International
Capital
Market
Association

ICMA CSDR-Settlement Discipline Working Group

Proposal for a pass-on mechanism under the CSDR framework

Meeting note from January 22 2019

Participating firms: *BAML, Barclays, BGC Partners, Citi, Credit Suisse, Danske Bank, Euroclear, Goldman Sachs, HSBC, Intesa San Paolo, LCH, LSEG, Nomura, Schroders, SocGen, Standard Chartered*
Participating associations: *AFME, EDMA Europe, The IA*

Meeting objectives

The meeting was intended to discuss the current ICMA proposal for a pass-on mechanism that could work under the buy-in framework for CSDR. Following developments to the proposal after it was discussed by the Group in November 2018, the Group was specifically asked to focus on:

- *Is there broad support for the proposal concept?*
- *Does it address all the key considerations?*
- *How could it be enhanced?*
- *What aspects (if any) may potentially conflict with the regulation?*
- *What should be the next steps?*

The goal is to finalize a workable proposal, with broad industry support, that can be taken to ESMA for their consideration.

Discussion

What constitutes a transaction chain?

It was suggested that a starting point for open discussion between the Group should be to agree what defines a transaction chain: is it a chain of linked transactions with the same intended settlement date (ISD), or is it a chain of linked transactions with potentially different ISDs; but perhaps within a range of dates? The initial view of the Group (and that of previous discussions) is that transaction chains should not be limited to transactions with the same ISD.

One member asked whether it was possible to obtain any statistics on average chain lengths, or how common it was for chains to have different ISDs. The Group felt that it was extremely difficult to obtain such empirical data, given that there is not overall sight of chains, and firms are only able to view their own particular situations.

ICMA's experience from developing and applying the ICMA Buy-in Rules is that transaction chains for fixed income rarely have the same ISD, and that one of the benefits of the pass-on mechanism (as exists today) is that it allows for different ISDs, so avoiding multiple buy-ins. It was noted, however, that in the CSDR context this would effectively have the dynamic of extending the 'extension period' beyond the prescribed timeline (7 or 4 days), which may not be permissible under a strict application of the regulation.

However, some members felt that the critical point was that the key benefit of an 'extendable' pass-on mechanism was that it reduced the number of buy-ins, potentially significantly, that are required to achieve the regulatory objective of ensuring settlement. In other words, the proposal was consistent with the objectives of the regulation, and that this needed to be emphasized.

A possible alternative?

It was suggested that there may be different approaches worth exploring, such as executing the buy-in at the start of the transaction chain, and then 'halting' any buy-ins along the chain (referencing the example used in Draft v3 of the proposal, this would mean B starting the buy-in process, against, A, with C, D, and E holding-off from initiating buy-ins). The key to this working would be to ensure that the relevant information is passed along the chain to ensure that parties know that they do not need to initiate a buy-in process.

Members felt that this would be difficult in practice, mainly due to the complexity of ensuring that the right information was passed along the chain, as well as to the relevant parties in the settlement chain (including the CSDs). It was suggested that this be explored and, similar to the current proposal, the pros and cons of the approach be highlighted. Another suggestion was that this could be included in the proposal as a 'second best' option.

The question was raised as to whether there could be any way of obtaining an overall perspective of a transaction chain in the non-cleared space. It was felt that this was challenging, even for CSDs (assuming the chain is limited to a single CSD), which again is one of the advantages of the existing ICMA pass-on mechanism and the current proposal.

The idea was floated of an industry body, such as ICMA or AFME, monitoring information flows in pass-on chains to ensure that they worked efficiently. This was broadly dismissed as unworkable, and it was pointed out that the regulation attempts to ensure overall compliance with the buy-in process by means of contractual arrangements between all parties in the settlement chain.

What if the chain is reversed?

It was noted that the pass-on proposal is based on a transaction chain whereby parties in the chain purchase securities for a particular ISD then sell them on for a later ISD. It does not address the case where parties may sell securities (short) for a particular ISD and buy them for a later ISD. In this case the buy-in process would have to be triggered at the start of the chain, rather than at the end. It was not clear how a pass-on mechanism would work in this scenario, since subsequent fails in the chain would not have reached their extension period.

It was agreed that this scenario should be outlined as a consideration in the proposal. While it would still be possible to apply contractual pass-ons (since these can be issued on ISD+1), it would be difficult to extend the initial buy-in beyond ISD+4/7. This similar scenario exists today, however, it is less of an issue since the initial buy-in is discretionary, rather than mandated. One member pointed out that this highlights the main problem with the mandatory buy-in regime in that it disincentivizes short-selling and could lead to a 'long only' market for some instruments.

Extending the extension period

One participant questioned whether ESMA would be able to accept the proposal since it effectively provided for an extension of the extension period with each new ISD in the chain. While this made sense from a market efficiency perspective, the regulators may feel confined by the Level 1 and Level 2 text, which is quite specific about extension periods.

Another member raised the issue of cash penalties, and the fact that in the case of the extension period being extended due to a chain, the original failing counterparty would still be incurring penalties. The Group felt that this helped to support the case for the proposal. Despite the potential effective extension of the extension period, the ultimate failing party would still be subject to settlement discipline measures and would still be incentivized to deliver at the earliest possible opportunity.

It was agreed that this point needed to be included in the proposal.

Scope of the pass-on proposal

It was pointed out that the examples used in the proposal are based on transactions in bonds, and there was a concern that this could be interpreted by the authorities as applying purely to fixed income. It was agreed that it should be made clearer that this is intended to apply to transaction chains in non-cleared securities, including equities, and was not specific to fixed income.

Operational information flows

The point was made that for any pass-on mechanism to work successfully, it would be important to ensure robust information flows between all parties in the settlement chain, including relevant custodians. It was agreed that there would be operational considerations related to this, but that this level of detail was beyond the scope of the proposal.

Pass-on timings

A member raised the question of appropriate timing for pass-ons, given the potential length of chains and the fact that parties may be in different time zones. ICMA explained that this consideration exists in current pass-on provisions, and this is why the ICMA Buy-in Rules provide for a minimum four business days' notice for the original buy-in. While the Rules require that pass-ons are served 'immediately', there was recognition that it could still take some time for a pass-on to reach the final party in the chain.

It was agreed that a similar consideration would need to be given for any pass-on mechanism post-CSDR, and that the final pass-on should still allow for at least a standard settlement cycle.

Wrapping up and next steps

It was agreed that ICMA would update the proposal draft based on the points discussed and suggested in the meeting, including a summary of the pros and cons of different pass-on mechanisms (including no pass-on facility). The updated proposal would then be circulated among the Group (soon) for further comments and refinement.

Ends

Andy Hill, January 2019