ESMA Consultation on Draft Regulatory Technical Standard on the CSD regulation

AMAFI's contribution

Association française des marchés financiers (AMAFI) is the trade organisation working at national, European and international levels to represent financial market participants in France. It acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI's members operate for their own account or for clients in different segments, particularly organised and over-the-counter markets for equities, fixed-income products and derivatives, including commodities. Nearly one-third of members are subsidiaries or branches of non-French institutions

Before responding to the specific questions of ESMA's consultation document, AMAFI would like to point out the following general comments.

I. – GENERAL COMMENTS

AMAFI would like to thank ESMA for this consultation on the Regulatory Technical Standards on the CSD Regulation focusing on the buy-in process. Indeed, as it is recognised by ESMA in this Consultation Paper (CP) many respondents to the previous CP, including AMAFI, called for changing the approach on the buy-in process with a clear identification on who is responsible for the buy-in case of OTC transactions.

We fully appreciate that ESMA, on this topic, takes into account market participants concerns and proposals.

AMAFI has always considered that the efficiency of the settlement process is a key element for public's confidence in the financial markets. A mandatory buy-in process for OTC transactions contributes to settlement efficiency.

In a nutshell, AMAFI really believes that only Option 1 is practicable and should be put in place. This option, together with some safeguards and pre-requisites that are detailed below, would fit the CSDR Level 1 provisions while being workable by markets actors at a lower cost.

Moreover, if we fully agree with the regulatory objectives to put in place a European market discipline regime, including buy-in obligations for OTC transactions, it must be reminded, that at least in France, but also in most European countries, the settlement of market transactions does not raise any particular issues for market participants.

For instance, according to figures from Euroclear France, the settlement fails rate represent between 1.13% (in cash) and 1.23% (in number of settlement instructions). In this context, it would be counterproductive to set up a very complicated regime (options 2 and 3).

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AMAFI considers that it is necessary to define some terms in order to have a common understanding of what is at stake on the buy-in process :

- **A transaction** is a deal between a selling party and a buying party which engages the seller to deliver securities and the buyer to pay them. In option 1 and in option 2 the buy-in applies to transactions (in fact to the seller since the buy-in only takes place in case of a lack of securities). The conclusion of a transaction will lead to two client instructions sent by each trading party to its custodian (or first intermediary in the custody chain).

- **An OTC transaction** is a transaction "not executed on a trading venue nor cleared by a CCP" as defined by ESMA in its RTS (for example in article 14(3)).

- **A client instruction** is strictly an instruction to receive / deliver securities, most of the time against cash, sent by the trading entity to the CSD's participant along a custody chain. The client instruction reflects the terms of the transaction. However, unless the counterparty is characterised as a CCP, the client instruction doesn't indicate if the underlying transaction is an OTC one or not. This will be particularly true for traded but not cleared transactions since participants to the settlement are custodians (per definition the trading venue cannot interpose itself so its role in the process ends as soon the transaction is concluded).

- **Settlement instructions** are between a delivering participant and a receiving participant. The participants are jointly engaged to deliver / receive as of their settlement instructions have been matched together by the SSS operated by the CSD. A settlement instruction may be identical to a client instruction or be an aggregation / netting of several clients' instructions. In option 3 the buy-in applies in fact to settlement instructions and not transactions since it requires a participant to trigger a buy-in process against another one. As said above, ESMA should be aware that at the settlement level settlement instructions are divided in two groups: those where one of the two participants is a CCP and all the others, should the transaction at the origin be an OTC transaction or an on-exchange transaction.

- **The trading chain** puts together all the entities involved by the trading. This term should be used in point 13(b) of ESMA's Consultation Paper rather than "settlement chain".

- **The custody chain** goes from the trading level to the settlement level maybe through several intermediaries (global custodian, local custodian, investor CSD,…). This term should be used in point 10, 11 14(a), 14(d), 18 rather than "settlement chain".

- **The settlement chain** links all the participants at the settlement level.

II. – RESPONSES TO THE ESMA SPECIFIC QUESTIONS

QUESTION 1:

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.

We largely believe that option 1, i.e. buy-in at the trading party level will be the most efficient and workable solution. Indeed option 2 holds both weaknesses of option 1 and of option 3 without saying that such a mixed solution will lead to uncertainties on who should really be responsible for the buy-in even if for the fall back principle the participant is in fact required to pay the cash compensation **as if** the buy-in failed (see our answer to Q4)

Option 3 is not in line with our firm belief that in order to match its goal it should be the real defaulting party i.e. the trading party that should be bought in. On top of that, it is crucial to note that this option will oblige the CSDs to bear risks not in line with the requirements.

Triggering the buy-in at the trading party level sounds the sole option possible on OTC transactions:

- First, it will make aware of his responsibilities the real defaulter to a transaction;
- Second, it will also allow the real receiving party to ask/receive the missing securities or equivalent cash compensation;
- Third, it will ease the reconciliation process as the trading parties would perfectly know who their failing counterparties are;
- Finally, trading level is the place where the distinction can be made between OTC transactions and transactions executed on a Trading Venue or cleared by a CCP (even the sole place for traded but not cleared transactions since a Trading Venue just do not exist per its definition beyond the trading level).

However we do recognise option 1 requires some together some safeguards and pre-requisites that are mentioned below.

- <u>Buy-in agents must be appointed well in advance</u>

  It is unrealistic to believe that following a fail, a receiving party is in position to easily find a buy-in agent. We anticipate that some entities will offer buy-in agent services and that market entities will sign agreements with at least one buy-in agents.

- <u>This buy-in agent must be rightly controlled to prevent any bad behavior</u>

  Only investment firms should have the right to provide buy-in agent services. Moreover the buy-in agent must have a structure in place to be able to directly or indirectly receive in a dedicated and protected account the securities that the failing party is allowed to transmit or the ones the buy-in agent has bought in.

- <u>A clear communication and information flow should be set up between the buy-in agent and the relevant CSD</u>

In effect, this CSD needs to be informed about the settlement of a pending transaction resulting from a buy-in process. An information flow to the National Competent Authority could be required.

QUESTION 2:

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.

There is no doubt that the trading party has all the information required to apply the buy-in. In a bilateral OTC transaction the trading party is in fact the sole entity which has all the information required to apply the buy-in process : date of the transaction, quantity, amount…. , and above all the name of the defaulting seller.

Envisaging that the fail is not due to a trading party but to an intermediary within the chain, is very rare and will correspond to issues regulations have addressed through specific requirements (ban of use of clients' assets for its own account, mandatory segregation between own account and client account, …).

QUESTION 3:

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.

We do not anticipate a need of collateralisation if option 1 is chosen. The conditions of the buy-in process will be included in the agreement between the trading party and the buy-in agent.

However, if option 2 were to be chosen, it means that there is a fall back solution involving the cash compensation to be paid by the CSD participant. In that case, it would also imply that the CSD participant will require his client collateral to guarantee the pending trades (the ones that have not settled in theoretical settlement date).This collateralisation cost could be important depending upon the size of the transaction.

QUESTION 4:

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.

Indeed option 2 owes several drawbacks that will break the balance that could be obtained in option 1:

- First it will blur the responsibility and miss the goal to avoid bad behaviors

ESMA considers that the fall back is an incentive for participants (point 19); we believe above all that it will be a disincentive for real defaulters (trading entities). Indeed, a trading entity may be inclined to let the CSD participant pay moreover if the latter is not directly link to the former. In case of a custody chain with several intermediaries, it is likely that the cash compensation may not reach the trading entity.

- Buy-in and fall back are not the same process

The buy-in (at the trading level) includes the analysis of all the transactions in order to determine the real defaulter and **thus avoid multiple buy-ins** (point 13b).

The original purpose of cash compensation is to put an end to an outstanding settlement when the buy-in attempt failed to find the whole missing quantity. This means that at this stage we already know who the defaulter is and who the one who suffered from the non-delivery is.

Fall back mixes both concepts in a way that is not workable. Indeed, the idea of the fall back is to ask the failing participant to pay a cash compensation to the receiving participant if the buy-in has not be performed at the trading level. But if the buy-in has not be performed it is likely that no analysis has been made so how can the CSD ask the failing participant to pay if it doesn't know who the failing trading party is and thus the failing participant representing the defaulter?

Does the fall back include also the requirement for a prior analysis? If yes, this will mean operational costs for the CSD as well as for any participants/intermediaries involved in the custody chain. If not, the fall back risks to apply to all failing settlements that are beyond the extension period and that cannot be linked to any current buy-in process.
Moreover, as written above, settlement instructions may not be identical to client instructions.

- Relation between the participant and its clients

It should be kept in mind that participants act only when being instructed by their clients. But cash compensation goes with the cancellation of the instruction so that the participant will need to get the agreement of its client which in turn will need to ask its clients.

- Need for collateralisation

Despite ESMA's explanation, since a participant may be exposed to financial risk due to the absence of a buy-in performed at the trading level to which, again, the participant may not be directly linked, the participant will at the end ask for collateral.

Due to the fact that the failing party may default between the launch of the buy-in and the reimbursement to the buy-in agent of all the amounts, we are of the opinion that the buy-in agent will ask itself for collateral in order to cover its counterparty risk. In this case the participant will simply pass on the requirement to its client and so on until the trading entity.

Should the buy-in agent, even if unlikely, do not ask for any collateral, the requirement for collateral will be done by the CSD participant and will apply to all settlements still outstanding after the ISD and until the actual settlement. As explained in the answer to the previous consultation, this will modify the relationship model between CSD participants and their clients and lead to additional costs for the latter.