on whether the reference price is higher or lower than the original transaction price.

However, where the cash compensation remedy is different from the buy-in remedy is in the fact that it creates a market risk for the purchasing ('receiving') counterparty. This is a critical consideration in providing for a cash compensation remedy. Up until the point where a cash compensation remedy is applied, the purchasing counterparty owns the securities it purchased in the original transaction, and maintains market exposure to those securities. These securities could be to match specific liabilities (such as investments made by a pension or insurance fund), or they could be part of an investment strategy or structure involving other securities or financial instruments, such as swaps. The moment the cash compensation remedy is applied, the purchasing counterparty no longer owns the securities, and thus any related liability or contingent position will instantly create a market risk for the purchasing counterparty. If they are able to offlay this risk immediately (by re-purchasing the securities, or similar securities, or unwinding any contingent trading positions), this risk is minimized. However, any delay in communicating that the cash compensation remedy has been enforced will create a market risk for the purchasing (receiving) counterparty. The longer that delay, the greater the exposure, and the more likely the purchasing counterparty will incur a financial loss. It is therefore inconceivable that a cash compensation process would be applied at any level other than the trading counterparty level (and which is discussed more fully in answering the questions related to Options 2 and 3).

Furthermore, given the expected significant increase in buy-ins being initiated under the mandatory buy-in regime (which, based on existing European settlement efficiency data, could see the initiation of many thousands of buy-in processes per day), and the lack of incentive for investment firms to act as a buy-in agent, it is highly likely that many, if not most, buy-in processes will result in a cash compensation remedy. This will be a significant increase in risk for trading counterparties, that can no longer be confident that a financial transaction they enter into will remain intact, or whether it will be effectively 'cashed out' in the near future.

The merits of a mandatory cash compensation remedy are challengeable, particularly with respect to the rights and risks of the purchasing counterparty, and if it is to be implemented, it should at least be at the trading counterparty level where the impacted parties are better able to protect their rights.

<u>Mandatory buy-ins, cash compensation, and securities financing transactions</u>

Mandatory buy-ins and cash compensation also create significant risk and a disincentive to lenders and repo-ers of securities. The repo and securities lending markets help provide essential liquidity to both securities markets and collateral markets, with lenders of securities usually only making relatively modest returns. Thus the incentives to repo or lend securities can, in most cases, be marginal. A mandatory buy-in regime will pose a significant disincentive to lenders of securities, and create additional risks for the repo and securities lending markets. These disincentives and risks apply to all 3 options (and in many ways more so to Options 2 and 3, given the significant additional risk to market counterparties under these options).

It should be noted that today, normally, there is no ability for a borrowing (or reversing) counterparty to execute a buy-in against the failing start-leg of a repo or securities lending transaction (however, they do retain the right to claim for loss of interest as well as to cancel the transaction). The reason for this is because a buy-in (or cash compensation) is not considered the appropriate remedy, since it would be remedying a loan of securities with an outright purchase, or the economic equivalent. Under CSDR, the collateral providers in 'term' securities financing transactions (SFTs) will be subject to mandatory buy-ins (with the exception of the provision in Article 7(4)(b) of the CSDR for very short-dated SFTs). This will put lenders of securities, in the event of a fail, at risk of taking on an additional outright market-exposure in the underlying securities through a buy-in, or facing similar market-based economic losses in the event of cash compensation; neither of which are commensurate with the risk-return profile of the underlying transaction.

In the case of failing end-legs of SFTs, under current discretionary 'mini-close-out' provisions in lending and repo agreements, lenders of securities can ensure that in the event of a failing return of securities, they can either wait until a time when the failing counterparty can return those securities (while earning a fee or interest), or they can close-out the transaction (with any difference in price being settled between the counterparties) at a time when they can secure a replacement purchase. Under the mandatory buy-in regime, lenders and repo-ers of securities will no longer have this flexibility or certainty, and run the risk of being 'cashed-out' of their positions against their wish. This is a significant disincentive to securities lending, and another notable unintended consequence of the Regulation.

<u>Deferral of the buy-in</u>

There is the possibility of mitigating the market risks of the purchasing counterparty by deferring the buy-in process in the event that a buy-in cannot be successfully executed. Article 7(7) of the CSDR provides for such a deferral with the ability to '*defer the execution of the buy-in to an appropriate later date*'. ESMA also provides for the possibility for deferral in the draft RTS published in December 2014 (Articles 11(7) and (8)), and again in the draft RTS of the June 2015 Consultation Paper. However, given the high probability of many buy-ins ending in cash compensation, and the risks this presents to the purchasing counterparty (and possibly the receiving participant under Options 2 and 3), **ICMA would recommend that ESMA amend the draft RTS to**:

(a) allow for a more flexible (and possibly open-ended) deferral period, particularly in the event that it may be difficult to find a buy-in agent, or the market for the underlying security is illiquid; and

(b) provide that where the buy-in cannot be executed or is only partially executed, and without the express communication of the purchasing counterparty (or receiving participant) to the contrary, **the default remedy is deferral** rather than cash compensation.

Involving trading venues

Article 14(1) in the draft RTS provides that for transactions executed on a trading venue and not cleared by a CCP, where the receiving party (assumed to mean trading counterparty) does not initiate the buy-in within two days of the elapse of the extension period, '*the trading venue shall appoint a buy-in agent*'. ICMA would like to refer ESMA to its response to the December 2014 Consultation Paper where it clearly explains why, in many instances, this is not possible.

Trading venues match buying and selling trading level counterparties. They do not settle trades, nor do they maintain a relationship with the settlement agents or CSDs of their trading members. A trading venue will not know whether a trade executed on it has settled or failed, nor whether or when a buy-in process should be initiated, or against whom. As has been explained previously, only the trading counterparties to the transaction have all the necessary information to know (i) if a buy-in process should be initiated, and (ii) against which trading counterparty.

While it is possible for trading venues to include a provision for buy-ins in its rules, it will not be in a position to enforce such rules. Thus, Article 14(1) in the new draft RTS should be amended to reflect this reality (see recommended amendments in Annex I).

ICMA raises this point again in the response to Question 5, where the draft RTS (Articles 14(1) and 15(1)) suggest that under Option 3, for non-CCP-cleared transactions executed on trading venues, the buy-in process would remain at the trading party level. While ICMA welcomes this 'participant exemption' in Option 3, it questions how it could be enforced given the lack of connectivity between trading venues and the settlement level.

Option 1: conclusions

It should not be overlooked that Option 1 contains a number of flaws, which are common to all of the three options, and which need to be addressed in the RTS (or possibly even the Level 1 text). Most notably:

- It does not provide a definition of the buy-in or its purpose with respect to a financial transaction.
- It does not define the scope of the buy-in process, in terms of the different entities (trading level, settlement level, and other), transaction types, and extraterritoriality.
- It does not explain the direction of payment of the price differential between the buy-in price and the original transaction price between trading counterparties (or settlement participants, if/where relevant) in the case where:

(i) the buy-in price is higher than the original transaction price; and
(ii) the buy-in price is lower than the original transaction price.

- It does not explain how the reference price for cash compensation is to be established[10].
- It does not explain the direction of payment of the price differential between the cash compensation price and the original transaction price between trading counterparties (or settlement participants, if/where relevant) in the case where:
  (i) the reference price is higher than the original transaction price; and
  (ii) the reference price is lower than the original transaction price.
- It attempts to include trading venues in the buy-in process, even though in most cases the trading venue will not have sufficient information to know that a buy-in process should be initiated or against whom.

While these points still need to be addressed in the RTS, given that a buy-in or cash compensation are market based remedies, with economic and contractual implications and risks for the trading counterparties involved, any buy-in and cash compensation process has to be applicable at the trading counterparty level, and this is the strength of Option 1.

As explained in the answers to the subsequent questions in the Consultation Paper, attempting to execute a buy-in or cash compensation process that does not directly involve the trading counterparties to the original transaction is extremely challenging, and creates undue risk for the trading counterparties as well as for the settlement participants involved.

[10] Article 15 in the draft RTS published in December 2014 does provide some guidance. It is not clear whether this Article is to be retained or re-drafted in the final draft RTS. However, ICMA would draw ESMA's attention to its response to the Consultation Paper of December 2014, which points out some of the challenges in establishing a reference price in a consistent and efficient way.

Q2: Please indicate whether the assumption that the trading party has all the information required to apply the buy in would be correct, in particular in cases where the fail does not originate from the trading party, but would rather be due to a lack of securities held by one of the intermediaries within the chain.

Not only does the trading counterparty have all the information required to apply a buy-in, but in most cases the trading counterparty will be the **only** entity to have all the information required. Furthermore, a fail will only be caused because the trading counterparty does not have sufficient securities to make delivery, and never due to a lack of securities by a settlement intermediary.

<u>Information flows</u>

The trading level counterparty is better placed than any other entity to know whether a buy-in should be initiated, whether a pass-on should be issued (and to whom), and to manage the overall buy-in process, as well as to manage their own market risk related to the buy-in or cash compensation.

Where the trading counterparty is not the CSD participant, they will still have full visibility of the settlement status of their transactions through the reports of the agent bank that is settling the trades on their behalf. Also, they will know better than anyone who they have traded with and the nature of the underlying transaction. This information is also critical from the risk management perspective of both the delivering and receiving counterparty.

In the case where the trading counterparty is also the CSD participant, not only will they know from the CSD whether a transaction has failed, unlike the CSD they are also in a position to know the nature of the underlying transaction and so are better placed to know whether a buy-in should be initiated. Furthermore, in the event that they are the failing counterparty, they are best placed to know why they are failing and, in the event of the fail being caused by a failing inward delivery, they are best placed to know that this is a pass-on situation. This is something that the CSD will not easily be able to know.

In fact, where CSDR provides that CSDs, CSD participants, or trading venues be involved in the buy-in process, they will only be able to do so effectively with information provided to them by trading level counterparties.

<u>Settlement intermediaries within a chain</u>

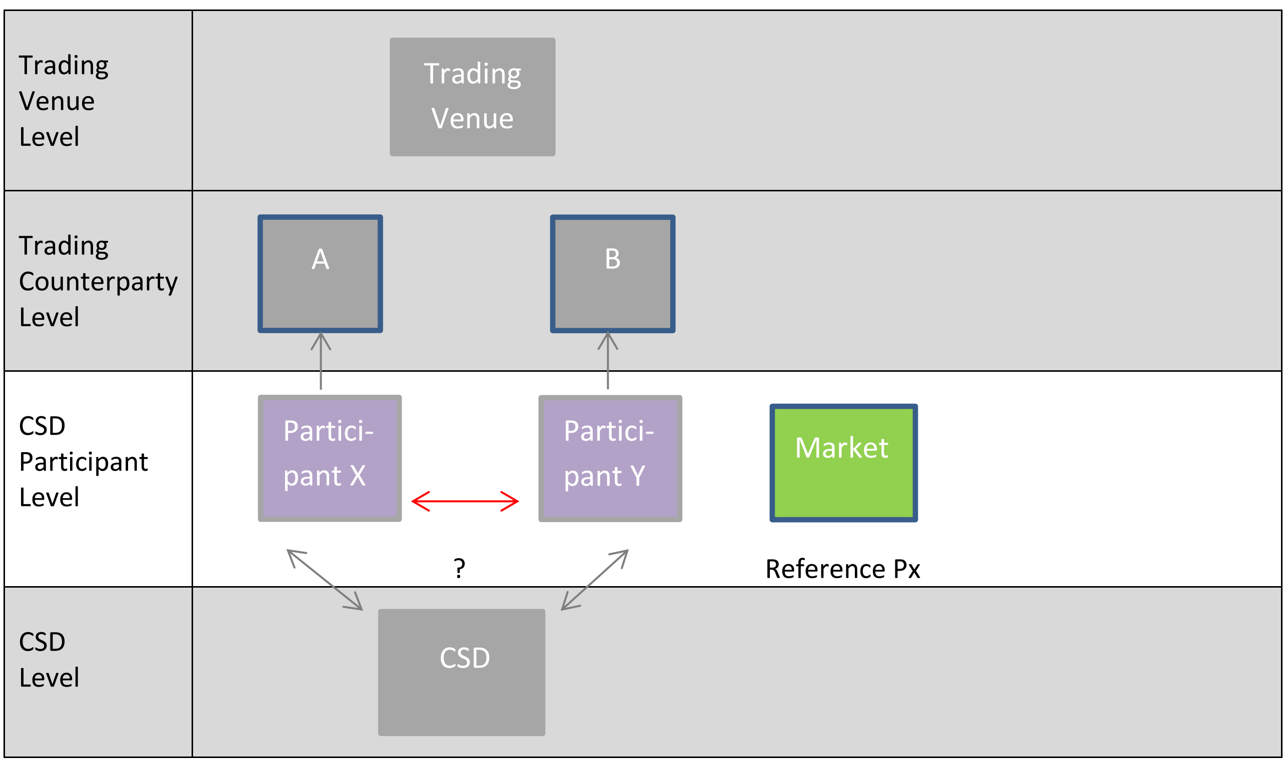
Where the question refers to '*a lack of securities held by one of the intermediaries with the chain*', it is not immediately clear whether this refers to trading counterparty intermediaries or settlement intermediaries. However, in the case of the latter, it is difficult to see how this could be an issue, since the implication would be that the settlement agent would not settle a transaction where securities were available. Settlement agents act in a purely directed agent role and as such have no capacity or right to prevent a trade settlement, but are instead fully dependent on their client's controlling availability of securities. The only case where the settlement agent would not settle the transaction would be where the agent is **unable** to settle, due to lack of securities in their underlying client's securities account – this could be due to their client selling short or the delivery being dependent upon a purchase of securities by their client which has in turn failed to settle – or due to a lack of cash in the client's account where they are the purchasing counterparty. Again, this brings the information necessary to initiate and manage the buy-in process back to the trading counterparty level.

Q3: Should you believe that the collateralisation costs attached to this option are significant, please provide detailed quantitative data to estimate the exact costs and please explain why a participant would need to collateralise its settlement instructions under this option.

ICMA appreciates that Option 2 ('trading level executing the buy-in with fall-back option') is very much a compromise solution that attempts to emulate the trading level buy-in process that currently exists, while complying with the Level 1 text that frames buy-ins and cash compensation within the context of CSD participants. However, ICMA considers Option 2 significantly different to Option 1 in that the 'fall-back', when applied, will not only put trading level counterparties at more risk than Option 1, including the purchasing counterparty, but it will also put CSD participants, and possibly even CSDs, at significant risk in the case of many client deliveries.

As a result, Option 2 will require that settlement participants will most likely require collateral from their clients to mitigate this increased settlement risk. In addition, trading counterparties will also be exposed to increased market risks as a result of the participant level cash compensation mechanism. This is explained below.

Figure 3: cash compensation under CSDR Option 2 (where the buy-in is not successfully executed)



<u>The risks of cash-compensation</u>

As highlighted in the answer to Question 1, cash compensation, while providing certainty of conclusion to the buy-in process, also creates market-risk for both trading counterparties – including the purchasing counterparty who initiates the buy-in.

As also explained in the answer to Question 1, there are several possible reasons why a buy-in might not be executed:

(i) The purchasing counterparty chooses not to initiate the buy-in process.
(ii) The counterparty being bought-in may not legally recognize the right of the purchasing counterparty to execute a buy-in.
(iii) A buy-in agent cannot be found.
(iv) The securities being bought-in are unavailable for guaranteed delivery.
(v) One of the trading counterparties could become insolvent during the buy-in process.

The Consultation Paper seems to imply that the most likely cause of a buy-in not being successfully executed is due to the trading counterparty initiating the buy-in becoming insolvent, in which event the cash compensation fall-back would be dis-applied[11]. In relation to this exclusion, ICMA would like to raise two issues. Firstly, ICMA questions why this exception only seems to apply to Option 2 and not Option 3. Secondly, ICMA would point out that given that the failing participant only has one day following the buy-in timeframe to provide evidence to the CSD that the trading party is subject to an insolvency proceeding, this exception is relatively limited.

However, irrespective of the problems with the proposed insolvency exemption, it is important to note that the most likely cause for a buy-in not being successfully executed will not be related to the insolvency of a counterparty, be rather it will be due either to a buy-in agent not being available, or the securities not being available for guaranteed delivery. With the likely significant increase in the instances of buy-ins being initiated across the European capital markets, the lack of incentive to act as a buy-in agent, less liquid securities markets, and relatively short timeframes to complete buy-ins, **it is a safe assumption that many, if not most, buy-ins will result in cash compensation being applied**.

<u>The settlement participant as guarantor</u>

It should thus be clear that whether a buy-in is successfully executed or not is out of the hands of both the receiving and delivering settlement participants. However, under Option 2 (and 3), the receiving settlement participant is liable for the cash compensation payment in the event that it is not successfully executed[12]. This effectively makes the delivering settlement participant guarantor for the successful settlement of its clients' trades. While it could be argued that the successful execution of the buy-in will negate this exposure to the delivering participant, as discussed, for the buy-in execution to be unsuccessful in many (if not most) scenarios will have nothing to do with the contracts between the settlement participants and their trading counterparty clients. Accordingly, under Option 2 (or 3), any

[11] ICMA notes that with reference to Article 7(12) in the CSDR, this would also apply in the event that insolvency proceedings are opened against a failing participants, and which would therefore apply to all three options.

[12] As discussed in Question 1, it is not clear whether the cash compensation payment is able to flow in either direction, depending on whether the reference price is higher or lower than the original transaction price. This is an important consideration, and would help clarify whether the mechanism is intended to be a remedy or a penalty. If the latter, this adds to the exposure of the receiving participant by creating an asymmetry in its market risk. This is discussed in more detail in the response to Question 5.

settlement participant in scope of the Regulation will need to mitigate the risks of their client failing and so resulting in a potential market exposure to themselves. This is illustrated in Example 2, below.

There are three potential options that a settlement participant could take to mitigate their potential liabilities under Option 2 (and 3):

(i) The settlement agent could require that its clients open accounts directly with the CSD. In this way, the trading counterparty would become the CSD participant, and the agent would simply manage and operate the account on behalf of the client. However, this (i) would be a significant additional expense for the trading counterparties, (ii) it may not be acceptable by the CSDs in many instances, and (iii) may undermine the role and commercial advantage of the settlement participant. For example, in the case of a Singaporean based trading counterparty that seeks to invest in Czech Government Bonds on a one-off basis, it is highly unlikely that the client would wish, or even be able, to open a direct account with the Czech CSD. This could also be seen as a barrier to transacting in pan-European markets.

(ii) Alternate to the above, the settlement agent could choose to mutualize its risks, in the same way as a CCP, demanding collateral from all its selling clients, at least in the instances where the sale does not relate to an existing position in its account, and is contingent on another transaction or movement of securities. However, unlike the CCP margining model, collateral would need to be posted on a trade-by-trade basis, with no scope for netting.

Given the weakness and challenges of the first mitigation option, ICMA would argue that the second option will be the most likely to be adopted by settlement participants. The impact of this is analyzed in a little further in the response to this Question.

<u>Risk to CSDs</u>

In the case where transactions are settled via CSD links, the same delivery risk facing settlement participants would apply to an investor CSD that is effectively a participant of an issuer CSD. In these instances, the investor CSD will effectively become guarantor for its clients' deliveries under Options 2 and 3, in the same way as described above for other settlement participants. With reference to the CSDR Level 1 and the draft RTS published by ESMA in December 2014, ICMA questions whether it is the intention of Option 2 (and 3) to create market risk for the CSD.

<u>The risks of settlement participant level cash compensation to trading level counterparties</u>

As discussed in the answer to Question 1, cash compensation creates market risk for the trading counterparties, including the purchasing counterparty. Under Option 2 (and 3), this risk is exacerbated by the fact that the trading counterparties are not responsible for managing the cash compensation process and are reliant on their settlement agents to execute and communicate the process. In turn, this creates a risk for the delivering CSD participant, who will be responsible for any cash compensation related to a client fail, and who may not be able to pass this on to the client.

Examples of the risks that participant level cash compensation creates for both the purchasing trading counterparty and the delivering participant are provided in the below boxes. What these examples seek to illustrate is that executing the cash compensation remedy at the settlement participant level:

i. Creates an extra level of communication and therefore market risk for the trading level counterparties, including the purchasing counterparty.
ii. Creates a market risk for the receiving settlement participant, where it may not be able to enforce the cash compensation against its client.

These market risks to the purchasing counterparty and selling counterparty are illustrated in Examples 1 and 3 respectively, while Example 2 highlights the previously explained risks to the delivering settlement participant.

Example 1: risk of cash compensation to the purchasing counterparty (Options 2 & 3)

Counterparty A purchases €10mm bonds from Counterparty B, at a price 100.00, which is a yield of 2.00%. At the same time, A pays a €10mm swap (as a hedge) against the bond position at a yield of 2.50%. Both the bonds and the swap have a 'dv01' of 10c (i.e. the price will increase by 0.10 for every 1bp decrease in yield).

The settlement of A's purchase from B fails. A initiates a buy-in against B, but by the time a buy-in agent is found, the timeframe for the buy-in has elapsed and the buy-in cannot be executed.

A's settlement agent, Participant X, executes a cash compensation remedy against B's settlement agent, Participant Y. The market has rallied 0.20% since the time of the original transaction, and the reference price is set at 102.00 (or 1.80%). The swap has moved in line, with a market rate of 2.30%.

X notifies A of the cash compensation *after* it was initiated. In that time, the market continued to rally for another 0.05%, with the swap rate now at 2.25%. A immediately unwinds the swap and awaits to receive the cash compensation.

Trading Counterparty A's P&L:

Cash compensation vs bond position:	+€200,000	(102.00-100.00 x €10mm)
Realization on swap unwind:	(€250,000)	(2.25% - 2.50% x €10mm)
Loss:	(€50,000)	

Example 2: risk of cash compensation to the delivering participant (Options 2 & 3)

Returning to Example 1, Participant X claims against Participant Y the amount of €200,000 as cash compensation to remedy Trading Counterparty B's failed settlement to Counterparty A.

Participant Y pays X, then claims against its client, B. B, however, is unable or unwilling to pay.

Participant Y faces a loss of (€200,000) as a result of B's settlement failure to A.

Example 3: risk of cash compensation to the selling counterparty (Options 2 & 3)

Counterparty B sells €10mm bonds to Counterparty A, at a price 100.00, which is a yield of 2.00%. At the same time, B buys €10mm of the benchmark sovereign bond at a price of 101.50 (which is a yield 1.75%). Both bonds have a dv01 of 10c.

B's reverse-repo to cover its short sale fails, which causes B's sale to A to fail. A initiates a buy-in against B, but by the time a buy-in agent is found, the timeframe for the buy-in has elapsed and the buy-in cannot be executed.

A's settlement agent, Participant X, executes a cash compensation remedy against B's settlement agent, Participant Y. The market has rallied 0.20% since the time of the original transaction, and the reference price is set at 102.00 (or 1.80%).

Y notifies B of the cash compensation *after* it was initiated. In that time, the market has retraced 0.10%, with the benchmark bond now at 1.65%, or a price of 102.50 . B is charged the cash compensation by Y, and unwinds its benchmark hedge at the prevailing market price.

Trading Counterparty B's P&L:

Cash compensation:	(€200,000)	(100.00-102.00 x €10mm)
Realization on hedge unwind:	€100,000	(102.50-101.50 x €10mm)
Loss:	(€100,000)	

<u>Option 2: Cost analysis</u>

AFME and ICMA have collaborated to estimate the potential market-wide collateralization requirement arising out of Option 2, based on current publicly available data on settlement volumes across EU CSDs and ICSDs, the percentage of client deliveries that would require collateralization, and an approximation of current CCP margin models for different security types.

It should be emphasized that in the limited time, and with limited access to detailed market data, the capacity to produce highly robust analyses is severely restricted. The analysis produced for this response is purely on a 'best efforts' basis, applying available data, and the pooling of estimates provided by members. While it does provide a sense of the potential risks that settlement participants could face, and the possible collateral requirement to mitigate that risk, it should by no means be treated as a definitive cost analysis, and perhaps more as a 'worst case' scenario.

In the analysis of Option 2, the potential requirement is based on the estimated exposure to settlement participants as a direct result of a client delivery going to cash compensation. Of course, not every client sale will result in a buy-in, and not every sale that goes to buy-in will result in cash compensation. Furthermore, the settlement participant will not be left liable in every case that a delivery does go to cash compensation. However, as explained above, from a risk mitigation perspective it is likely that the settlement participant will look to collateralize the potential worst-case scenario: i.e. that any delivery has the possibility of going to cash compensation and that they may be liable for any variation between the cash compensation reference price and the original transaction price.

Methodology

1) As the buy-ins (and subsequent cash compensation) apply at the settlement level, the analysis takes the most recent publicly available ECB data[13] on annual settlement volumes for the 37 EU (I)CSDs and securities settlements systems. This provides the total annualized value of delivery instructions, broken down by asset type (bonds, short-term paper, equities, and other instruments).

2) Next, all delivery instructions received from CCPs are removed from the settlement data. These are already subject to CCP buy-in rules and have already been margined by the CCP. This provides the total number of non-cleared delivery instructions (regardless of whether OTC or on trading venue). We did consider whether it was also meaningful to remove instructions relating to non-CCP-cleared transactions executed on trading venues, since it could be that the cash compensation remedy is intended to apply at the trading party level for these instructions under Option 2 (as per Article 15(1) in the draft RTS). However, at settlement level it is difficult to distinguish between OTC and 'on venue' transactions, and this cannot be made based on the ECB data. As result of these difficulties, and given the lack of certainty that the intention is effectively to 'exempt' these transaction from participant level cash compensation, we did not exclude transactions executed on trading venues.

3) In order to account for the exemption for short-dated securities financing transactions (under Article 7(4)(b) of the CSDR), the estimated annual volume of non-cleared repos with a term of under one week was extrapolated using data from the most recent ICMA Repo Market Survey[14].

[13] ECB Statistical Data Warehouse – Securities Settlement Statistics 2014 (ECB 'Blue Book')
[14] ICMA Repo Market Survey, December 2014

We did not have data on the number of exempt securities lending transactions, but assumed that this would be a relatively small subset of the overall total.

4) From the resulting settlement instructions, those that are at risk of a buy-in will only be those deliveries where the securities are not already in place in the selling counterparty's account and are contingent on another purchase or delivery of securities, or where existing securities are not available for re-use and so can guarantee the delivery. Based on estimates provided by a range of settlement agents (AFME and ICMA members), we settled on a median percentage of deliveries where delivery could not be guaranteed of 20%.

5) Settlement agents broadly agreed that any collateralization would be required on trade date. Thus we make the assumption that the settlement exposure of any in-scope delivery, for the most part, will exist for two-days (with standard T+2 settlement for most securities). We do not provide for the possibility of longer or shorter settlements, but assume that these, as a net impact, will be relatively inconsequential. Furthermore, the estimate of two-days does not include the probability of late settlement, or transactions that go to buy-in or deferral. This will be a much smaller subset (based on settlement efficiency rates), but its exclusion (for convenience of calculation) skews the estimated overall exposure to the downside.

The process for calculating the potential in-scope delivery instructions is illustrated in Table 1 below.

Table 1: calculating the amount of at-risk delivery instructions under Option 2

2014 Data	Instructions (€ million)	Total ex-SFTs (€ million)	20% at risk of fail (€ million)	2 days value[15] (€ million)
Bonds	985,685,752			
Bonds (CCP)[§]	53,056,873			
Total B	**932,628,879**	932,241,525	186,448,305	1,473,900
Short-term paper	97,030,445			
SP (CCP)[§]	5,430,929			
Total S	**91,599,516**	91,561,471	18,312,294	144,761
Equities	58,085,807			
Equities (CCP)[§]	5,140,098			
Total E	**52,945,709**	52,923,719	10,584,744	83,674
Other	20,066,002			
Other (CCP)[§]	20,366			
Total O	**20,045,636**	20,037,311	4,007,462	31,680
Total (excl CCP)	**1,097,219,740**	1,096,764,026	219,352,805	**1,734,014**

[15] This is calculated by dividing the annual number by 253 (based on 253 UK business days in 2014) and multiplying by 2.

[§] Excluding data for Euroclear Bank, for which the ECB data does not distinguish between CCP-cleared and non-cleared delivery instructions.

6) Given that the settlement participant's exposure in the case of cash compensation is limited to the variation between the reference price and original transaction price, it will be necessary for the settlement participants to estimate this exposure based on the volatility of the underlying securities. Each participant will probably design their own risk models to calculate this, but in many respects this will not be dissimilar to the risk models and margin requirements of CCPs (ICMA would refer ESMA to the AFME response to this Consultation Paper which highlights the similarity with the CCP risk model). We therefore apply approximate averages of a range of current CCP margin factors applied across the various asset classes. It is important to stress that where there was a significant range within asset classes, we settled at the most conservative end, based on the assumption that most volumes would likely be in more liquid (and presumably less volatile) securities.

The margin factors applied are:

- Bonds and short-term paper: 3-6% (average: 4.5%)
- Equities: 6-12% (average: 9%)
- Other instruments: 25-40% (average 32.5%)

Table 2 illustrates the potential rolling collateral requirement based on the above methodology.

Table 2: potential two-day rolling collateral requirement under Option 2

2014 Data	At-risk deliveries value (€ million)	Average margin %	Total collateral requirement (€ million)
Bonds	1,473,900	4.50%	**66,325**
Short-term paper	144,761	4.50%	**6,514**
Equities	83,674	9.00%	**7,531**
Other	31,680	32.50%	**10,296**
Total	1,734,014		**90,666**

What the analysis shows is the possible market-wide collateralization requirement under Option 2 to cover the 'fall-back' cash compensation risk of settlement participants (approximately €90 billion). This would be a rolling requirement; in other words, the average outstanding market collateral requirement at any time. This is effectively the permanent drain on collateral that would be created by Option 2

Option 2: conclusions

While Option 2 attempts to provide for a trading level remedy in most instances, it overlooks the many reasons why a buy-in may not be successfully executed, most of which are out of the control of either the trading counterparties or the settlement participants. In a mandatory buy-in regime, it is highly probable that many, if not most, buy-ins will result in the cash compensation remedy being applied.

Cash compensation, when applied at the participant level, as opposed to the trading counterparty level, creates market risks for:

(i) The delivering settlement participant (including investor CSDs)
(ii) The purchasing counterparty
(iii) The selling counterparty

ICMA, having consulted with its settlement participant members, does not see any significant difference in terms of the market risks to these members under either Option 2 or 3 **with respect to client deliveries**. Accordingly, ICMA would expect such settlement participants to require collateral against client deliveries, at least where there is no existing position in the client's account to guarantee the delivery. ICMA would further expect any applicable collateral model to be not dissimilar to those applied by CCPs to their general clearing members.

As will be discussed more in the response to Question 5, **ICMA and its members are strongly opposed to any buy-in or cash compensation remedy that is applied at the settlement participant level, and not at the trading counterparty level**, even if this is intended to be a 'fall-back', since it will create undue market risks for participants that are not party to the original transaction. In turn, this risk has to be mitigated by means of additional cost to all trading counterparties through increased transaction and settlement costs.

Q4: If you believe that option 1 (trading party executes the buy-in) can ensure the applicability of the buy-in provisions are effectively applied, please explain why and what are the disadvantages of the proposed option 2 (trading party executes the buy-in with participant as fall back) compared to option 1, or please evidence the higher costs that option 2 would incur. Please provide details of these costs.

ICMA would like to refer ESMA to its response to Question 3. There seems to be an underlying assumption in Option 2 that the only reason why a buy-in would not be successfully executed is due to a lack of enforceability at the trading counterparty level. As explained, this is not the case, and the most likely reasons for a buy-in not being successfully executed are:

(i) the securities cannot be found for guaranteed delivery; and
(ii) a buy-in agent cannot be found to execute the buy-in.

Given a significant increase in the number of buy-ins being initiated, relatively short buy-in timeframes, and illiquid markets for many securities, this suggests that many, if not most, buy-ins will result in cash-compensation.

As also explained and illustrated in the response to Question 3, a cash compensation remedy applied at the settlement participant level, as opposed to at the trading counterparty level, creates market risks for:

(a) the delivering settlement participant (including investor CSDs);
(b) the purchasing counterparty; and
(c) the selling counterparty,

Under Option 2, the delivering settlement participant cannot assume that it is anything other than guarantor for the deliveries of its selling clients' trades (so, exactly the same as under Option 3), and will therefore need to mitigate this risk, most likely through requiring collateral from its selling clients. **This is discussed and costed in the response to Question 3**.

While ICMA appreciates that Option 2 is an attempt to provide for a trading level buy-in process, while remaining consistent with the Level 1 text, ICMA would argue that the Level 2 RTS is not the appropriate means to address such fundamental legal challenges, not least when the outcome is to increase the risks faced by EU based settlement participants and market infrastructure.

Art.15(3)(e) of the draft RTS states that the '*CSD rules shall provide that the participant shall recover that amount from its clients*'. ICMA, however, is not convinced that such a provision in the technical standards can establish a sufficient legal basis for any contractual agreements between settlement participants and their clients that would allow the participant to claim reimbursement from their clients for any costs arising from a participant level buy-in or cash compensation. This is particularly true where the resulting obligations are inconsistent with current agreed market practice and the relevant civil law obligations. Also, the more settlement participants that are involved in the chain, the more difficult it becomes to establish contractual agreements linking the trading level counterparty to the delivering participant incurring the cash compensation cost. Furthermore, any such agreements may be difficult to enforce and are prone to legal challenge, particularly in the instance where the costs arising from the cash compensation process would not restore the trading counterparties to the position they would have been in had the original transaction settled. This potential 'asymmetry risk' in the Level 1 CSDR buy-in and cash compensation provisions is discussed more in the response to Question 5.

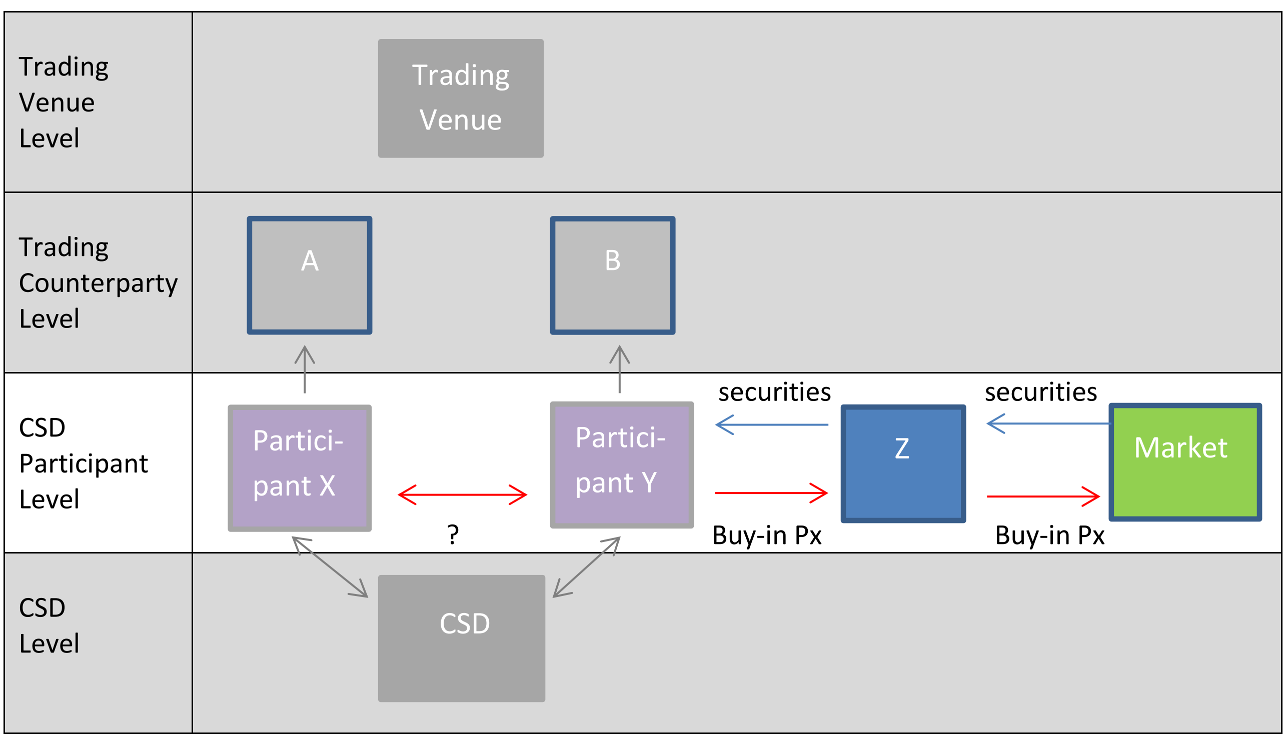
These problems are exacerbated by the fact that many of the settlement participant's clients will be based in non-EU countries and thus not generally subject to EU law. As mentioned in the response to Question 1, ICMA does not believe that technical standards are the appropriate means to address the fundamental legal challenges arising from the extraterritorial effects of the Level 1 text.

Q5: Please provide detailed quantitative evidence of the costs associated with the participant being fully responsible for the buy in process and on the methodology used to estimate these

While Option 2 attempts to provide for a buy-in process that is initially executed a the trading counterparty level (although, as explained, this cannot be relied upon), Option 3 ('CSD participant level executing the buy-in') provides for both the buy-in and the cash compensation remedy being applied at the settlement participant level. While Option 2, compared to a trading level buy-in process, creates market risk for both trading counterparties and the delivering participant once the process goes to cash compensation, Option 3 also creates these risks, but even in the event of the buy-in execution being successful. Furthermore, with the buy-in taking place at the participant level, Option 3 provides additional risks for the receiving counterparty that is responsible for instructing the buy-in. This is largely recognized in the Consultation Paper as the fundamental weakness of Option 3, and is likely to require significant collateralization of client purchases by the receiving settlement participant.

An additional consideration is that the asymmetry to the buy-in process that is suggested in Article 7(6) of the CSDR; while being a contentious issue for all three options, in the case of Option 3 this could be more difficult to enforce by the settlement participant. This is also discussed.

Figure 4: the buy-in under CSDR Option 3



Risks to the receiving participant

As ESMA acknowledges and discusses in the Consultation Paper, the primary challenge arising from Option 3, relative to Options 1 and 2, is that it creates additional market risk for the receiving settlement participant. In the event that the purchase made by the trading counterparty fails, the receiving settlement participant of that client will be responsible for the buy-in, which will be initiated against the settlement participant of the failing trading counterparty. The receiving participant would be responsible for appointing and transacting with the buy-in agent in order to take delivery of the securities (Article 15(2)(a)-Option 3 in the draft RTS). This makes the receiving participant, in the first instance, liable for any difference between the buy-in execution price and the original transaction price[16]. While it is not detailed in the draft RTS, it is implied that the receiving participant would then claim this difference from the delivering participant, who in turn would claim this from their failing client. This risk is illustrated in Example 4.

It is not immediately obvious from the Consultation Paper whether this 'participant level' buy-in process is intended **not to apply** to non-CCP-cleared transactions executed on trading venues (as per Articles 14(1) and 15(1) in the draft RTS). As explained in the response to Question 1, in most cases the trading venue will not have any relationship with the settlement participants or CSDs, only with its trading level members. However, if the intention under Options 2 and 3 is to treat non-cleared transactions executed on trading venues in the same way as Option 1, with trading level buy-ins and cash compensation, this would go some way to reducing the potential risks to trading parties and settlement participants created by Option 3.

The potential market risk to the receiving participant is effectively the same exposure to the variation between the 'remedy price' and the original transaction price that the delivering participant is subject to under Option 2, in the event that the participant is not reimbursed by the failing client. However, whereas in the case of Option 2 where the delivering participant only faces this exposure on client sales where it cannot guarantee delivery (i.e. where the sale is contingent on a pending purchase or delivery), in this instance the receiving participant does not know which receipts are more likely to fail than others, since this is completely dependent on the clients' trading counterparties and not the clients themselves. In other words, the receiving settlement participant would be exposed to all client purchases (as discussed in paragraph 36 of the Consultation Paper).

One solution to mitigate some of this exposure could be to force clients to become direct participants of the CSD. However, as discussed in the answer to Question3, this will be an expensive and, in most cases, impractical solution. Accordingly, under Option 3, the only practical means for the receiving settlement participant to mitigate their risk would be to collateralize the buy-in risk of every single client purchase.

[16] This difference will also include the 'buy-in premium', which is the difference between the guaranteed delivery buy-in price and fair market value at the time of the buy-in. This premium is largely unpredictable, and in many instances can be significant.

Example 4: risk of the buy-in to the receiving participant (Option 3)

Returning to Example 1 in the response to Question 3: Counterparty A purchases €10mm bonds from Counterparty B at a price of 100.00.

The settlement of the transaction fails and X, A's settlement agent, initiates a buy-in against Y, B's settlement agent.

The buy-in is successfully executed at a price of 102.00, and the bonds are delivered to X. X will then claim against Y for the buy-in price differential, of 2.00.

Y does not pay X the claimed amount.

Participant X faces a loss of (€200,000) as a result of Counterparty B's settlement failure to A.

Option 3: Cost analysis

In estimating the possible collateral requirements by settlement participants to mitigate their potential risk exposure under Option 3, ICMA applied the same methodology as for the AMFE-ICMA approach to providing the cost analysis for Option 2. In doing so, ICMA would again stress the limited time and access to detailed market data that would be required to support a robust and meaningful cost analysis. What ICMA therefore provides is a 'best efforts' analysis based on publicly available data and the pooling of estimates provided by members. Furthermore, ICMA applies the same reasoning as that provided by ESMA in the Consultation Paper in discussing the weaknesses of Option 3 (paragraphs 33-39). As with the analysis for Option 2, while it does provide a sense of the potential risks that settlement participants could face, and the potential collateral requirement to mitigate that risk, it should by no means be treated as a definitive cost analysis, and perhaps be regarded more as an indication of a 'worst case' scenario.

Methodology

1) ICMA uses the same approach as in answering Question 3: applying settlement data from the 2014 ECB Blue Book, stripping out both CCP settled transactions and an estimate of short-dated (exempt) non-cleared repo transactions. This provides the total of non-cleared receipt instructions that would be in-scope of potential buy-ins. Since it is not possible to consistently distinguish at the settlement level between OTC transactions and transactions executed on a trading venue (and with reference to the point raised earlier in this response related to the enforceability of a 'trading venue' exemption for settlement participants), we make no provision for this potential 'participant exemption' in the data.

2) Again, the exposure would, in most cases, be on a rolling two-day basis, so would only apply to two-days' worth of outstanding settlement instructions at any time. We do not make any allowance for longer or shorter settlement cycles, which are assumed to be relatively negligible

once included. Also, there will be a need for collateralization beyond intended settlement date in the event of a fail, but this is also not included.

3) Unlike client deliveries, there is no means by which a receiving participant can be certain of whether a receipt can settle. From a worst case scenario perspective, the receiving participant would therefore have to assume that every receipt can potentially fail and result in a buy-in (this is the 100% collateralization scenario that ESMA highlights in Paragraph 36 of the Consultation Paper).

4) Assuming that the receiving participant is only liable for any variation between the buy-in execution price and the original transaction price (and this assumption is discussed a little further on), then, as with delivering participants discussed in the Option 2 analysis, the receiving participant will need to apply a volatility based methodology to determine the appropriate margin on a security or asset type basis. In the analysis here, we apply the same CCP based margin factors as in Question 3.

5) Finally, and as discussed below, the same risks and potential margin requirements would apply to the delivering participant as described in the response to Question 3, and which would need to be included in any overall assessment of the collateral requirements for Option 3.

Table 3 illustrates the resulting potential collateral requirement based on these assumptions.

Table 3: potential two-day rolling collateral requirement under Option 3

2014 Data	**Total instructions value (€ million)**	**At-risk receipts value (€ million)**	**Average margin %**	**Receipt collateral requirement (€ million)**	**Delivery collateral requirement (€ million)[17]**	**Total collateral requirement (€ million)**
Bonds	932,628,879	7,369,498	4.50%	331,627	66,325	**397,953**
Short-term paper	91,599,516	723,806	4.50%	32,571	6,514	**39,086**
Equities	52,945,709	418,369	9.00%	37,653	7,531	**45,184**
Other	20,045,636	158,398	32.50%	51,479	10,296	**61,775**
Total	1,097,219,740	8,670,071		453,331	90,666	**543,997**

What the analysis shows is the possible market-wide collateralization requirement under Option 3 to cover the potential risks to settlement participants from failing receipts, as well as their potential delivery risks (approximately €540 billion based on the available data and assumed methodology). Again, this would be a rolling requirement; in other words, the average outstanding market collateral requirement at any time. This is effectively the permanent drain on collateral that would be created by Option 3. While this assumes the need for collateralization of 100% of non-CCP-cleared receipts (as

[17] This is the same as under Option 2 (see Table 2)

discussed by ESMA in the Consultation Paper), it may be possible that not all receipts would require collateralizing. As discussed, it may even be the intention of Option 3 that for non-cleared transactions executed on trading venues the settlement participant level buy-in process does not apply, in which case these transactions would not require collateralization. However, what the analysis seems to suggest is that even allowing for these possibilities, the overall need for collateralizing settlement instructions under Option 3 is likely to be highly significant.

Possibility of full collateralization

The above analysis is based on the assumption that the risk to the receiving settlement participant is purely related to the variation between the buy-in price and the original transaction price. That is, the receiving settlement participant is able to use the purchasing client's cash[18] for the original, unsettled transaction to pay the buy-in agent. As far as ICMA is aware, this has not been legally tested, and may require provisions in the settlement participant's agreements with its clients to authorize the use of client money to fund a transaction that the client may not have originally agreed to (i.e. the buy-in).

Where the settlement participant is not authorized to use the client's money for the original transaction to finance the buy-in, then not only is the settlement participant liable for any variation between the buy-in price and the original transaction price, but they are liable for the entire purchase price of the buy-in. In other words, the settlement participant would not only require collateralization to cover the buy-in price variation risk (as estimated above), but would also have to collateralize for 100% of the original transaction. Effectively, this would be the same as requiring all purchasing clients to pre-fund their purchases on trade date (as well as posting collateral to cover the buy-in price variation risk).

Under this scenario, the collateral (or pre-funding) requirements for Option 3 would be staggering (essentially the same figure as in the total *At-risk receipts* column in Table 3 above).

Risks to the buy-in agent under Option 3

One argument put forward is that under Option 3, buy-in agents may require margin since they could be exposed to the 'buy-in premium'[19] in the event that the receiving participant is unable to make payment for the buy-in (for instance, where it is not sufficiently collateralized by its purchasing client). ICMA, however, does not think that this is a valid argument. Buy-in agents are trading level counterparties (usually investment or commercial bank trading desks), so it is unlikely that they would demand collateral for what is effectively a client order. Rather, they will make an assessment based on the perceived counterparty credit risk of the settlement participant instructing the buy-in and, where they feel the risk is too high, will simply refuse to act as agent. As discussed earlier, finding buy-in agents

[18] Which could also be contingent on an onward sale
[19] The concept of the buy-in premium is explained in Annex II

under a mandatory buy-in regime could prove to be problematic and one of the main factors why buy-ins may not be successfully executed.

Risks of multiple buy-ins under Option 3

As recognized by ESMA in the Consultation Paper, another risk of establishing the buy-in process at the settlement participant level is that attempting to emulate the trading level 'pass-on' mechanism (as discussed in the response to Question 1 as a strength of Option 1) at the settlement participant level is far more difficult. As discussed in the response to Question 2, the trading level counterparties are generally the only actors with all the necessary information to successfully initiate a buy-in or to instruct a 'pass-on' since they will not only know who their trading counterparties are, but also the nature of the underlying transaction and the reason for the fail. Settlement level participants may not have this information, and in the event of a buy-in may not be able to identify successfully where a pass-on is warranted. Accordingly, under Option 3, the possibility of multiple buy-ins due to a single transaction fail is significantly increased.

The settlement participant as a trading party

A further consideration related to Option 3 is that it would effectively require settlement participants to act in the role of trading parties (i.e. appointing a buy-in agent, and subsequently transacting with that buy-in agent to take delivery of the securities). This broadens the role of the settlement participant form settlement agent or custodian to trading entity with principal risk. This could have serious ramifications for the way in which settlement participants will need to be capitalized and regulated.

Risks to the delivering participant

Similar to Option 2, the delivering participant faces the risk that they are unable to pass on any price variation related to either the buy-in or cash compensation. Thus settlement participants, under Option 3, will not only need to collateralize all client purchases, but will also need to collateralize client sales where the delivery is dependent on a client purchase or delivery of securities. This is included in the cost analysis above (see Table 3).

Risks to the purchasing counterparty

Similar to the cash compensation remedy being applied at the CSD participant level, as explained in the response to Question 3 and illustrated in Example 2, applying the buy-in process at the CSD participant level creates an additional level of communication, and therefore market risks, for the selling trading counterparty being bought-in. The successful execution of the buy-in, in exactly the same way as the cash compensation remedy, immediately creates a market exposure for the selling counterparty that will need to be unwound or hedged[20].

The asymmetry of the CSDR buy-in process

As briefly discussed in the introduction to ICMA's response to this Consultation Paper, even where there is immediate communication through the settlement intermediary chain to notify the selling counterparty of the buy-in execution, they could still be unfairly penalized (and the purchasing counterparty unfairly enriched) due to the wording in Article 7(6) of the CSDR.

Article 7(6) states:

'…where the price of the shares agreed at the time of the trade is higher than the price paid for the execution of the buy-in, the corresponding difference shall be paid to the receiving participant by the failing participant …'

Applying this would mean that for a successfully executed buy-in, where the buy-in execution price is below the original transaction price, rather than to restore the settlement participants (and, ideally, their trading counterparty clients) to the economic position they would have been in had the original transaction settled, this would instead create a profit for the receiving participant and a loss for the delivering participant. This is illustrated in Example 5, below.

What Example 4 illustrates is that not only does the buy-in create an unfair loss for the selling counterparty and an unfair profit for the purchasing counterparty, but that this penalty/enrichment is directly proportional to the extent that the buy-in execution price is below the original transaction price[21]. This is effectively the same as the selling counterparty being forced to provide the purchasing counterparty with a free put (struck at the initial transaction price) in the event the transaction does not settle.

Not only is it questionable whether the intention of the Regulation is to provide a free put to the purchasing counterparty at the expense of the selling counterparty, but ICMA is concerned that this asymmetry may be difficult to enforce in the contracts between settlement participants and their clients. In other words, under Option 3, the risk of this free put will be borne by the settlement participant and not by the trading level counterparty.

ICMA requests that ESMA seek clarity related to Article 7(6) from the European Commission, and that in the final RTS it provide clarity on the expected direction of payment of the buy-in execution price and

[20] Note that in the case of a buy-in being successful, there is no market exposure for the purchasing counterparty. This only occurs in the case of cash compensation.

[21] This also seems to overlook (or potentially confuse) the fact that the cost of a buy-in to the selling counterparty is created by the difference between the buy-in execution price and the prevailing market 'fair value' price (i.e. the 'buy-in premium'), and not the difference between the buy-in execution price and the original transaction price.

original transaction price, whether for trading counterparties (Options 1 and 2) or settlement participants (Option 3), in the cases where:

(i) the buy-in price is higher than the original transaction price; and

(ii) the buy-in price is lower than the original transaction price.

Example 5: Applying Article 7(6) to the Option 3 buy-in process

Counterparty B sells €10mm bonds to Counterparty A, at a price 100.00.
B's reverse-repo to cover the short-sale fails, which in turn causes B's sale to A to fail.

A's settlement agent, Participant X, initiates a buy-in against B's settlement agent, Participant Y. This is successfully executed at the prevailing market price of 98.00.

X notifies A that the buy-in has been successful. A does not need to do anything.
Y notifies B that the buy-in has been successful, and B immediately offsets its exposure at the prevailing market price.

Y pays X the difference between the buy-in price and the original transaction price (2.00), which is respectively debited from and credited to B and A's accounts.

Trading Counterparty A's P&L:

Mark-to-market:	€0	(98.00-98.00 x €10mm)
Payment of the buy-in difference:	€200,000	(100-98.00 x €10mm)
Profit:	€200,000	

Trading Counterparty B's P&L:

Mark-to-market:	€0	(98.00-98.00 x €10mm)
Payment of the buy-in difference:	(€200,000)	(100.00-98.00 x €10mm)
Loss:	(€200,000)	

The asymmetry of the cash compensation process

While Article 7(6) of CSDR creates confusion over the settlement of the buy-in price differential between the trading counterparties (or settlement participants), there is also a lack of clarity, both in the Level 1 and in the draft RTS, over the settlement of the cash compensation between trading counterparties (or settlement participants). As with buy-ins, if the differential cannot be paid in either direction, depending on whether the reference price applied is higher or lower than the original transaction price, this too creates a free put for the purchasing trading counterparty, at the expense of the selling trading counterparty (Option 1) or the delivering participant (Options 2 and 3).

Again, ICMA requests that ESMA provide clarity in the final RTS on the expected direction of payment of the cash compensation between the cash compensation actors, whether for trading counterparties (Option 1) or settlement participants (Options 2 and 3), in the cases where:

(i) the reference price is higher than the original transaction price; and

(ii) the reference price is lower than the original transaction price.

This will be critical in determining the additional market exposure potentially being borne by the trading counterparties, as well as their settlement participants, who, under Options 2 and 3, will need to include this exposure in their risk mitigation.

Option 3: summary

Option 3 ('CSD participant level execution') creates significant risk for not only the trading counterparties (both purchasing and selling) that will have the buy-in or cash compensation processes taken out of their control, but also for the settlement participants.

Most significantly, this is likely to impact the receiving settlement participant that is responsible for executing the buy-in. In the best case scenario, the exposure to the receiving settlement participant will be the equivalent of the variation between the buy-in price of any execution and the original transaction price struck by its client (and not the entire cost of the buy-in price).

If one is to assume that a significant number of receipts will need to be collateralized by settlement participants, even if not all receipts, the overall collateral requirements are likely to be significant, and will also need to include the collateralization of delivery risks that equally apply under Option 2.

Furthermore, Option 3 presents numerous other challenges, including increased risk of multiple buy-ins, counterparty risks to buy-in agents, and the possibility that settlement participants may have to take on the role of trading parties with implicit capital and regulatory requirements.

Conclusion

ICMA and its members remain firmly opposed to the introduction of a mandatory buy-in regime to the non-centrally-cleared European capital markets. As has been illustrated by various impact studies, such a regime will be expensive and difficult to implement and enforce, and will create significant market disruption, while reducing market liquidity and widening bid-offer spreads. A buy-in (or cash compensation) regime enforced at the settlement participant level creates new layers of contractual and legal complexity, as well as market risks for those participants that will need to be mitigated or mutualized. Ultimately, these will be costs borne by investors, and, potentially, capital raisers, and not by the investment banks that provide market pricing and settlement services. Furthermore, a mandatory buy-in regime will put EU (I)CSDs at a competitive disadvantage to non-EU CSDs, and will almost certainly lead to a migration of liquidity away from European markets in securities that can be settled in both EU and non-EU CSDs, driving away both investors and issuers from the European capital markets. All of these outcomes are in complete contradiction to the goals of Capital Markets Union.

However, ICMA accepts that mandatory buy-in regulation is now passed into law, and appreciates the challenges facing ESMA in drafting the RTS for a mandatory buy-in regime, particularly in light of the inherent, and well documented, short-comings in the Level 1 text. ICMA would even go as far as to say that without significant amendments to the Level 1, this is an impossible task. In light of these challenges, ICMA, on behalf of its members, welcomes ESMA's Consultation Paper on The Operation of the Buy-in Process, and hopes that its response herein helps to support the eventual drafting of Level 2 regulatory technical standards that can be implemented with the minimum cost and disruption to the markets.

To summarize the key points made in the ICMA response:

- **Option 1, while not without significant flaws, is the closest process to how buy-ins currently work, and therefore the least worst of the three options**.

- Option 1 could be contractually applied by means of a standard market protocol, to which trading counterparties are required to become signatories under the rules and requirements of EU CSDs, CSD participants, and trading venues.

- Option 2 overlooks the fact that many buy-ins will not be successfully executed due to reasons beyond the control of the trading counterparties (primarily a lack of available securities or a willing buy-in agent). This will be exacerbated by a significant increase in buy-in volumes, relatively short timeframes to execute a buy-in, and declining market liquidity. It is therefore likely that many, if not most, buy-ins will result in cash compensation.

- The cash compensation remedy, when applied at the settlement participant level, creates market risk for the purchasing counterparty, the selling counterparty, and the delivering settlement participant (which could also be a CSD). (Applies to both Options 2 and 3)

- **The risks to the delivering settlement participant under Option 2 are likely to result in the participant requiring collateral from its clients against any sale where the delivery is contingent on another purchase or delivery.**

- **Under Option 3, the risks to the receiving settlement participant (which could also be a CSD) could result in the participant requiring collateral from its clients against most, if not all, purchases. This market-wide collateralization requirement is likely to be significant.**

- Under Option 3, in the event that the receiving participant is unable or unauthorized to use its clients' money to finance a buy-in purchase, they may also require full collateralization of any client purchases (effectively the same as pre-funding any client purchase on trade date).

- The buy-in remedy, when applied at the settlement participant level, also creates additional market risks for the selling counterparty and the delivering participant (which could also be a CSD). (Option 3)

- Option 3 creates other problems, including the increased risk of multiple buy-in, counterparty risks to buy-in agents, and the possibility that settlement participants may have to take on the role of trading parties with implicit capital and regulatory requirements.

- An explicit asymmetry for buy-ins, and an implicit asymmetry for cash compensation[22], creates additional market risk for the selling counterparty (Options 1 and 2) and the delivering participant (Options 2 and 3), in the form of a 'free put' granted to the purchasing counterparty or the receiving participant. This could also be difficult to enforce at both the trading and settlement participant level.

In addition to these points, ICMA, on behalf of its members, would again like to use the opportunity of this response to support ESMA's proposal in the December 2014 Consultation Paper and draft RTS to request a delay in the implementation of settlement discipline measures (in particular mandatory buy-ins). This will be essential for the market to prepare for a buy-in regime, particularly with regard to the extensive operational enhancements and legal agreements that will need to be in place to support a mandatory buy-in regime, even if implemented at the trading level. ICMA further suggest that a mandatory buy-in regime not be implemented until after the full and successful roll-out of TARGET2-Securities, **and accordingly recommends a minimum postponement of 24 months before attempting implementation**.

[22] Articles 7(6) and 7(7) in the CSDR

Annex I

Suggested amendments and enhancements to the Draft Regulatory Technical Standards on the operation of the buy-in under the different options

Recitals

Draft RTS	Comment
(4) The settlement of an instruction aims at ensuring the final settlement of a transaction concluded between trading parties. For transactions executed on a trading venue and for transactions cleared by a CCP, the trading venue members and the clearing members respectively are the parties to the transaction and therefore the parties that should ~~perform~~ appoint the buy-in agent, where relevant. They have the relevant information to execute it. For transactions not executed on a trading venue nor cleared by a CCP.	'Perform' is ambiguous. The RTS should provide clarity on what is expected of the trading level counterparties with respect to the buy-in process.
(6) Either Option 1 and 2 (trading party) *The buy-in agent will act upon request from the receiving party, but the cost will be borne by the failing party. It is appropriate to set a framework so that the buy-in agent will ~~act in the interest of the failing party~~ strive to achieve best execution, and will have no affiliation or conflict of interest with the trading parties involved in the buy-in process.*	It is important that the buy-in agent apply 'best execution policy' and have no conflict of interest with any of the trading counterparties involved in the buy-in process.
(7) Either Option1 and 2 (trading party) *In order to limit the number of buy-ins and preserve liquidity of the market for the relevant instrument, the failing party should be allowed to deliver the financial instruments to the receiving party up to the ~~moment when it is informed that the buy-in agent is appointed. As from that point in time, in order to prevent a situation where the receiving party would receive twice the financial instruments from the buy-in agent and from the failing party, the failing party should be able to deliver the financial instruments to the buy-in~~*	In the interest of reducing the number of buy-ins, there is no reason why the failing trading counterparty should not be able to continue to attempt to deliver securities to the receiving counterparty at least up until the end of the day the day before the buy-in is scheduled to be executed. This underscores the point that ICMA has repeatedly made that as part of the overall risk mitigation of the buy-in process it is essential that the buy-in execution be identified in the process as a discrete event, and that the buy-in date be part

~~*agent or to the entity performing the auction with the approval of that agent or entity*~~ *end of day before the scheduled day for the buy-in execution, or until an agreed time when the receiving party is reasonably able to instruct the buy-in agent to halt the buy-in execution.*	of the buy-in notification process. Not only will this allow for a longer timeframe for the selling party to make delivery and so avoid the buy-in, but this also better enables the trading counterparties to manage their market risk arising out of the buy-in process. Furthermore, in the event of a buy-in auction, it may be possible for the failing counterparty to continue to deliver securities up until a time before the auction is scheduled, at which point the auction could be canceled. There should not be a provision for the failing counterparty to deliver securities to the buy-in agent, or any other trading counterparty other than the purchasing (receiving) counterparty. To do otherwise would increase the operational risk of all parties concerned. In the event of a deferral, these same provisions should apply to the deferred buy-in, again allowing the selling party (or delivering participant) to deliver securities to the purchasing party (or receiving participant) at least up until the day before the deferred buy-in execution date.
(9) With the aim to ~~balance the uncertainty resulting from the buy-in process and the interest of the parties to close the transaction~~ protect the interests of the receiving party, in case the buy-in fails, in the absence of express communication of the receiving party choice, the buy-in process should be ~~terminated and the cash compensation should be paid~~ deferred.	Cash compensation creates a market risk for the purchasing (receiving) counterparty, and it is in their best interest that the process results in a buy-in rather than cash compensation. The deferral effectively protects the rights of the receiving counterparty, whereas cash compensation will compromise those rights.
(11) Either Option1 and 2 (trading party) *A transaction may in some cases be part of a chain of transactions and instructions. In order to avoid that a buy-in has to be performed for each settlement fail in a chain of transactions a CSD should allow the parties to pass on the buy-in notification, which could be further passed on to other parties involved in the cause of the settlement fail in reasonable time to ensure that the process is effective. The CSD should remain informed of the pass-on and of the identity of the party receiving that notification.*	For the 'pass-on' process to work effectively it may be necessary to set a cut-off time for when notifications related to the buy-in process are passed through the chain. Under ICMA 'buy-in rules', this is 10am London time on the same day that any notification is received (this also applies to the original buy-in notification itself). Under a mandatory buy-in regime, this may need to be accelerated to something approaching 'real time' to ensure efficiency of the process. However, ICMA believes that this should be a market driven solution, rather than something prescribed in the RTS.

Article 12: General

Draft RTS	Comment
2. The buy-in process shall comprise the following elements: (a) the notifications, as specified in Article 13; (b) the appointment ~~without undue delay~~ of a buy-in agent as soon as is practicably possible, where relevant; (c) the determination of the buy-in date; (d) the selection and instruction of the venue for the buy-in auction, where relevant; (e) the attempted execution of the buy-in process through the acquisition of the securities by the buy-in agent or through an auction; Either Option 1 and 2 (trading party) *(~~d~~ f) the completion of the buy-in process through the delivery to the receiving party by the buy-in agent or the entity executing the auction, of all or some of the bought-in securities and the payment of the cash compensation for the non-delivered securities to the receiving party by the failing party, either following or instead of deferral.*	To be practically applied, the buy-in process needs to provide for: (i) the possibility that a buy-in agent cannot be appointed 'without undue delay' (ii) an explicit date for the execution of the buy-in (iii) the possibility that the buy-in may not be executed (say in the case that a buy-in agent cannot be found or the securities are not available for guaranteed delivery)

Article 13: Notifications

Draft RTS	Comment
1. The notifications referred to in point (a) of Article 12(2) shall be served upon the following steps and contain the following information: (a) without delay upon the initiation of the buy-in process, a notification specifying the settlement fail it relates to;	To minimize the risk to the trading parties involved in the buy-in process, the notification process should provide for: (i) An explicit date when the buy-in is to be executed (and possibly the time in the event of a buy-in auction)

(b) without delay upon the appointment of the buy-in agent, a notification specifying the date of the appointment and the name of the buy-in agent~~;~~,or, where relevant, details of auction venue; (c) the determination of the date on which the buy-in execution will take place, or, where relevant, the date and time of the scheduled buy-in auction; (~~c~~d) ~~on the last business day of the buy-in process~~ as soon as the buy-in has been executed or at a time when the buy-in is deemed to have failed, a notification specifying the results of the buy-in process; (~~d~~e) as the case may be, without delay, upon election of a choice made pursuant to Articles 15(1)(b) or (c), 15(2)(b) or (c) and 15(3)(b), a notification of such choice; (~~e~~f) as the case may be, ~~at the latest upon the last business day of the deferral period~~ as soon as the deferred buy-in has been executed or at a time when the deferred buy-in is deemed to have failed, a notification specifying the results of the deferred buy-in process.	(ii) Immediate notice on the successful execution or failure of the buy-in process, both for the initial buy-in process and the deferred buy-in process.
~~2. For transactions executed on a trading venue and not cleared by a CCP, the receiving party shall provide the relevant notifications referred to in paragraph 1 to the failing party and to the trading venue which shall transmit it to the CSD~~.	There seems little value in this process, given that in most cases the trading venue will have no knowledge of whether the original transaction settled or failed, nor will it add any value to the information chain between the trading counterparties and the relevant CSD related to any buy-in process. It would be far more efficient for the relevant trading counterparty to inform the CSD directly (as specified in Article 13(4), thus dis-intermediating the unnecessary involvement of the trading venue.

Article 14: Appointment of the buy-in agent and execution

Draft RTS	**Comment**
1. For transactions executed on a trading venue and not cleared by a CCP, the rules of a trading venue shall provide that the receiving party shall appoint a buy-in agent consistent with the buy-in rules under CSD Regulation. ~~The trading venue shall appoint a buy-in agent where the receiving party does not do so within two business days following the elapse of the extension period.~~	ICMA queries whether Article 14(1) applies to all three options, or just to Options 1 and 2. If it also applies to Option 3, then this would mean that for non-CCP-cleared transactions executed on trading venues, the trading party would still be responsible for appointing the buy-in agent, rather than the settlement participant. Furthermore, in the case of Option 2, would it mean that the cash compensation remedy is applied at the trading party level (so effectively the same as Option 1)? In most cases, for transactions not cleared by a CCP, a transaction executed on a trading venue will be indistinguishable from a transaction executed in the OTC market from a settlement perspective. In other words, once the transaction is executed, the trading venue will have no involvement in whether the transaction subsequently settles or fails, and does not have the necessary information to initiate a buy-in process. Under Options 1 and 2 the appointment of a buy-in agent should only be by the purchasing counterparty, and in the case of Option 3, by the receiving participant.
5. Either Option1 and 2 (trading party) *Failing parties shall be allowed to deliver the securities until the end of day before the scheduled day for the buy-in execution, or until an agreed time when the receiving party is reasonably able to instruct the buy-in agent to halt the buy-in execution. ~~receipt of~~ The details of the buy-in date, and possibly the time, will be included in the notification referred to in Article 13(1)(~~b~~c).* *~~The failing parties shall thereafter be allowed to deliver the securities to the buy-in agent or to the entity that executes the buy-in auction upon agreement of that entity.~~*	See comments relating to Recital 7 and the suggested addition to Article 13(1). As also explained, delivering securities to the buy-in agent does not guarantee delivery to the purchasing counterparty (or receiving participant) and merely adds another level of settlement risk.

Article 15: Completion of the buy-in process

Draft RTS	Comment
1. For transactions executed on a trading venue but not cleared by a CCP: (a) when the buy-in has been successful, the securities shall be delivered to the receiving party and the failing and receiving parties shall ensure that the settlement instruction is cancelled; (b) where the buy-in failed, the receiving party shall notify without delay ~~to the trading venue and~~ to the failing party whether it prefers to defer the buy-in, or whether it prefers to receive the cash compensation. In the absence of such notification, the ~~failing party shall pay to the receiving party the cash compensation~~ the buy-in shall be deferred; (c) where the buy-in results in a partial delivery of securities, the receiving party shall accept the bought-in securities. For the non-delivered securities, the receiving party shall notify without delay to the trading venue and to the failing party whether it prefers to defer the execution of the buy-in or to receive cash compensation. In the absence of such notification, ~~the failing party shall pay the cash compensation to the receiving party~~ the buy-in shall be deferred.	Similar to the comments related to Article 14(1), ICMA requests clarity on whether this is also intended to apply to Option 3 in the case of non-CCP-cleared transactions executed on trading venues. Furthermore, does this also apply to Option 2 in the case of cash compensation, with this being applied at the trading party level (in the same way as Option 1)? Re (b): Notifying the trading venue is a redundant step (see comments on Article 13(2) above). Re (b) and (c): Cash compensation creates market risk for the receiving party, whereas deferral does not. As explained in the comments related to Recital 9 (above), in the interests of the receiving party, the default should always be deferral.
3. Either Option1 (trading party) *For transactions not executed on a trading venue nor cleared by a CCP:* (a) when the buy-in has been successful, the securities shall be delivered to the receiving party and the failing and receiving parties shall ensure that the settlement instruction is cancelled; (b) where the buy-in failed, the receiving party shall notify to the failing party without delay whether it prefers to defer the buy-in, or whether it prefers to receive the cash compensation. In the absence of such notification, ~~failing party shall pay to the receiving party the cash compensation~~ the buy-in shall be deferred; (c) where the buy-in results in a partial delivery of	In theory there should be no difference between Articles 15(1) and 15(3). Re (b) and (c): Cash compensation creates market risk for the receiving party, whereas deferral does not. As explained in the comments related to Recital 9 (above), in the interests of the receiving party, the default should always be deferral.

securities, the receiving party shall accept the bought-in securities. For the non-delivered securities, the receiving party shall notify to the failing party without delay whether it prefers to defer the buy-in or to receive the cash compensation. In the absence of such notification, ~~the failing party shall pay the cash compensation to the receiving party~~ the buy-in shall be deferred.	
3. or Option 2 (trading party with the participant as a fall back) *For transactions not executed on a trading venue nor cleared by a CCP:* (a) where the buy-in has been successful, the securities shall be delivered to the receiving party and the failing and receiving parties shall ensure that the settlement instruction is cancelled; (b) where the buy-in failed, the receiving party shall notify without delay to the failing party whether it prefers to defer the buy-in, or whether it prefers to receive the cash compensation. In the absence of such notification, ~~the failing party shall pay the cash compensation to the receiving party~~ the buy-in shall be deferred; (c) where the buy-in results in a partial delivery of securities, the receiving party shall accept the bought-in securities. For the non-delivered securities, the receiving party shall notify to the failing party without delay whether it prefers to defer the buy-in or to receive the cash compensation. In the absence of such notification, the buy-in shall be deferred; (d) where the CSD does not receive the information referred to in Article 13(3)(c) on the results of the buy-in on the business day following the end of the buy-in process, it shall notify the failing participant of the absence of evidence that the buy-in process was performed; (e) where the failing participant does not provide to the CSD the evidence that the buy-in process was performed or that the trading party is subject to an insolvency proceeding, within one business day following the notification referred to in the first subparagraph, the failing participant shall pay	Re (b) and (c): Cash compensation creates market risk for the receiving party, whereas deferral does not. As explained in the comments related to Recital 9 (above), in the interests of the receiving party, the default should always be deferral

the cash compensation to the receiving participant. The CSD rules shall provide that the participant shall recover that amount from its client.	

Article 16: Partials

Draft RTS	**Comment**
When the relevant securities are available in the account of the delivering participant, partial settlement offered by CSDs in accordance with Article 3(9) shall be applied from the last business day of the extension period, irrespective of any contractual choice made by the participants.	It may not always be possible to mandate that partial settlement is offered, particularly in the case of omnibus accounts where the beneficial ownership of available securities may not be clear.

Requested additional technical standards

Required RTS	**Comment**
The definition of the buy-in A buy-in is a contractual remedy available to a purchasing counterparty of financial securities in the event that the selling counterparty fails to deliver the securities. The outcome of the buy-in should be to restore the trading counterparties to the same economic position they would have been in had the transaction settled on the intended settlement date.	The purpose of the buy-in needs to be made very explicit in the RTS. This also needs to state unambiguously whether it is a remedy to facilitate a contractual obligation, or whether it is intended as a settlement penalty for a failing party (or participant). There is nothing in the Level 1 text to suggest that it should be anything other than a remedy, but this needs to be made clear, particularly in light of the phrasing of Article 7(6) of the CSDR.
Completion of the buy-in: the direction of the payment between parties (or participants) of the difference between the buy-in execution price and the original transaction in the event that: (a) The buy-in price is higher than the original transaction price (b) The buy-in price is lower than the original transaction price	This is critical for trading parties and settlement participants in order to quantify and manage their settlement risk. It will also help clarify what was intended in the wording of Article 7(6) of the CSDR which suggests that the selling party (or delivering participant) is being forced to provide the purchasing party (or receiving participant) with a free put in the event of a buy-in.

The scope of transaction types under buy-in rules	There is a need for the RTS to provide clarity on the type of transactions where buy-in rules will apply, or not. For instance, the treatment of securities movements which do not represent an underlying trade, such as margin pledges, realignments between accounts, or corporate action relates movements. Furthermore, clarity would be welcomed regarding the treatment of a settlement fail that is caused by the purchasing party, not the selling party.
Revised Extension Period	Article 7(4)(a) of the CSDR provides that the extension period can be increased to 7 business days '*where a shorter extension period would affect the smooth and orderly functioning of the financial markets concerned*'. ICMA has maintained, and clearly illustrated in its February 2015 Impact Study, that in the case of all fixed income securities, the maximum possible extension period is more than warranted. ICMA has also pointed out the impracticalities of using the MiFID II/R liquidity calibrations to determine extension periods, not least since this in itself is the subject of much debate over its reliability with respect to its intended purpose. ICMA recommends that the MiFID II/R liquidity calibrations be dropped from the RTS, and that all fixed income instruments be afforded the maximum possible extension period of 7 business days.
Revised Timeframe to deliver the financial instruments	Article 7(3) of the CSDR provides that following the initiation of the buy-in process, the (financial) instruments shall be '*delivered to the receiving participant within an appropriate time-frame*'. In the draft RTS published in December 2014, ESMA suggest that the timeframe to deliver the financial instruments (i.e. the time between the end of the extension period and the delivery of the securities to the receiving participant) also be based on the MiFID II/R liquidity calibrations. ICMA would highlight the same issues with using a

	contentious, and as yet un-finalized, determinant as with determining extension periods. Other than the liquidity of underlying securities, other critical factors to consider include: (i) The required time to appoint a buy-in agent (which may not be straightforward). (ii) The possibility of using a buy-in auction, which may be periodical, and requires time to notify potential sellers. (iii) The time to settle the buy-in following the successful execution of the buy-in (in most cases, T+2). With this in mind, ICMA would recommend **a minimum timeframe of 7 business days for all buy-ins**, regardless of the underlying security.
Clarity on the timeframe for deferral	Article 7(7) in the CSDR provides that where a buy-in fails or is not possible, '*the receiving participant can choose to be paid cash compensation or to defer the execution of the buy-in to an appropriate later date ('the deferral period')'*. Given that cash-compensation is usually undesirable from the perspective of the purchasing counterparty, and creates market risks, ICMA would suggest that not only does deferral of the buy-in become the default option where the buy-in is not possible or fails, but that the deferral period be longer than the original timeframe for the buy-in process. ICMA's recommendation is that the deferral period, in the interest of the purchasing counterparty, be kept as flexible and open as possible; ideally at the discretion of the purchasing counterparty. The RTS should also specify that in the event of deferral, it should be possible for the selling party (or delivering participant) to deliver securities to the purchasing party (or receiving participant) at least up until the day before the deferred buy-in execution date (see comments on Recital 7).
Clarity on the exemption for Securities Financing Transactions	Article 7(4)(b) of the CSDR provides an effective exemption for the first-leg of SFTs where the

	timeframe (i.e. the 'term') is '*sufficiently short and renders the buy-in process ineffective*'. In the December 2014 Consultation Paper, ESMA clarifies this as meaning where the second-leg of the SFT is anterior to the last possible date that the buy-in process could be settled. ICMA would agree with this definition, but believes that further clarity is required in the RTS to define this period as being the extension period, plus the maximum possible timeframe for the buy-in, **plus the possibility for deferral**, applicable to the underlying security.
Provision for a resolution process	Whether in the RTS, or a recommended delegated act, the Regulation should provide for a resolution process related to the buy-in process. Both buy-ins and cash compensation can lead to disputes over the buy-in price or reference price applied, particularly where this deviates significantly from perceived fair market value. Further causes for potential disputes can include costs to trading parties or settlement participants as a result of delayed notification of the buy-in execution or cash compensation application, or whether a buy-in should even be applied to the underlying transaction or movement of securities. In a mandatory buy-in regime, such disputes are likely to be significant, and to mitigate the ensuing systemic risks to market stability and liquidity from 'doing business', the co-legislators will need to establish a systematic means to manage these disputes and to achieve prompt, consistent, and equitable resolutions.

Annex II

Buy-ins, how they work, and the challenges of CSDR[23]

Introduction

Buy-ins are a widely available and often used remedy in the event that a financial transaction does not settle (a 'fail'). It most commonly takes the form of a contractual right of the purchaser of securities and a means by which to secure delivery of those securities from a third-party in the instance that the original selling counterparty is unable to make delivery. Recently, the concept of the 'buy-in' has become a hotly discussed topic in the context of European securities markets, as EU law, in the form of a provision in the CSD-Regulation, attempts to reconstruct buy-ins, not in only terms of how they work, but also with respect to their legal construct, making them a mandated obligation[24], rather than a right.

The purpose of this paper is to provide an explanation of what a buy-in is and its function as an available contractual remedy in financial securities markets, as well as to illustrate, very simply, the dynamics and flows of the buy-in process. The paper then looks at the provision for mandatory buy-ins under the EU CSD-Regulation (passed into law in August 2014), and highlights how this seems to re-construe what a buy-in is, and, accordingly, why the regulation will be highly problematic to implement and enforce.

What the paper does not explore is the broader issue of *mandatory buy-ins* in the context of market impact, such as implementation costs for various market participants, the practicalities of processing millions of buy-ins per year, and the unintended consequences for market pricing and liquidity[25]. These have been analyzed and discussed elsewhere, and are now broadly understood. Rather, this is a practical 'nuts-and-bolts' discussion of the buy-in process, and the challenges of implementing *mandatory buy-ins* under CSDR.

How this paper is organized

The paper is in two parts. Part I is an overview of what a buy-in is, and how, operationally, buy-ins work today. Through examples and illustrations, it explains buy-ins, the delivery of the securities by the buy-in agent, the cash settlement where the buy-in price is higher or lower than the original transaction price, buy-in chains and pass-ons, cash compensation, as well as the benefits and challenges associated with executing buy-ins and cash compensation.

Part II seeks to highlight the practicalities, and challenges, of the CSDR approach to buy-ins. While CSDR does not define what a buy-in is, or what it is intended to do, it does provide for who should be responsible for, and be affected by, a buy-in, as well as the related cash-flows. Meanwhile, the Level 2 Consultation Paper builds on the Level 1 to propose three different potential mandatory buy-in processes. Again, these options are illustrated and explained.

[23] This paper was first published by ICMA in July 2015

[24] And not necessarily an obligation of the failed-to purchasing counterparty.

[25] For example, see: ICMA, 2015, 'Impact Study for CSDR Mandatory Buy-ins'

Executive Summary

What is a buy-in and how do they work?

- A buy-in is a contractual remedy available to the purchasing counterparty to a financial transaction in the event that the selling counterparty fails to deliver the purchased securities.
- The purpose of the buy-in is to restore the counterparties to the transaction to the economic position they would have been in had the original transaction settled.
- The bought-in securities are delivered to the failed-to purchasing counterparty, and not to the failing selling counterparty.
- Failing chains of linked transactions can be resolved by means of a pass-on mechanism and a single buy-in that is initiated and executed at the end of the chain.
- Buy-ins are not a penalty mechanism, however, the bought-in counterparty will often incur an economic loss due to the 'buy-in premium' (the difference between the buy-in price and the current market 'fair value').
- Buy-ins can be difficult to execute, particularly for illiquid securities, and finding a buy-in agent may not always be possible.
- A cash compensation remedy is a means to provide certainty of outcome to the buy-in process, but this creates issues around the rights of the receiving counterparty as well as determining the appropriate reference price.
- Buy-ins are usually a discretionary right, rather than an obligation, and in some circumstances may be difficult to enforce.

The challenges of implementing CSDR mandatory buy-ins

Level 1

- The 'buy-in' is not defined, nor is the purpose of the buy-in explained.
- The buy-in process seems to apply to CSD participants, which may not be the same as the trading counterparties to the transaction.
- The provision for the payment of the price differential between the buy-in price and the original transaction price is reversed, compared to standard buy-in processes.

The Level 2 Options

- The RTS do not specify how the price differential between the buy-in price and the original transaction price should flow.
- The trading counterparties to the original transaction may not be involved in the buy-in or cash compensation process (Options 2 and 3).
- The buy-in process could require the involvement of a trading venue, which may not have sufficient information to initiate the buy-in process.
- The RTS do not specify how the reference price for cash compensation is to be determined.
- Where the buy-in process only involves the trading counterparties to the original transaction (Option 1), the buy-in, in some circumstances, may not be enforceable.

Part I: What is a buy-in and how do they work?

What is a buy-in?

A buy-in is a contractual remedy available to a purchasing counterparty of financial securities in the event that the selling counterparty fails to deliver the securities[26]. Where the selling counterparty fails to deliver on the agreed settlement date, the purchasing counterparty has the right to enforce delivery by instructing a third-party (a buy-in agent) to purchase and deliver the securities to replace the original transaction. Any differences between the price of the original transaction and the buy-in price are settled between the selling and purchasing counterparty. The purpose and effect of the buy-in process is to return all counterparties to the economic position they would have been in had the original transaction settled on the intended settlement date.

Example of the buy-in process

Counterparty A sells 100 bonds to counterparty B at price of 98.50.
The trade does not settle, and B elects to initiate a buy-in against A.
The buy-in agent (Z) purchases the bonds at a price of 99.25 and delivers them to B at the same price (99.25).
Simultaneously, B cancels the original settlement instruction with A.
A pays B the difference between the original transaction and the buy-in price, i.e. 0.75.
If A now re-sells (or marks-to-market) their original 100 bonds (at the market price of 99.25), both A and A will be in the same economic position they would have been in had the transaction settled.

Figure 1: the original transaction

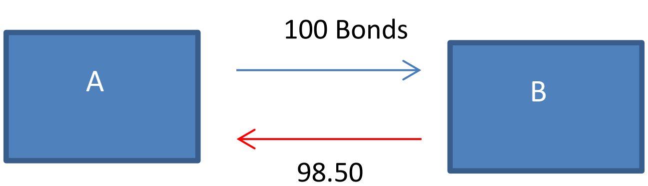
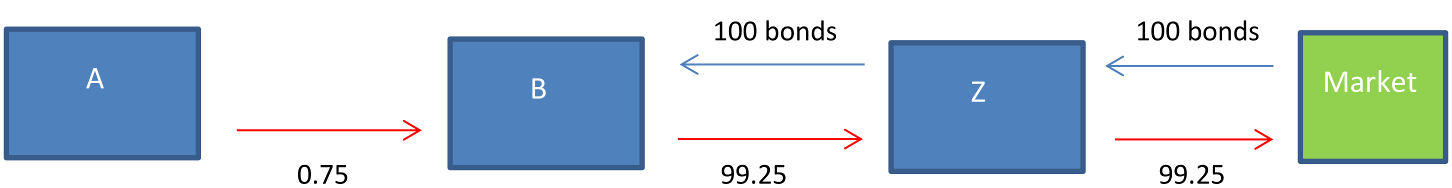


Figure 2: a standard buy-in



[26] It should be noted that in some instances the fail is caused by the purchaser, and not the seller, in which case the equivalent remedy is a 'sell out'. However, CSDR overlooks this eventuality and resolution, and therefore so will this paper.

The above diagram shows clearly how the buy-in restores the economic position of A and B. B receives the securities at the equivalent price of the initial transaction (99.25-0.75), and A, after re-selling/marking their position at the new market price of 99.25[27], is economically in the same position as if the original trade had settled at 98.50 (99.25-0.75).

The delivery of the securities by the buy-in agent

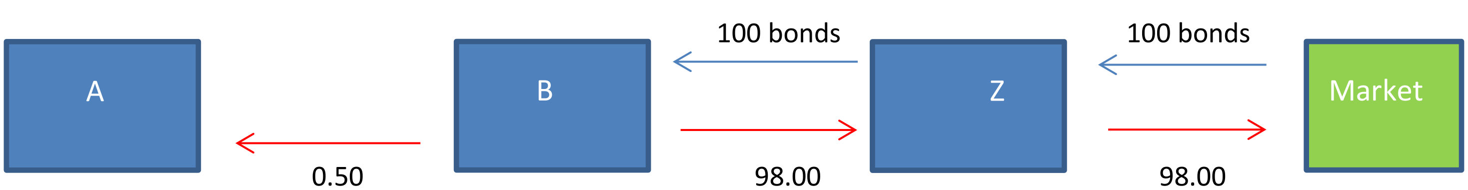
Note that in the above example the bought-in securities are delivered to the purchasing counterparty (who then cancels the original transaction with the selling counterparty). This is critical, since it ensures that the purchasing counterparty, who initiates the buy-in, takes delivery of the securities. For instance, were the buy-in agent to deliver the securities to the failing, selling counterparty, this would not guarantee that the purchasing counterparty receives the securities (for instance, the selling counterparty could have other delivery commitments in the same securities), and therefore would not ensure that the buy-in results in a satisfactory remedy. As we will see later, this also helps explain why, in the case of linked fails ('fails chains'), the buy-in is always initiated and settled at the **end** of the chain and not at the start. While the terminology may be confusing (the failing counterparty is said to have been 'bought-in'), it should be clearly understood that they **do not** receive the bought-in securities: the failed-to purchasing counterparty receives the securities, and the original transaction with the failing selling counterparty is canceled.

A buy-in where the buy-in price is lower than the transaction price

In the previous example, the price of buy-in is higher than the original transaction price, and so the selling counterparty (A) pays the difference to the purchasing counterparty (B). In the event where the buy-in price is lower than the original transaction price, the cash payments move in the opposite direction; i.e. the purchasing counterparty would pay the difference to the selling counterparty. Again, this is to ensure that both counterparties are restored to the correct economic position, and that neither is unfairly disadvantaged or advantaged.

In the above example, if the buy-in price had been at 98.00, the buy-in flows would work as below:

Figure 3: a standard buy-in where the buy-in price is below the original transaction price



[27] It is important to understand that after the selling counterparty (A) is bought-in, the original settlement instruction is canceled which restores A to the position they were in before the original transaction. The new position will either need to be flattened (through another sale) or marked-to-market; either of which (after the price differential between the buy-in price and the original transaction price is settled between A and B) will restore A to the economic position they would have been in had the original trade settled.

In this scenario, B effectively still pays the original price of 98.50 for the bonds (98.00 + 0.50). Meanwhile, after A re-sells/marks their bonds at 98.00, and receives the payment from B of 0.50, they are also in the same position as if they had sold their bonds at 98.50 (98.00 + 0.50).

Buy-in agents and fees

A key component of the buy-in process is the buy-in agent. Buy-in agents are usually broker-dealers (most often market-makers in the securities being bought-in), with no affiliation to either the purchasing counterparty initiating the buy-in, or the selling counterparty being bought-in. The buy-in agent is generally appointed by the purchasing counterparty initiating the buy-in, and is expected to execute the buy-in in the best interests of the purchasing counterparty (i.e. purchasing the securities for guaranteed delivery in a timely fashion), while carrying out due diligence in terms of the selling counterparty being bought in, by securing the best (i.e. lowest) possible price for the buy-in (the reason for this will be explained a little further on).

Naturally, being a buy-in agent, and the process and due diligence of executing a buy-in, can be an arduous and time consuming task, and clearly distracts from the broker-dealers commercial priorities (i.e. making prices and providing liquidity to their clients). It is therefore often possible (though seldom applied) for buy-in agents to charge a *reasonable* fee for their time and efforts, which is passed on to the selling counterparty being bought-in. This is illustrated in the two examples below.

Figure 4: a buy-in with a buy-in agent fee (buy-in price higher than original transaction price)

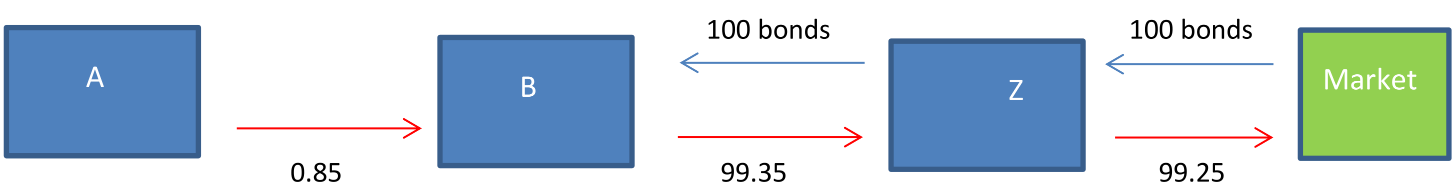
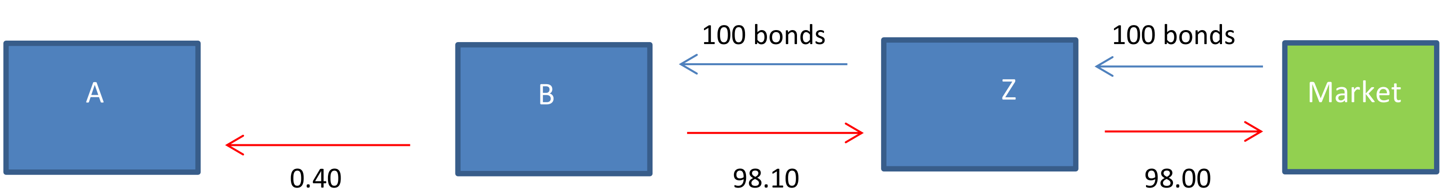


Figure 5: a buy-in with a buy-in agent fee (buy-in price lower than original transaction price)



In both of the above cases (based on the original trade in *Figure 1* and the scenarios in *Figures 2 and 3*), the buy-in agent (Z) charges 0.10 commission, or fee, which it passes on to the purchasing counterparty (B). B, in turn, passes this 0.10 cost on to the selling counterparty being bought-in. In this way, both A and B are restored to their original economic position, with the notable exception of A paying the costs of the buy-in agent.

Buy-in chains

Often transactions can be linked (say, in the case of matched-principal intermediation), in which case a fail by a selling counterparty can lead to a sequence of market fails (known as a 'fails chain'). In this instance, the fails chain can be completely settled with one singe buy-in at the end of the chain through a simple process known as a *pass-on*. This is illustrated below.

Figure 6: original inter-connected transactions

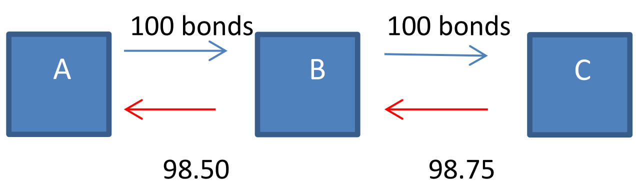
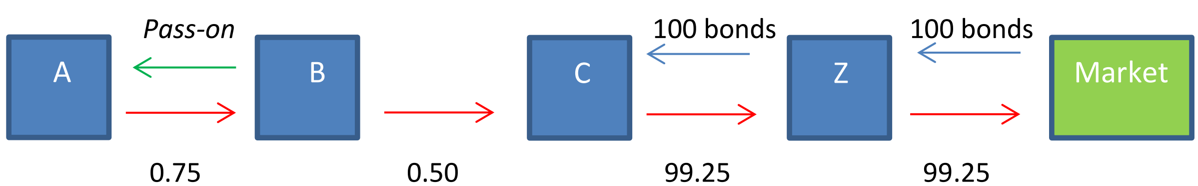


Figure 7: settling the buy-in chain



In the scenario illustrated in *Figure 6*, A fails to deliver securities to B, who in turn fails to C. Figure 6 illustrates how the buy-in process using pass-ons resolves the fails-chain.

C issues a buy-in against B, and appoints the buy-in agent, Z, to execute the buy-in.
B, who is an intermediary in the chain, issues a **pass-on** to A, who is failing to them and causing them to fail to C.
Z purchases the bonds in the market (at 99.25), and settles them to C at the same price.
C cancels its trade with B, and B pays 0.50 (99.25 - 98.75) to C.
B cancels its trade with A, and A pays B 0.75 (99.25 - 98.50).

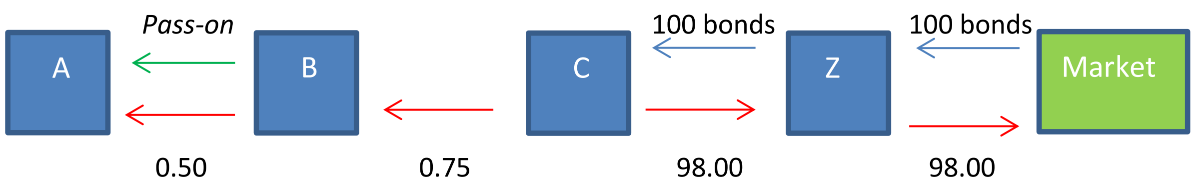
In this way, C takes delivery of the securities and all counterparties in the chain are restored to the economic position they would have been had the original transaction(s) settled (as per *Figure 5*):

C owns the securities at the equivalent of 98.75 (99.25 - 0.50).

B has no position, but nets 0.25 (0.75 - 0.50).
A re-sells/marks its securities at the new market price of 99.25, which, after paying the buy-in difference to B, is economically the same as selling the securities at 98.50 (99.25 - 0.75).

As in *Figure 3*, the same logic applies to the flows in the event that the buy-in price is lower than the original execution price. This is illustrated in *Figure 8*, below.

Figure 8: settling the buy-in chain where the buy-in price is lower than the original trade price



Again, it can be seen that all counterparties are returned to the economic position they would have been in had the original transaction(s) settled:

C owns the securities at the equivalent of 98.75 (98.00 + 0.75).
B has no position, but nets 0.25 (0.75 – 0.50).
A re-sells/marks its securities at the new market price of 98.00, which, after **receiving** the buy-in difference from B, is economically the same as selling the securities at 98.50 (98.00 + 0.50).

<u>The benefits of the pass-on mechanism to remedy fails-chains</u>

Figures 7 and 8 illustrate very clearly how the pass-on mechanism helps to resolve the entire fails-chain with just one buy-in, and returns the entire chain to the economic position that they would have been in had the original failing transaction in the chain settled. The key benefits of this mechanism are:

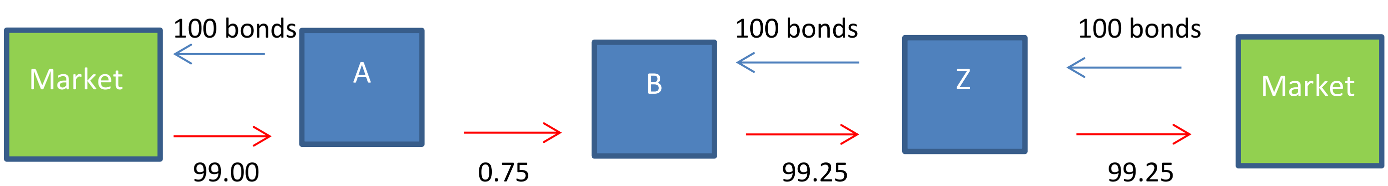
(i) The buy-in only need be initiated by the final counterparty in the chain (who will know that they are the last in the chain since they have an inward fail and no onward delivery).
(ii) There is no need for any counterparty in the chain, the buy-in agent, or any other party to have overall visibility of the chain; each counterparty only need know who *they* have transacted with.
(iii) Since the securities are delivered directly by the buy-in agent to the last counterparty in the chain, there is no settlement risk (see earlier point about the risks of delivering the bought-in securities to the failing selling counterparty, and how this does not necessarily ensure delivery to the receiving counterparty).
(iv) It avoids exposing counterparties that are effectively 'flat' to the risks of being bought-in on a position they do not have.

Does a buy-in penalize the failing counterparty?

A buy-in is not intended to penalize a failing counterparty, nor is it the appropriate legal construct to attempt this. As should be clear already, a buy-in is a contractual remedy designed to restore the trading counterparties to the economic position they would have been in had the original transaction settled. However, the failing counterparty being bought-in will invariably suffer some economic cost through the process. This is as a consequence of the buy-in execution price being higher than the market 'fair value' price. The reason for this difference is that a buy-in will be for *guaranteed delivery*, which means that the seller into the buy-in must physically hold the securities and be able to deliver them to the buy-in agent; this invariably commands a premium. Furthermore, a buy-in in itself is a signal to the market that securities will be purchased *no matter what the price*, and so sellers will adjust their offer prices accordingly. As a general rule, the less liquid the security, the greater the *buy-in premium*.

The cost of the buy-in premium to the failing counterparty is illustrated below, drawing on the same scenario of *Figures 1 and 2*.

Figure 9: the cost to the failing counterparty due to the buy-in premium



In this scenario the buy-in is executed at 99.25, compared to a 'fair' market price of 99.00. B is restored to its original position of buying the securities at an equivalent of 98.50 (99.25 – 0.75), however, when A re-sells/marks its position, it incurs a loss of 0.25 (99.00 – 98.50 – 0.75).

It should also be remembered that even where the buy-in execution price is the same as the market price, the counterparty being bought-in will most likely still incur a cost through the bid-ask spread (with the buy-in executed at the 'ask' price, and the bought-in counterparty re-selling/marking their position at 'bid'). Furthermore, the bought-in counterparty may be liable for any fees charged by the buy-in agent (see earlier section).

Buy-in auctions

A possible alternative to the classic buy-in agent model is a buy-in auction. In this scenario, the receiving counterpart, rather than appoint a buy-in agent to go into the market to find the securities, would initiate a buy-in auction on a third-party trading venue. Holders of the securities being bought-in could then tender their securities allowing the buy-in to be executed at the most competitive price. Such a process, in theory can add a degree of transparency and liquidity to the buy-in process, as well as streamlining and automating the process.

However, it does not necessarily negate the need for agents, and it may be prudent (or even required) that an agent execute the buy-in purchase in the auction, particularly where the counterparty initiating the buy-in is not a member of the venue hosting the auction. Similarly, many of the counterparties tendering securities into the auction may need to do so through an agent that is also a member of the venue. However, the time, effort, and risks of the buy-in agent (see next section) are significantly reduced.

In the case of linked transactions and fails chains, the process employing the use of pass-ons is exactly the same as illustrated in *Figures 7 and 8*, with the buy-in auction process being initiated by the purchasing counterparty at the end of the chain, and any price differential being subsequently settled along the chain.

Challenges with buy-ins

Despite the buy-in remedy being widely available, relatively few buy-ins are actually executed relative to number of failed transactions. Also, initiating a buy-in process does not necessarily result in successful execution, particularly where the underlying securities are illiquid. These factors can be attributed to a number of challenges related to the buy-in process:

(i) The buy-in process is very time consuming for all parties concerned, including the counterparty initiating the buy-in and the buy-in agent.
(ii) Finding buy-in agents can be difficult, particularly as there is little incentive for market-makers to act as a buy-in agent. There is no legal obligation to act as a buy-in agent.
(iii) Buy-ins can have a distortive impact on market pricing, partly due to the required premium for guaranteed delivery, but also through its signaling function that there may be a ‘distressed-buyer’ in the market.
(iv) Where the buy-in execution price is significantly higher than the perceived market ‘fair value’, this can lead to legal disputes between the counterparty being bought-in and the counterparty issuing the buy-in, and possibly even the buy-in agent.
(v) Buy-ins ae not always executable, particularly where the underlying securities are illiquid. In this instance the purchasing counterparty initiating the buy-in may not be able to receive their securities, and could be left with the option of either cancelling or deferring the buy-in, or, in some instances, electing for cash settlement (see next section).
(vi) Based on the contracts between trading counterparties, or the terms of the transaction, a buy-in (or pass-on) may not be legally enforceable in some jurisdictions. Trading counterparties need to be aware of this, and adjust their pricing, or their decision to transact with certain counterparties, accordingly.

Cash compensation

Where a buy-in is not possible, some buy-in regimes allow for the possibility of ‘cash compensation’. In this case the original transaction is canceled (no securities are delivered to the purchasing counterparty), and cash differences are settled between the counterparty based on a reference price for the securities, which represents the ‘fair’ market value. This is intended to be the economic equivalent of the purchasing counterparty receiving their securities as per the original transaction, and subsequently selling them at the market price at the time of the cash compensation resolution. Economically, this is very similar to the classic buy-in illustrated in *Figures 2 and 3*, but with no delivery of securities.

The three examples below illustrate the cash compensation process.

Figure 1: the original transaction

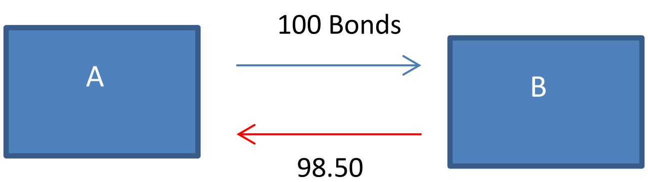


Figure 10: cash compensation where the reference price is higher than the original transaction price

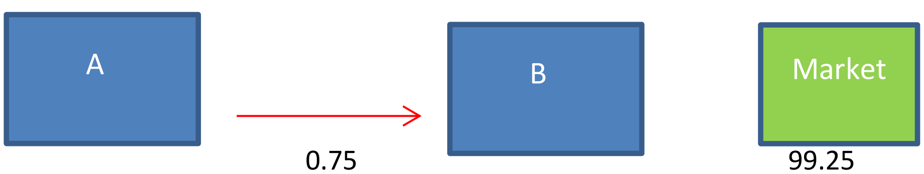
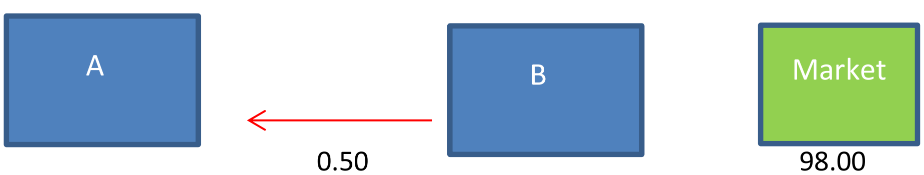


Figure 11: cash compensation where the reference price is lower than the original transaction price



As with buy-ins, it can be seen that the cash differentials paid between the counterparties can go in either direction, depending on the reference price being applied. Again, this is to ensure that the counterparties are restored to an equitable economic position, and that neither is unfairly penalized or enriched.

The same process can be applied to fails-chains, again using the pass-on mechanism, with a single reference price determining the cash differentials that are passed along the chain (similar to *Figures 7 and 8*).

The challenges with cash compensation

There are two main challenges with a cash compensation mechanism:

(i) If the cash compensation resolution is automatically applied (say in the case of buy-in failing), it could be argued that this compromises the rights of the failed-to purchasing counterparty. Even where a transaction is failing, the transaction is still valid, and the purchasing counterparty retains their intended economic exposure to the purchased securities[28]. For example, this could be an insurance or pension fund that purchase assets to match a specific liability. While cash compensation attempts to produce the same economic remedy as a buy-in from a 'snap-shot perspective', it is very different in that it replaces the purchaser's intended exposure to a particular financial instrument with a cash payment. The purchasing counterparty may wish to maintain their exposure until the securities are delivered (or bought-in), and could argue that cash compensation is an unsatisfactory, and even disadvantageous, remedy.

(ii) Setting the appropriate reference price can be difficult, and contentious. The failing seller and the failed-to purchaser may disagree on what is market 'fair value', particularly if the security is illiquid. In the case where cash compensation is the chosen remedy as a result of a buy-in not being possible, there is an implication that there is no applicable market 'fair value' price. Choosing the wrong reference price runs the risk of inadvertently enriching or penalizing either of the counterparties to the transaction.

The benefits of cash compensation

Despite the difficulties in applying a cash compensation remedy for failing transactions, there are also some potential benefits:

(i) It can provide some certainty where a buy-in is not possible, and prevents the buy-in process being stretched out indefinitely. This is particularly important for CCPs, who need to minimize their internal exposures.

(ii) In some cash compensation agreements, the reference price is capped relative to the original transaction price. While this is not necessarily consistent with establishing an equitable remedy (i.e. it does not ensure that the reference price represents fair market value and so restore both counterparties to the economic position they would have been had the transaction settled), it does at least limit the *cash compensation premium* exposure of the failing selling counterparty[29].

[28] Although they will assume counterparty exposure to the failing selling counterparty until the securities are eventually settled, or bought-in.

[29] However, the introduction of 'caps' or 'floors' to cash compensation changes the structure of the mechanism, with it taking on some of the features of a penalty mechanism, rather than it being a purely equitable remedy.

Buy-ins: a summary box

- A buy-in is a contractual remedy available to the purchasing counterparty to a financial transaction in the event that the selling counterparty fails to deliver the purchased securities.
- The purpose of the buy-in is to restore the counterparties to the transaction to the economic position they would have been in had the original transaction settled.
- The bought-in securities are delivered to the failed-to purchasing counterparty, and not to the failing selling counterparty.
- Failing chains of linked transactions can be resolved by means of a pass-on mechanism and a single buy-in that is initiated and executed at the end of the chain.
- Buy-ins are not a penalty mechanism, however, the bought-in counterparty will often incur an economic loss due to the 'buy-in premium' (the difference between the buy-in price and the current market 'fair value').
- Buy-ins can be difficult to execute, particularly for illiquid securities, and finding a buy-in agent may not always be possible.
- A cash compensation remedy is a means to provide certainty of outcome to the buy-in process, but this creates issues around the rights of the receiving counterparty as well as determining the appropriate reference price.
- Buy-ins are usually a discretionary right, rather than an obligation, and in some circumstances may be difficult to enforce.

Part II: CSDR and buy-ins

What does the Level 1 provide for?

CSD-Regulation, which was passed into EU Law in August 2014, aims to improve the efficiency and safety of EU settlements systems. Article 7 of the regulation focuses on measures to address settlement fails, which includes a provision for the mandatory initiation of buy-ins where the settlement of financial securities in a transaction fails:

Article 7(3)
…where a failing participant does not deliver the financial instruments…to the receiving participant within 4 business days after the intended settlement date ('extension period') a buy-in process shall be initiated whereby those instruments shall be available for settlement and delivered to the receiving participant within an appropriate time-frame.

There are 3 key exemptions to this rule: (i) where the liquidity of the financial instrument is low[30], the extension period can be increased to 7 days; (ii) the extension period for SME growth markets can be increased to 15 days; and (iii) in the case of securities financing transactions that are sufficiently short in duration, the start-leg can be exempted.

However, the purpose of this analysis is not to focus on the technicalities around extension periods, or which transactions are out of scope, but rather on the buy-in process outlined in the Regulation. More details of this are provided in Articles 7(6) and (7).

Article 7(6)
…where the price of the shares agreed at the time of the trade is higher than the price paid for the execution of the buy-in, the corresponding difference shall be paid to the receiving participant by the failing participant no later than on the second business day after the financial instruments have been delivered following the buy-in.

Article 7(7)
If the buy-in fails or is not possible, the receiving participant can choose to be paid cash compensation or to defer the execution of the buy-in to an appropriate later date ('deferral period'). If the relevant financial instruments are not delivered to the receiving participant at the end of the deferral period, cash compensation shall be paid.

Cash compensation shall be paid to the receiving participant no later than on the second business day after the end of either the buy-in process referred to in paragraph 3 or the deferral period, where the deferral period was chosen.

The key observation here is that the buy-in initiation and process is framed in terms of the *receiving* (i.e. purchasing) and *failing* (i.e. selling) ***participant***. 'Participant' refers to the members of a CSD in scope of the regulation, which is not necessarily the same as the trading counterparties. In many cases, this could

[30] Defined in the legislation as '*where a shorter extension period would affect the smooth and orderly functioning of the financial markets concerned'*

be the settlement agent of the trading counterparties. So immediately the buy-in process provided for in CSDR is very different to the normal buy-in process in two key respects:

(i) Initiating a buy-in is no longer the right of the failed-to purchasing counterparty, but rather an obligation that is out of their hands.

(ii) The buy-in process no longer applies to the purchasing and selling counterparties, but rather to the *participants* of the regulated CSD, which may not be involved in the transaction(s).

This creates two fundamental requirements for the regulation to be implemented:

(i) A mechanism to ensure that the buy-in process is initiated (with or without the involvement of the purchasing counterparty).

(ii) The creation of a contractual relationship between trading counterparties and CSD participants in relation to the buy-in process.

ESMA attempts to do this in the suggested buy-in processes outlined in the Consultation Paper published in July 2015, and which are examined a little later.

What does a Level 1 buy-in look like?

Article 7(6) is interesting in that it provides for a scenario that is very different to the normal buy-in process. It states that where the buy-in execution price is lower than the original transaction price, **the difference is paid by the failing participant to the receiving (purchasing) participant**. Compare this with Figure 3 in the earlier section, which illustrates how in a normal scenario, the cash difference would be paid by the receiving counterparty to the failing counterparty.

The buy-in process outlined by Article 7(6) is illustrated below. Note that for simplicity we will assume that both the selling and receiving participants are also the trading counterparties.

Figure 1: the original transaction

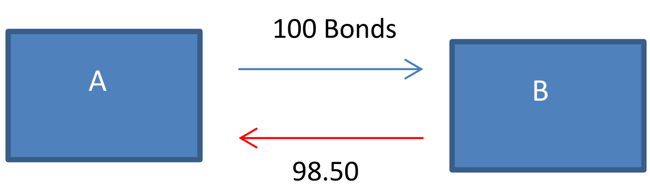
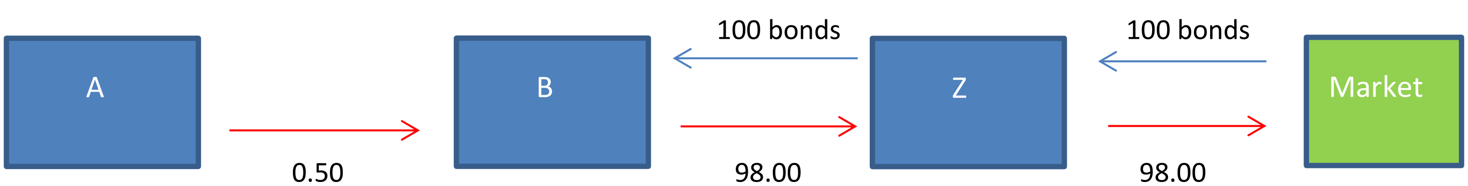


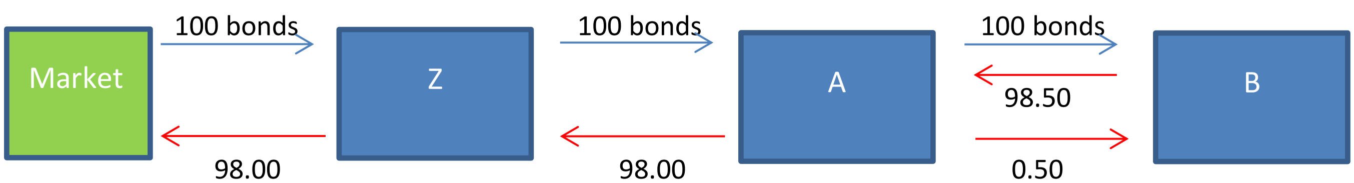
Figure 12a: CSDR buy-in where the buy-in price is below the original transaction price



In this scenario B not only receives the securities at a lower price from the buy-in agent (98.00), but also receives an additional payment from A (0.50).
Meanwhile, A not only takes a loss in terms of the re-sale/mark of its bonds (from 98.50 to 98.00), but also makes an additional payment of 0.50 to B.
Neither counterparty is restored to the economic position they would have been in had the original transaction settled. Instead, B is unfairly enriched by the equivalent of 1.00 (98.50 – 98.00 + 0.50), while A is unfairly penalized by the same amount (98.00 – 98.50 – 0.50).

This raises the question of whether this is the intention of the regulation, or could it even be an error in the text? One possible explanation is that CSDR was not drafted with a standard buy-in in mind, but with a buy-in process where the bought-in securities are delivered to the failing counterparty rather than to the receiving (purchasing) counterparty (i.e. the buy-in is executed at the start of the chain). This possibility is illustrated below:

Figure 12b: CSDR buy-in where the buy-in price is below the original transaction price (alternative interpretation)



In this scenario, the buy-in agent, Z, purchases the securities at 98.00, which it then sells to A (the failing counterparty) at the same price. A is then able to make good its delivery to B, as per the original transaction, at the agreed price of 98.50. However, the regulation requires that A also pays the difference between the original transaction price and the buy-in price (0.50).

However, this still does not restore both counterparties to the economic position they would have been in had the original transaction settled.

B receives the securities at the original transaction price, but also receives an addition al payment from A of 0.50. Thus B effectively purchases the securities an effective price of 98.00 (0.50 less than the original transaction).
A receives the new securities from the buy-in agent at 98.00, and so delivers to B at the original price of 98.50, but also makes an additional payment of 0.50 to B. This leaves A 0.50 worse off than they would have been had the original trade settled.
So even in this scenario, the receiving (purchasing) counterparty is unfairly enriched, and the selling (failing) counterparty is unfairly penalized.

So in conclusion, it is very difficult to reconcile Article 7(6) with how buy-ins work in current market practice, even if the buy-in delivers the securities to the failing counterparty (the start of the chain). It is beyond the scope of this analysis to make any assumptions on whether the wording of Article 7(6) is intentional, or if it is a drafting error, but it is clear that what is provides for is not consistent with any recognized buy-in process.

The ESMA Consultation Paper (June 2015)

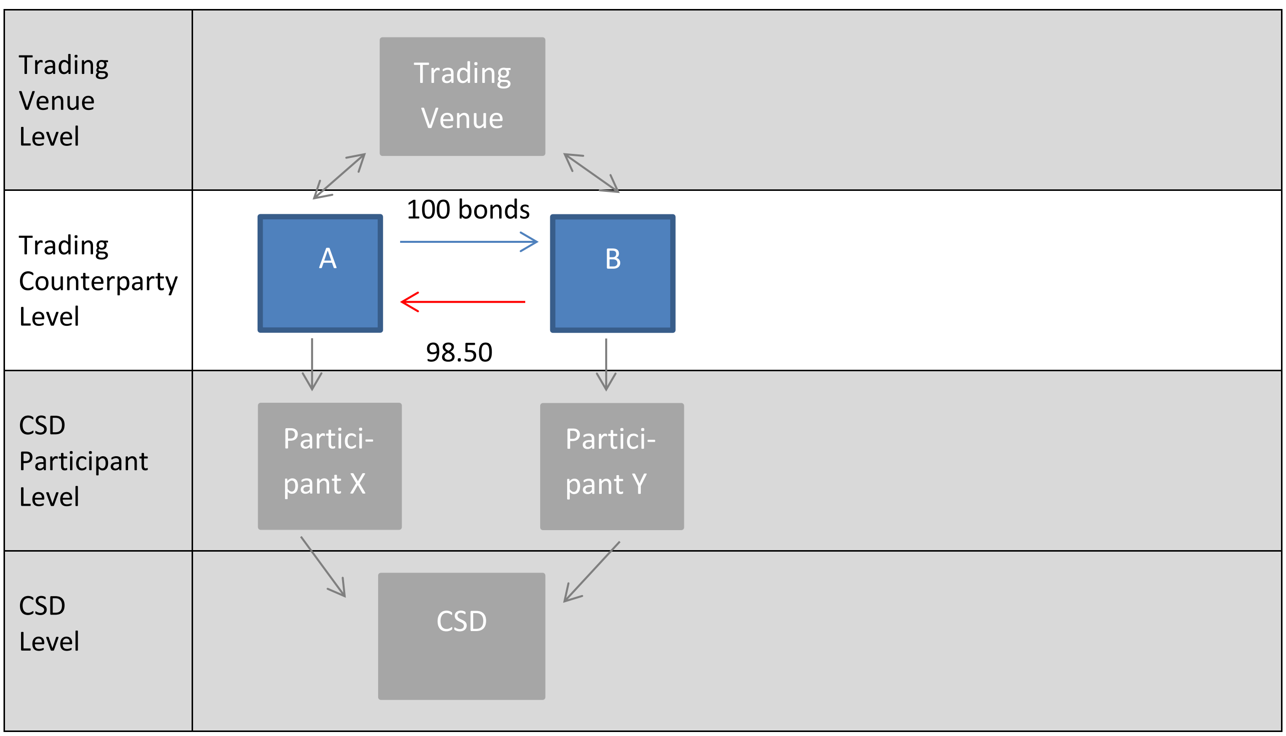
In June 2015, ESMA published a Consultation Paper focusing specifically on the Level 2 regulatory technical standards (RTS) of *the operation of the buy-in process*. It should be noted that these options relate to non-cleared transactions[31]. The paper presents three possible options, for the buy-in process under CSDR:

(i) Trading level execution
(ii) Trading level with fall-back option execution
(iii) CSD participant level execution

Of note, the various options introduce three new actors into the buy-in process: CSD participants, CSDs[32], and trading venues[33]. This adds new layers of complexity that need to be considered.

If we take *Figure 1*, used earlier in this paper, as the basis of a simple transaction between two trading counterparties (A and B), we now need to view it from the perspective illustrated in *Figure 13* as the basis of our analysis of the three options.

Figure 13: the original transaction – the CSDR perspective

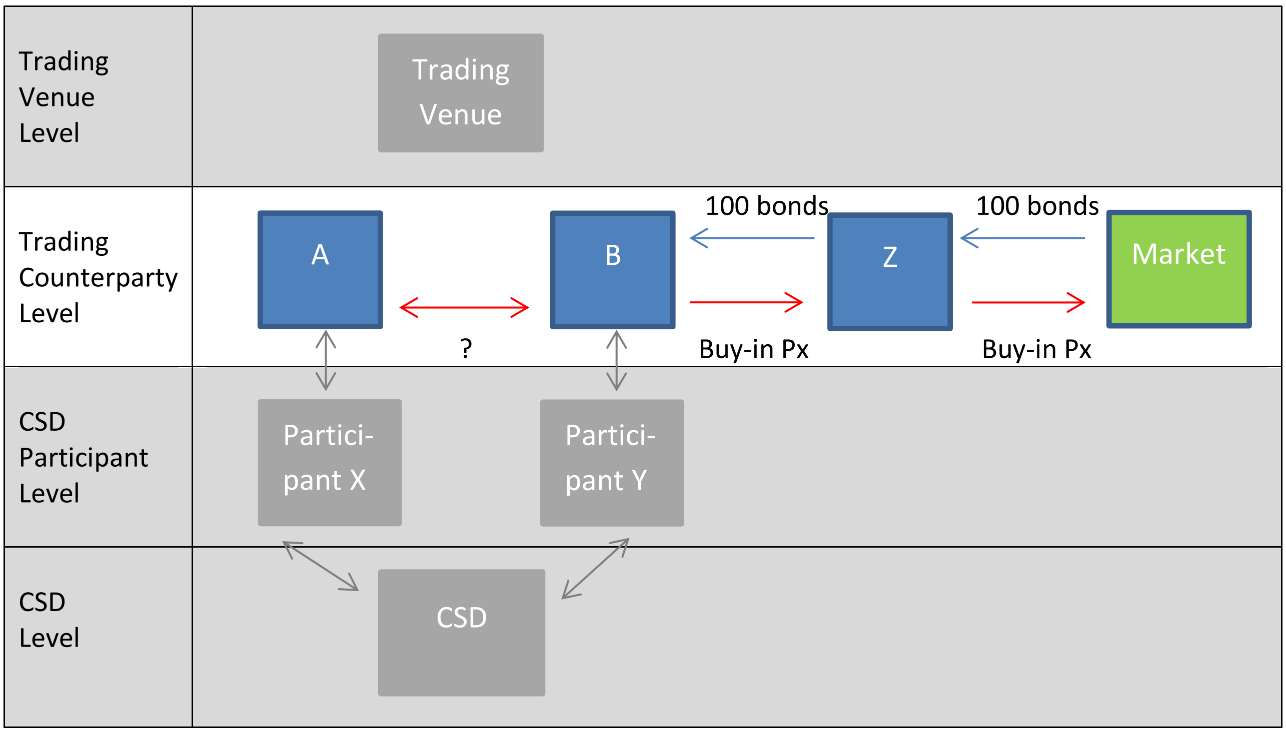


[31] CCPs are out of scope of the CSDR mandatory buy-in provisions.
[32] In the case of CSDs, the involvement in mainly in the form of including buy-in provisions in their rules, and information flows to support the buy-in process, rather than actually participating in the buy-in process itself.
[33] Importantly, CCPs are not in scope of CSDR mandatory buy-ins. Many, if not all, CCPs will have their own buy-in rules as part of their counterparty risk mitigation, and which will be very similar to the trading counterparty level buy-in model.

Option 1: Trading level execution

Option 1 provides for the buy-in to be performed by the trading counterparties that concluded the transaction, and for the buy-in agent to deliver the securities to the receiving (purchasing) counterparty. In most respects, this is the same as the standard buy-in process that currently exists, and which is illustrated in Part 1 of this paper (see *Figures 2 and 3*).

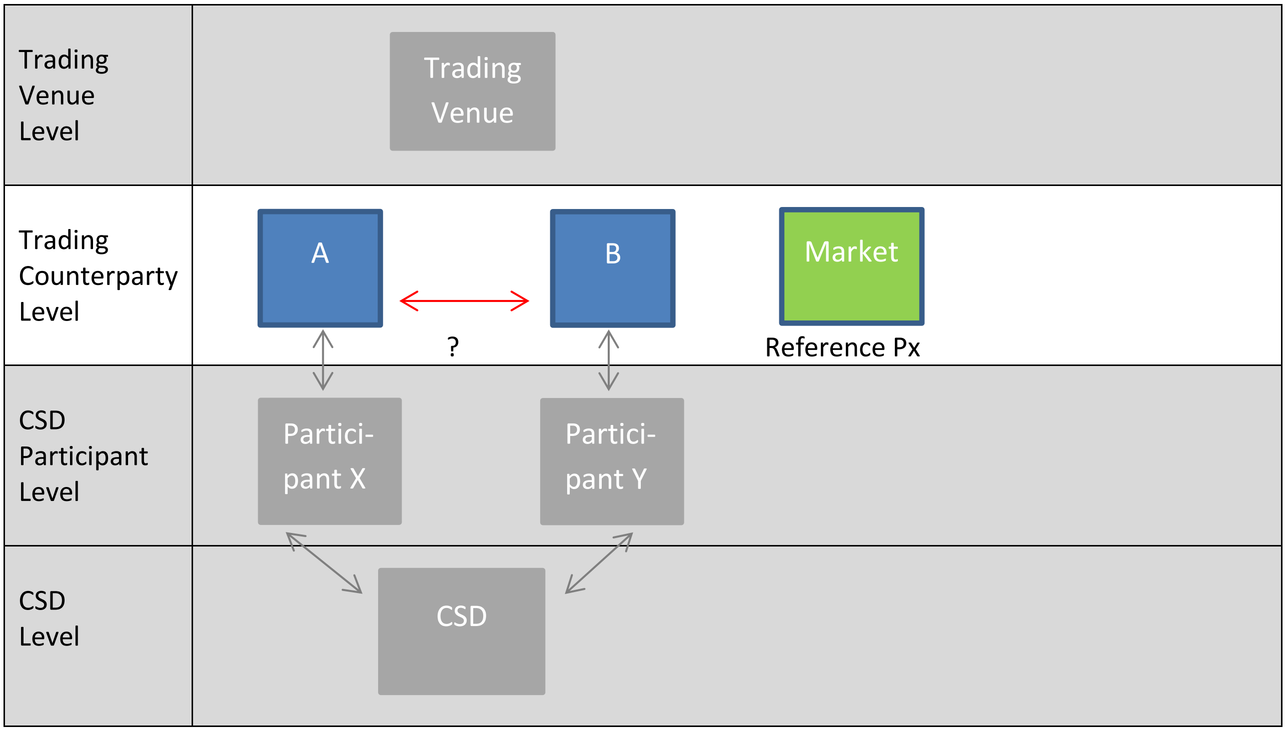
Figure 14: A buy-in under CSDR Option 1



In terms of the operational flow, this is identical to the standard buy-in illustrated in *Figure 2.* However, neither the Consultation Paper nor the draft RTS provide clarity on how the price differential is settled between the counterparties. It may be that this is deliberately avoided in light of Article 7(6) of the Level 1. This lack of clarity needs to be borne in mind when considering all three options, and it cannot be assumed that the payments of cash differentials are necessarily consistent with the standard buy-in model.

In the event that the buy-in is not successfully executed, Option 1 provides for a cash compensation remedy. Again, this is at the trading counterparty level, so similar to *Figure 10* in Part 1. However, the draft RTS only provide for cash compensation to be paid by the failing (selling) counterparty to the receiving (purchasing) counterparty, which would be consistent with the reference price being higher than the original transaction price (see *Figure 10*), but not where the reference price is lower than the original transaction price (see *Figure 11*). The RTS does not exclude the latter option, but again, without clarity, it is difficult to make assumptions about the intent of the RTS. Furthermore, the CP and draft RTS provide no details on how the reference price for the cash compensation is established.

Figure 15: when the buy-in under CSDR Option 1 fails: cash compensation



<u>Other considerations for Option 1</u>

The two main implementation issues with Option 1, from a *mandatory* perspective, are:

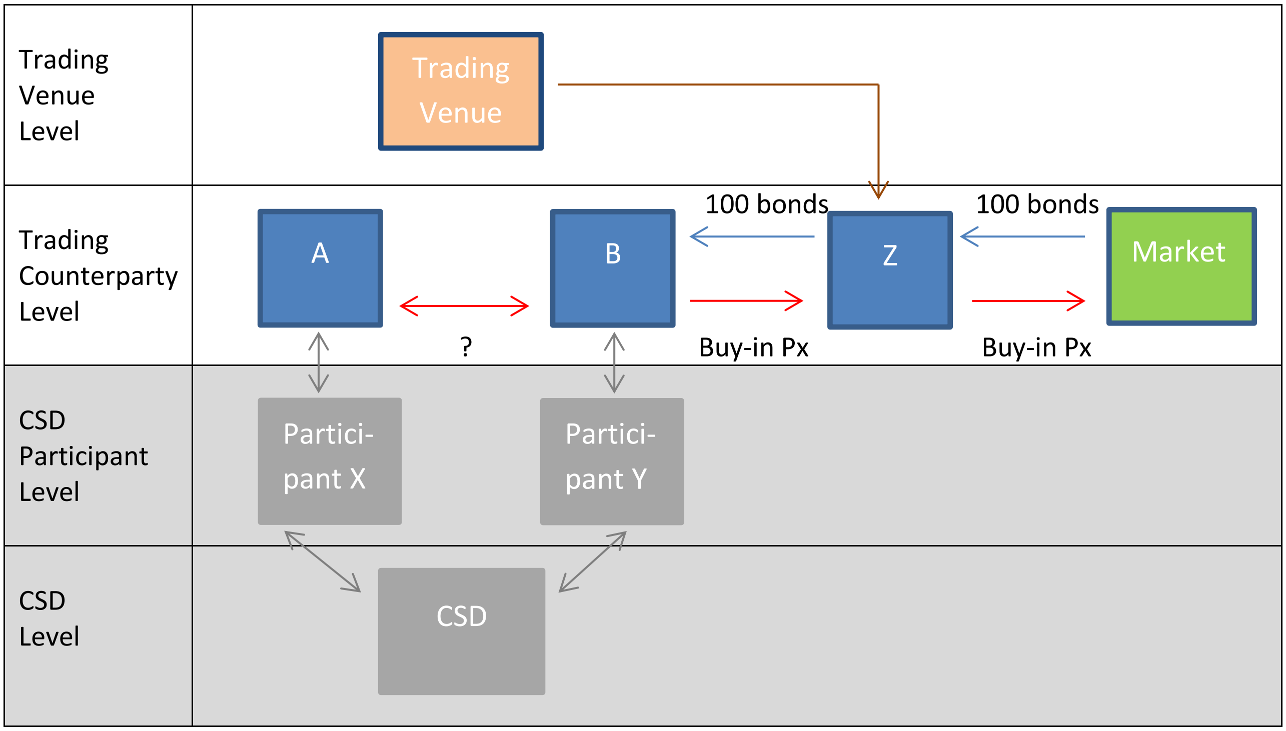
(i) How to ensure that the receiving (purchasing) counterparty initiates the buy-in process?
(ii) How to enforce the buy-in against the failing selling counterparty where the contractual agreements of the transaction do not allow for this?

For transactions executed on a trading venue, the draft RTS attempt to address the first issue by providing that where the receiving counterparty does not initiate the buy-in, the trading venue will.

Draft RTS: Article 14(1)
For transactions executed on a trading venue and not cleared by a CCP, the rules of a trading venue shall provide that the receiving party shall appoint a buy-in agent. The trading venue shall appoint a buy-in agent where the receiving party does not do so within two business days following the elapse of the extension period.

Neither the CP nor the RTS explain how the trading venue will know that the buy-in needs to take place. As has been discussed widely in pervious consultations, in many markets (in particular fixed income) the trading venue is not in a position to know whether any transaction it processes has settled or failed, or that a buy-in can or should be initiated. Overlooking this obvious challenge for now, *Figure 16* illustrates the proposed solution to the receiving counterparty not initiating the buy-in.

Figure 16: CSDR buy-ins when the receiving counterparty does not initiate the buy-in



Regarding enforceability of a buy-in against a failing selling counterparty, as with existing buy-in remedies, this is an issue where the terms of the transaction or the legal agreement between the counterparties does not provide for buy-ins. This is identified in the CP as the key challenge in implementing a *trading level* mandatory buy-in regime, and so Options 2 and 3 in the CP seek to address this.

<u>Option 2 – Trading level with fall-back option execution</u>

Similar to Option 1, the onus for initiating the buy-in falls on the receiving (purchasing) counterparty. However, in the case where the trading counterparty does not perform the buy-in, the failing participant will pay cash compensation to the receiving participant. Thus the buy-in process, in the first instance, is the same as that illustrated in *Figure 14*, but in the second instance resembles a cash compensation remedy (similar to *Figure 15*), but at the participant level. This is illustrated in *Figures 17a and 17b.*

Figure 17a: a buy-in under CSDR Option 2

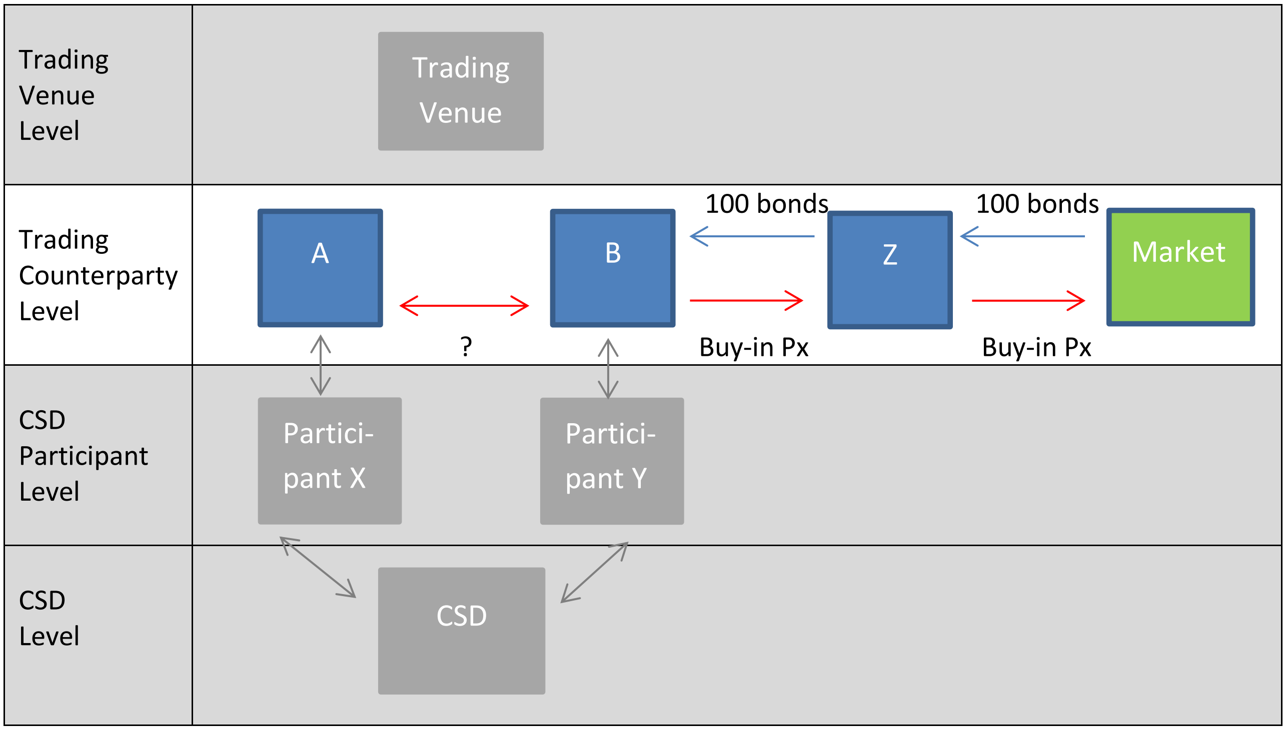
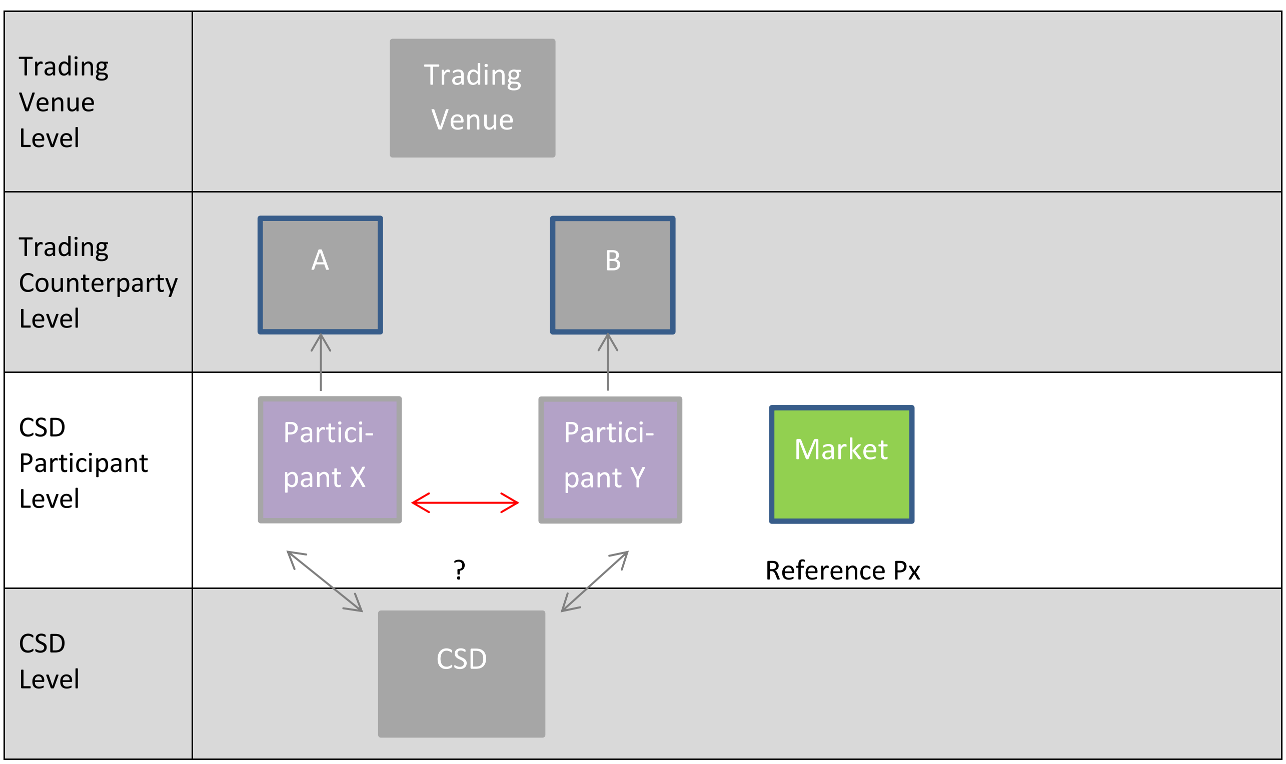


Figure 17b: cash compensation under CSDR Option 2 where the trading counterparty does not initiate the buy-in

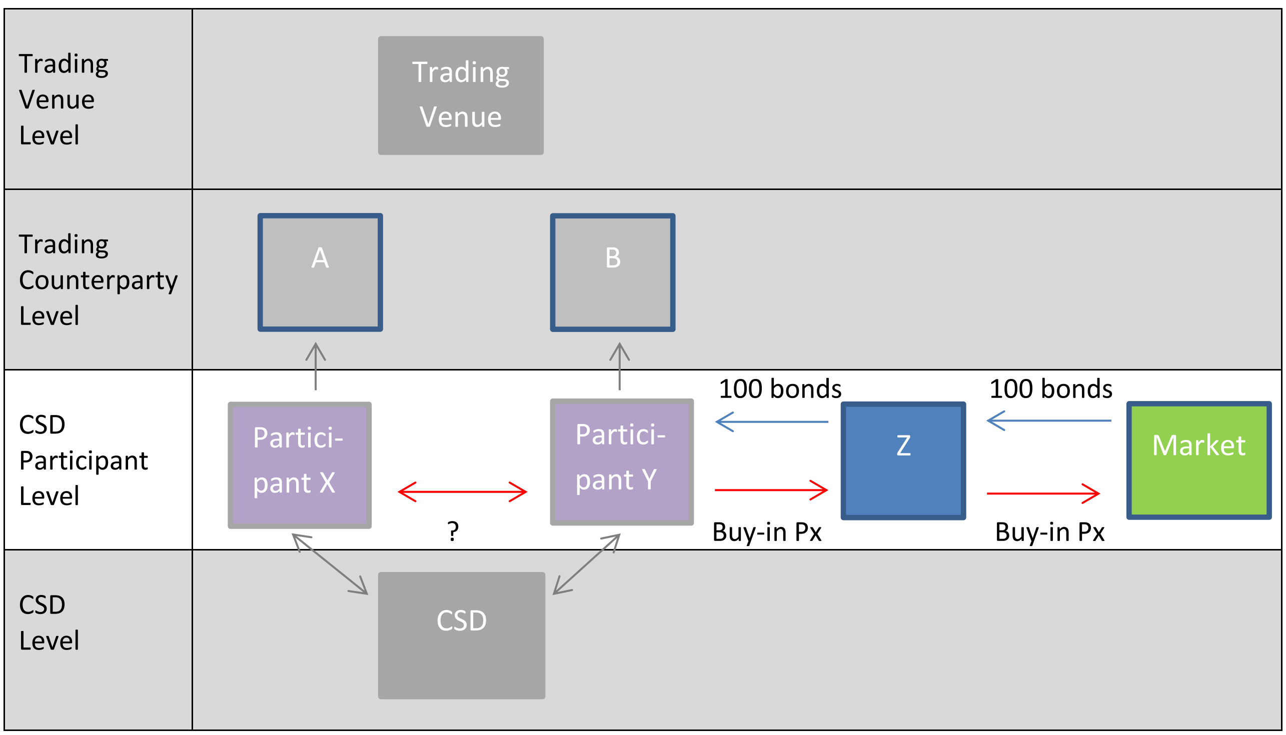


Where the buy-in under Option 2 is initiated by the receiving (purchasing) counterparty, but cannot be executed, then the same cash compensation remedy is available at the trading counterparty level as in Option 1. Again, it is not clear how the reference price for cash compensation is agreed, or whether the price differential is intended to flow in both directions depending on whether the reference price is lower or higher than the original transaction price.

Option 3 – CSD participant level execution

Under Option 3, the buy-in takes place at the participant level, with the receiving (participant) initiating the buy-in. This is illustrated in *Figure 18*.

Figure 18: a buy-in under CSDR Option 3



In the event that the buy-in cannot be executed, then a cash compensation remedy is available at the participant level (the same as *Figure 17b*).

The primary difference with Option 3 compared to a standard buy-in is that the buy-in process may not involve the trading counterparties to the failing transaction.

The challenges of implementing CSDR Mandatory Buy-ins: a summary box

Level 1

- The 'buy-in' is not defined, nor is the purpose of the buy-in explained.
- The buy-in process seems to apply to CSD participants, which may not be the same as the trading counterparties to the transaction.
- The provision for the payment of the price differential between the buy-in price and the original transaction price is reversed, compared to standard buy-in processes.

The Level 2 Options

- The RTS do not specify how the price differential between the buy-in price and the original transaction price should flow.
- The trading counterparties to the original transaction may not be involved in the buy-in or cash compensation process (Options 2 and 3).
- The buy-in process could require the involvement of a trading venue, which may not have sufficient information to initiate the buy-in process.
- The RTS do not specify how the reference price for cash compensation is to be determined.
- Where the buy-in process only involves the trading counterparties to the original transaction (Option 1), the buy-in, in some circumstances, may not be enforceable.