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**Date: 06/05/2015**

Dear Sirs

**RE: Consultation Paper ESMA/2015/1065 - Regulatory Technical Standards on the CSD Regulation; The Operation of the Buy-in Process**

The Investment Association represents the UK asset management industry. Our members manage over £5 trillion in the UK of assets on behalf of UK, European and international clients, both retail and institutional. Collectively, our members make up the second-largest asset management industry in the world.

We are grateful for the opportunity to comment on ESMA's latest proposals concerning the operation of the buy-in regime under the CSDR Regulation (CSDR).

Our members undertake discretionary portfolio management for a wide range of institutional and private clients, in the context of which they execute trades for their clients' portfolios mainly with broker dealers off-exchange. As such, they would be "trading parties" in the context of this latest consultation.

Annex 1 contains our responses to the specific consultation questions. In conclusion, we recommend strongly that option 3 be pursued - requiring the receiving participant to arrange the buy-in would:

- ensure that the buy-in could be initiated at the earliest possible opportunity, thus minimising further market risk to the failing participant;
- avoid lengthy communication chains and the associated additional potential points of failure in the process;
- avoid potential systems changes for investment managers who have invested in straight-through processing between their trade processing and client/fund accounting systems;
- avoid the need to re-paper agreements between portfolio management clients and their respective investment managers and custodians.

*Please note, however, that considerable concern remains across all sectors of the industry regarding the negative impact a mandatory buy-in regime will have on market liquidity and costs, which will be passed on to investors. Without prejudice to these concerns, our response to this consultation is based on the premise that buy-ins will be mandatory, as dictated currently by CSDR. As such, our*

*recommendation is driven by the operational concerns of our members, which are common to options 1 and 2.*



A separate concern, whoever were responsible for arranging the buy-in, is that when the provisions of CSDR itself and the proposed RTS (weaving together the texts from the previous consultation (ESMA/2014/1563) and the latest proposals) are combined, it is not clear how the settlements would flow and therefore how the regime would work. As members of this Association are most interested in the case where the failed transaction was neither executed on a trading venue nor cleared through a CCP, we use this case to illustrate in [Annex 2](#) what we believe is significant problem.

We would welcome the opportunity to explore further with you the scenarios described in Annex 2 as well as our responses to the consultation questions.

Yours faithfully

**David Broadway**  
**Investment Operations Lead**

## ANNEX 1 - INVESTMENT ASSOCIATION TO THE CONSULTATION QUESTIONS



**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.**

We share ESMA's concerns regarding enforceability and consistency with the Level 1 text of CSDR. The difficulties of the trading party being in a different Member State to the CSD and its NCA may not be insurmountable, but the mechanism would be more complex (requiring co-operation and among NCAs and clear empowerment of the trading party's NCA to take enforcement action) and would not address the situation of a third country trading party.

**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.**

We agree that the trading party would be well placed to appoint an appropriate buy-in being likely to know where best to source the liquidity. However, it is also furthest away from the CSD where the settlement fails.

Sell-side firms will either undertake their own custody or appoint a third party custodian on commercial terms. In contrast, investment managers will deal with multiple, sometimes many, custodians that are appointed by their clients. They do not have direct commercial relationships with those custodians or their local agents that are the actual CSD participants.

An obligation on the trading party would require a chain of communications though multiple levels of custody to ensure that the investment manager at the one end was able to monitor the settlement of each trade at the other. This would include within the firm itself between the back office function that faces the clients' custodians, and the front office, which would need to organise any buy-in. In addition, the back office may be outsourced to a third party service provider. In that situation the steps might be as follows:

- (i) Local CSD participant identifies the failed settlement
- (ii) CSD participant reports the fail to its client/parent global custodian for which it is agent
- (iii) Global custodian validates the report and forwards it to the investment manager's back office outsourcing provider, from which it received the original settlement instruction
- (iv) Outsourcing provider validates the report and advises its contact team at the investment manager
- (v) Contact team alerts the trading desk to arrange the buy-in

Note that, the outsourcing provider at step (iii) potentially would need to consume failed trade communications from multiple custodians in different formats.

We believe such a chain would be operationally inefficient and at greater risk of procedural failure compared to a scenario in which the CSD participant arranged the buy-in. Moreover, it would extend the time between identification of the fail and execution of the buy-in, thus extending unnecessarily the failing party's exposure to market risk.

Added to the above, a further chain of communication would be required in the reverse direction to deliver the settlement instructions for the buy-in transaction to the local CSD participant. Moreover,

this is likely to require systems changes for some investment managers in order to issue the settlement instructions to the relevant custodian without impacting the accounting at client level. In order to generate a settlement instruction the order itself needs to be created in the system. For some firms currently, this order will result in a series of client accounting entries, which may impact tax calculations and, in the case of an investment fund, flow through to the calculation of the fund's own trading prices. Given that the intention of the buy-in is to fulfil the settlement of the original trade, systems that currently deliver such straight-through processing would need to be able to recognise a buy-in transaction as such rather than as a new or replacement trade and handle it accordingly.

Placing the buy-in obligation on the trading party would also require re-papering of clients' agreements with both their custodians and investment managers in order to bridge the contractual gap between them.

For the reasons given above, we do not support option 1.

**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.**

For the reasons discussed above, we do not support either of options 1 or 2, in which the trading party has the obligation to arrange the buy-in.

Our understanding of option 2 is that the fall-back would be to the failing participant to pay cash compensation in the event that the receiving trading party failed to arrange the buy-in, as it would anyway in accordance CSDR Article 7(7) if the buy-in failed or were not possible under any of the suggested options.

It seems to us therefore that the only aspect addressed by option 2 that might not already be covered by option 1 would be where the receiving trading party failed to meet its obligation to arrange the buy-in, and this were deemed to be neither a failed buy-in or otherwise a case of the buy-in not being possible, as described in CSDR Article 7(7). As such, we see the potential demands of delivering participants to be collateralised by their clients under this option against their exposure in the event of default on the part of the client as marginal compared to any other alternative.

**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.**

In view of our responses to the previous questions we do not comment further on the enforceability of the buy-in under option 2 or its merits or otherwise compared with option 1.

We would, however, note that Article 15 of the original proposed RTS, which we assume ESMA intends to retain, determines that the buy-in agent would determine the reference price for calculating the compensation in the event that buy-in is not possible. The latest proposals do not address how the compensation should be calculated in the event of a fall back, given that no buy-in agent might have been appointed.

**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 costs.**

We are not in a position to provide detail concerning the costs that would be incurred by CSD participants. However, although we note ESMA's concerns regarding the potential costs of posting collateral, as we have indicated in our response to question 3, we believe the liability of delivering participants for adverse price movements in the event of settlement failure is determined by the Level 1 text, as is their liability for the costs of executing a buy-in.

On a separate matter, we suggest that regulatory changes may be required in order to ensure that custodians (as the CSD participants) have the appropriate regulatory permissions to arrange deals for the purposes of appointing and instructing the buy-in agent. This may not be the case today in all instances.



## ANNEX 2 - POSSIBLE SETTLEMENT SCENARIOS FOR BUY-IN TRANSACTIONS



ESMA does not state in the consultation paper how the latest text is intended to sit within the draft RTS proposed in the earlier consultation, but it seems to us that the latest proposed articles 12-17 would be inserted after Article 11 (per 2014/1563), some of which would also be deleted. The absence of any guidance on this in the latest consultation makes it difficult to visualise clearly how the execution, settlement and compensation processes would work together.

### CSDR and RTS provisions

The latest Article 12(2)(d) indicates that the completion of the buy-in would result in delivery of the bought-in securities by the buy-in agent to the receiving trading party (options 1 and 2) or receiving participant (option 3). In addition Article 15(3) indicates that where the buy-in is successful, the settlement instruction for the original transaction shall be cancelled.

In the light of this, it seems the buy-in would be settled between the receiving party (used as a generic term for the purposes of this analysis) and the buy-in agent, although in practice the settlement would take place at the CSD and therefore between the accounts of the receiving participant and the buy-in agent or their custodian.

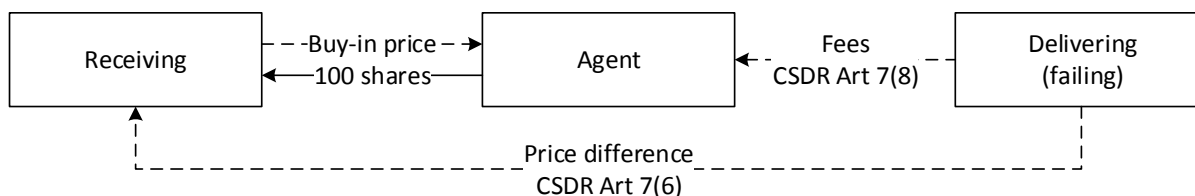
CSDR Article 7(6) states that the failing participant shall, within two business days of settlement of the buy-in, pay to the receiving participant any difference between the original trade price and the buy-in price, where the original price is the higher. Therefore, having settled the buy-in with the buy-in agent as above, the receiving participant would receive payment of the price difference separately from the failing participant per Article 7(6).

Finally, CSDR Article 7(8) states that the failing participant shall reimburse the buy-in agent for all amounts paid in relation to the buy-in including fees.

### Potential scenarios

Given an original trade to purchase 100 shares against payment of 98.50, we see three potential scenarios for the buy-in, which either are not provided for clearly (or at all) in the proposed RTS or appear to deliver results that we do not believe are intended, as follows:

(a) *Buy-in settled (cash and shares) between buy-in agent and receiving party; delivering (failing) party pays buy-in fees and price difference:*



In this scenario, the operation of CSDR Article 7(6) this means that where the buy-in price were **lower**, the receiving party would both pay less for the securities and receive the difference again as a cash payment. Conversely, the failing party would suffer twice - though a lower mark to market value of their remaining position and having made the cash payment to the receiving participant.

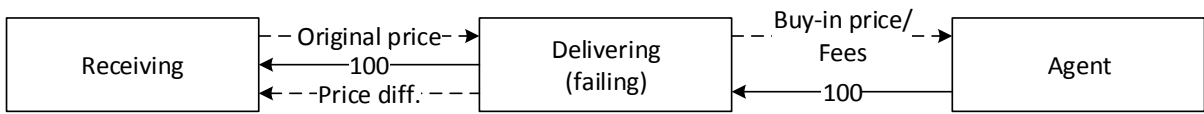
For example, if the buy-in price were 98.00, the receiving party would pay this lower price to the buy-in agent and receive 0.50 from the failing party.



Moreover, there is no reference in CSDR to compensation of the receiving party in the event of a successful buy-in should the buy-in price be **higher**. If that were to happen, the receiving party would have to settle with the buy-in agent at the higher price (eg. 99.00) with no compensation receivable under CSDR Article 7(6). The failing party would benefit from the higher mark to market value of its position so would not be incentivised to settle the original trade, contrary to the objectives of CSDR Article 6(4).

We do not believe it can be the intention to deliver a double benefit to the receiving party in the event of a falling price, or for them to suffer should the price rise. It is also not clear that this scenario is consistent with CSDR Article 7(8), as the payment for the shares would pass to the buy-in agent from the receiving participant.

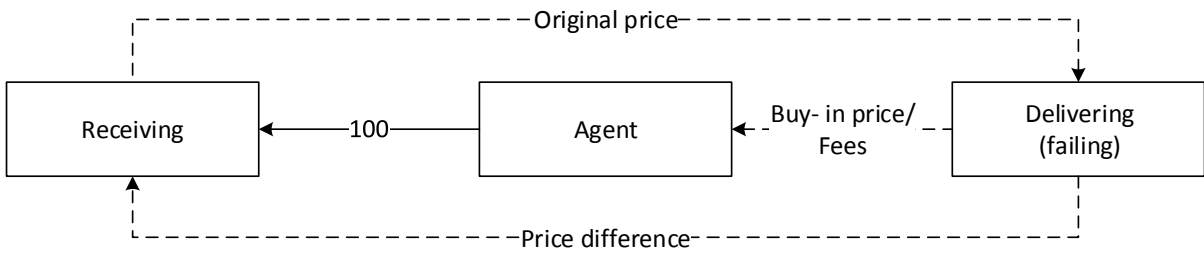
*(b) Buy-in settled (cash and shares) between buy-in agent and delivering (failing) party; separate settlement of the original trade between the delivering (failing) and receiving party:*



In this scenario, the receiving party would benefit from a lower buy-in price (eg. paying 98.50 and receiving 0.50 back), while the failing party would be left with its original position at a lower value, thus incentivising the failing party to settle the original trade. The receiving party would also be protected from a higher buy-in price as it would pay only the original price, while the failing party would be neutral given the higher mark to market value of its position. As such, the outcomes in each case would appear to be acceptable.

However, this scenario requires the bought-in shares to be delivered by the buy-in agent against payment to the failing party and then on to the receiving party against payment for the original trade, which seemingly is excluded by the latest proposed RTS Articles 12(2)(d) and 15(3). Notwithstanding this, it is more consistent with CSDR Article 7(8), as all payments associated with the buy-in are made by the failing party to the buy-in agent.

*(c) Cash settlement of the buy-in between the buy-in agent and delivering (failing) party; stock delivered directly to the receiving party:*



The outcomes of this scenario would be similar to (b) above, while the bought-in shares would be delivered by the buy-in agent to the receiving party in accordance with the latest proposed RTS Article 12(2)(d). It is also more consistent with CSDR Article 7(8) in that all amounts associated with the buy-in would be payable by the failing party to the buy-in agent.

However, the latest proposed RTS Article 15(3) suggests that the original settlement instructions should be cancelled, without making specific provision anywhere for any payment to be made by the receiving party.

In the light of the above, it seems to us that the last scenario would be the one that best accommodates CSDR Article 7(6) (compensation in the event of a successful buy-in) and delivers the desired outcomes. It is markedly different from the buy-in processes we understand operate today, however, and we believe the RTS would need to provide explicitly that the cash settlement of the original trade should be made against the delivery of the shares by the buy-in agent to the receiving party.

### Summary and conclusion

In considering our response with members, we have had to make various assumptions as to the possible intended communication and process flows due to a lack of clarity in the proposals and how they fit with CSDR and the remainder of the RTS. This has led to uncertainty and concern regarding:

- (a) the information flows between the various parties concerning the identification of the buy-in requirement, notification of its execution and who faces who with regard to its settlement;
- (b) which parties lead what - the consultation paper in particular for the most part refers simply to the trading party or participant without clarity as to whether they are talking about the failing or receiving side; and
- (c) how the cash would flow from end-to-end.

Although scenario (c) would appear to be the closest fit with the CSDR and the RTS as currently written, we have doubts that it is what was intended, requiring either a free payment by the failing party to the buy-in agent, against which it would then deliver the securities to the receiving party or what suspect would be a new "tripartite" delivery versus payment process for CSDs involving all three parties.

Scenario (a) would involve the simplest settlement flows and largely mirror processes that exist today - we believe this should be the process in practice. As we have noted above, however, the requirement in CSDR Article 7(6), as written currently, would produce a somewhat bizarre outcome if the receiving party were to obtain the bought-in shares at a lower price than the original trade and also received a cash payment in respect of the price difference from the failing party. We believe the outcome of a buy-in should be economically neutral for both parties compared to the settlement of the original trade, notwithstanding the settlement penalties imposed separately on the failing party.

Indeed, we believe the current text of Article 7(6) may have been cast in error and urge ESMA to engage with the European Commission in an effort to have it corrected so that the failing party would be required to make good to the receiving party in the event that the buy-in price is higher than the original trade, while the receiving party should return the difference to the failing party where the buy-in securities were acquired more cheaply.