

**EAPB comments on the Consultation on
Draft Regulatory Technical Standards on the CSD Regulation
(ESMA/2015/1065)**

6 August 2015

The European Association of Public Banks (EAPB) is pleased to provide the European Securities and Markets Authority hereafter with its comments on the proposed Consultation Paper on Draft Regulatory Technical Standards on the CSD Regulation (ESMA/2015/1065).

Introduction

The EAPB appreciates ESMA's analysis of the responses to its consultation launched in December 2014 and the changes to the regulatory technical standards for the buy-in process it is now considering as a result. We welcome ESMA's decision to solicit the views of market participants on these proposed changes despite the pressure to finalise the draft technical standards on schedule and we will do our utmost to reply to the questions raised as comprehensively as possible. Given the tight deadline for submitting comments, however, as well as the fact that many of the relevant specialists at our member banks are currently on vacation, we have only been able to analyse cost aspects to a limited extent.

We agree with ESMA's conclusion in para 37 of the consultation paper that transforming the settlement activity into a fully collateralised system would be contrary to the objective of the level 1 text. The same goes for the view in para 39 that increasing the costs of investing in securities would render EU securities markets less attractive and would, moreover, be contrary to the objectives of the CSD Regulation and of capital markets union. Moreover, we think that requirements for the buy-in must be integrated with the existing national civil law regulations and we would therefore like to point out that the Union has no competence to amend or extend the national civil laws by means of technical standards.

Aside from replying to questions 1 to 5, our comments therefore focus on analysing the proposed options 1 and 2 and on suggesting some improvements.

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.

- 1. How placing the responsibility for the buy-in on the trading party will ensure the buy-in requirements are effectively applied.**

Requirements for the buy-in reflect the legal consequences in the area of impairment of performance law and compensation law. Therefore, they should not disregard the civil law applicable on the markets. Option 1 considers the civil law regulations comprehensively and it also implements them in full, as regards the content, in compliance with the applicable compensation law.

However, at the moment, in many member states of the European Union there is no business custom for compulsory recovery (buy-in) of securities provided too late in the area of OTC-transactions. But this does not mean that there are no legal prerequisites to facilitate a buy-in. The parties to an OTC-transaction already accept a contractual obligation to provide specific securities on a specific settlement date. In our opinion we must also start with the existing legal relationships:

If the 'trading party' that has an obligation to provide securities does not provide them on time and in accordance with the contract ('failing party'), the receiving party is basically entitled to claim compensation for damages under civil law. Theoretically, the 'receiving party' already has an opportunity to procure the required securities by other means, in place of the securities from the 'failing party', and to charge the costs incurred to the 'failing party', as compensation for damages. The procedures envisaged in Art. 7 of the CSDR and the technical standards for Option 1 already correspond with the requirements of the civil law provisions on compensation for damages.

So there is already a contractual relationship in place between the trading parties affected by a settlement fail. This relationship is also essential for handling the buy-in processes. The intermediaries commissioned with the transaction settlement are only the so-called vicarious agents of the trading parties. Contractual relationships always exist between the intermediaries of the seller party and buyer party. In contrast, there is no direct contractual relationship between a failing CSD participant and the receiving party.

However, until now, it has been business practice to refrain from using the opportunity afforded by buy-ins that could actually be claimed through the courts. In other words: the trading parties operating on the market do (voluntarily) not exercise their right to compensation for damages in the form of the buy-in.

So far, our experience shows that the market has no requirement to establish the compulsory buy-in as a business custom, for example, from the point of view of improving the settlement efficiency, because alternative opportunities seem more flexible. Especially in the case of illiquid securities, the party entitled to a buy-in regularly refrains from the buy-in, because later settlement by the contractual party is commercially more advantageous than creating additional costs relating to a buy-in, the result of which is anyway uncertain. Additionally the introduction of a compulsory buy-in process decrease the settlement-efficiency, because many institutes have to set-up a process for the buy-in modalities, although they will not use it or benefit from it. However, a new market practice will undoubtedly develop due to the introduction of a mandatory buy-in as the EU harmonised compulsory measure for settlement fails.

This means that at the time when technical standards for Art. 7 of the CSDR on a buy-in become effective, the usual legal consequences in the case of settlement fails will also come into use in the area of OTC, with the trading parties adhering to these as a new market practice. Moreover, the receiving party as an affected party always has an interest to assert its rights if it is not forced to refrain from it by a contrary business custom.

As regards the actual implementation of the buy-in, it should be noted that the receiving party has an interest in obtaining securities and basically has no interest in cash payment. Contrary to their settlement agents, the trading parties can also judge best how and where the buy-in will be successful, based on their market overview and access to different markets.

We draw the conclusion that the new market practice would lead to an actual buy-in. The procedure regarding CCP-cleared transactions, where the relevant market practice already exists and is thus known to market participants as a basic principle, may serve as an example. Here, the CCP (as a trading party) initiates the buy-in with the clearing members (also in their role as trading parties) that do not settle on time and do not correct the issue, even after expiry of an additional settlement period. Art. 7 of the CSDR also clearly evoke this principle.

As soon as these regulations are also established as a new market practice for the area of OTC-transactions, the trading parties will take care of implementing the buy-in procedure in their own interests. It should be taken into account that the requirements for the buy-in are not about legal inspection measures that cannot be applied in third countries, but is about claiming compensation for damages that result from the contractual relationship between the trading parties, irrespective of the country in which the parties are based.

The big disadvantage of the obligation on the part of the CSD participants would be that they have no contractual relationship with the initial transaction. The liability of the CSD participants, as envisaged in the fall-back solution of Option 2, could therefore only be legally justified if the CSD participants had to accept guarantee or guarantor liability for someone (receiving party) with whom they would have no contractual relationship and whom they wouldn't even know!

However, the introduction of such a guarantee by means of technical standards cannot be based on any civil law principle. The European Commission also does not have the competence to amend or expand the civil law of the member states, or to extend compensation liability to uninvolved third parties by issuing technical standards in the form of a delegated regulation.

Although we understand the efforts of the ESMA to introduce a mechanism that would ensure the implementation of the buy-in also in third countries, the solution cannot involve shifting the liability for unwanted actions of contractual parties to uninvolved third parties. This would allow for serious risks in the otherwise little risky area of securities settlements. This would be quite contrary to the objective of the CSDR to ensure a secure and effective settlement.

With respect to the situation which the ESMA tries to avoid by means of Option 2, in other words that trading parties (based in third countries) simply do not implement the mandatory buy-in, it should be taken into account that these situations have not led to damages or additional costs for the system. In contrast, Option 2 does equally little to encourage the parties obliged to perform the buy-in to actually implement it. Moreover, the parties obliged to perform the buy-in (as the injured parties) would possibly suffer further damages, because unwanted cash compensation would be imposed on them instead of the expected securities. The CSD-participant of the seller could incur high costs and risks due to the payment of cash compensation.

Therefore, one should initially wait to see the effects of Option 1 (changes in market practice). Alternative actions could be taken later, when it actually transpires that the buy-in requirements are not observed outside the EU and thus, damages arise. However, such an assumption beforehand is equal to an allegation.

[A possible solution mechanism would be to introduce a central buy-in institution that automatically receives all buy-in orders for the benefit of the receiving party. This mechanism would ensure that the introduction of buy-in would not depend on the trading parties' taking action. Another advantage would be that many organisational difficulties could also be solved in connection with multiple buy-ins (e.g., transfer of buy-in notes and

all information related to it, disruption of the buy-in chain by a CCP, different transaction volumes within the trading chain, ensuring that the failing party delivers to the buy-in agent in a timely fashion).]

We know that Art. 7 Para. 8 of the CSDR¹ states that the "failing participant shall reimburse", however, we think that the ESMA should not only see itself forced by the wording of this provision to envisage such a regulation in the technical standards, but the ESMA's task is in fact to develop an "appropriate buy-in process" pursuant to Art. 7 Para. 15 (c) of the CSDR². The original proposal of the EU Commission initially envisaged, in Art. 7 Para. 3, that the failing participant should be subject to a buy-in, whereas the final text states that a buy-in process shall be initiated if a failing participant does not deliver.

Concluding from the aforesaid considerations, the Public Banks are of the opinion that for OTC Transactions, the buy-in can only be executed at the level of the trading parties and not at the level of the settlement activity. We therefore support Option 1 but want to point out that liability of the failing CSD participant must be strictly limited (e.g. insolvency proceedings against the failing trading Party).

2. Cost-benefit elements

Option 1 will not substantially increase the risk of Settlement Providers and can be implemented with reasonable costs. Furthermore collateralisation of Settlement instructions can be avoided. The most important factor of Option 1 is a well-established and reliable information flow from the CSD, via the CSD-participant, to failing trading party.

A new business practice ("from now on participants will not refrain from exercising a right to compensation for damages") shall be introduced by the coming into force of Art. 7 of the CSDR, in conjunction with the technical standards that implement this.

Implementation into the CSD framework of rules: a reference might be necessary in the CSD general framework of rules to state that a new business practice arises in the relevant national markets when the technical standards come into force.

¹ "The failing participant shall reimburse the entity that executes the buy-in for all amounts paid in accordance with paragraphs 3, 4 and 5, including any execution fees resulting from the buy-in. Such fees shall be clearly disclosed to the participants."

² "the details of operation of the appropriate buy-in process referred to in paragraphs 3 to 8, including appropriate time-frames to deliver the financial instrument following the buy-in process referred to in paragraph 3. Such time-frames shall be calibrated taking into account the asset type and liquidity of the financial instruments;"

The obligations for forwarding information related to the above (especially in connection with the buy-in: introduction, result, forwarding to other trading participants) (fully automatic) are connected with the changes to the systems of all market participants.

Further data:

- In a standard against-payment settlement, the involved trading parties do just exchange the SSI's for securities (if they are trading just OTC-bonds / equities). With the buy-in introduction it is necessary to hold available the SSI's for money transfer in case of cash-compensation.

Additional process:

- The mandatory buy-in-process requires new processes in the back offices (e.g. Reportings, search and define a buy-in-agent, etc). Although it is foreseeable, that buy-in will be very rarely become effective.
- Establish a legal opinion in every trading institute: Which counterparts are not affected from the ESMA-supervision and could therefore ignore the compulsory buy-in? Afterwards value the legal risk.

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.

The assumption that the trading party has all the information required to apply the buy-in is correct. The fail report contains all necessary information the receiving party needs.

Even for the assumed situation when a 'settlement agent' (one of the intermediaries within the chain) is responsible for the settlement fail, the trading parties receive all the necessary information in the 'fail report' to allow them to

- procure the required items within the 'extension period' ('failing party');
- authorise the buy-in after expiry of the 'extension period' ('receiving party').

The trading parties have and provide all information regarding the desired securities transaction themselves. Only the information that the settlement has not been made as agreed would be required in addition. This information shall be provided to the parties by the CSD via the relevant supply chain.

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.

We think that "the collateralisation costs attached to this option are significant". Indeed, a 'CSD-participant' can have a direct contractual relationship with the 'trading party', but this is not necessarily the case. Multiple 'intermediaries' ('chain') can exist between the 'participant' and the 'party'. Even for the situation that a direct contractual relationship exists, every non-payment risk of the 'party' would have to be assessed pursuant to bank supervisory authority risk identification principles and secured by the relevant collaterals and own capital. For this purpose, information about participants that are not known to the 'participant' and which are not part of a direct contractual relationship would have to be determined and also assessed.

Example: for the German OTC-market it means that the equivalent of

EUR 27,958,528,500,000.00

(in words: twenty seven trillion, nine hundred and fifty eight billion, five hundred and twenty eight million, five hundred thousand)

would have to be considered for collateral purposes with the year 2014 taken as reference.

The actual 'collateralisation costs' would be measured according to how creditworthiness and risk assessment plus own capital securitisation turn out.

These figures result from the volumes settled via the German CSD, Clearstream Banking AG Frankfurt, in the year 2014 for the OTC area. Accordingly, a total of 82.68 million transactions were settled for the German market³, with a total value of EUR 79.882 trillion. The proportion of OTC transactions here was 35%.

Even if we follow the opinion of the ESMA that an actual 'fail', with the failing participant actually being made to pay the cash compensation is relatively rare, 100% of all settlement transactions must however be involved in the risk assessment. Because each settlement instruction can fail and the trading party could remain inactive in the case of each resulting buy-in.

³ <http://www.clearstream.com/clearstream-en/newsroom/clearstream-s-december-and-year-2014-figures/69886>

For the purpose of risk evaluation, the CSD participant would have to carry out a creditworthiness assessment of its client (and possibly of the intermediaries involved) and also an assessment of the conduct of a trading party that is unknown to the participant and which should carry out the buy-in. To make matters worse, the assessments of the transaction fail rates must also be considered. Moreover, it is not clear how the collateralisation should be made – using securities that can facilitate the settlement or using money to facilitate the cash compensation payment.

We would like to state that, due to the trading model and own capital situation of many custodians that perform low-risk transactions, a low fail probability can also lead to high collateralisation costs due to possible numerically very high cash compensation (OTC!).

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 addition to the disadvantages already stated in Q1, the following difficulties are also apparent:

The CSD participant would have to contractually agree with its client that the latter bears the costs of the refund of the cash compensation paid by the CSD participant. There is admittedly no legal base for this and the CSD participant also does not have any commercial means to enforce this obligation. As we have already shown in the remarks to Q1, the legal situation is that the failing trading party is obliged to compensate the receiving trading party for damages. If a vicarious agent used for the settlement of securities is responsible for a settlement fail, the failing trading party can indemnify its vicarious agents, but not the other way round. The failing participant (C) cannot demand that its client (B) refunds the cash compensation. We doubt whether the regulation to refund the expenditure in Art 15 Para. 3 of the technical standards is valid in terms of law. It would require a civil law norm that justifies the claim, and a technical standard is not such an instrument. There is even less chance that the client (B) could demand a refund from its client (A). Channelling the cash compensation to the failing trading party does not seem legally possible.

Moreover, it is feared that the fall-back option (payment of cash compensation by the failing participant) could lead to the inappropriate conduct of the trading participants. According to Art. Para. 3 (e), the failing participant is obliged to make a payment, if it cannot prove to the CSD that the buy-in was 'performed' or the trading party is subject to bankruptcy

proceedings. Both these will always be difficult to prove for the failing participant, because it does not necessarily have a contractual relationship with the trading party, so the risk of payment exists even if the buy-in has been performed but there is no notification about it. This by no means encourages the receiving party to perform a buy-in.

[Moreover, it could be the case that the trading parties (buyer and seller) collude to carry out transactions with securities that the seller does not even have. A lower purchase price is agreed with the awareness that the market price is much higher. The buyer does not perform the buy-in and C would have to pay the cash compensation, which is forwarded from D to the buyer via the chain. The buyer and seller share the cash compensation, C must try to demand a refund.]

The passing of cash compensation via supply chain from D to the buyer is also connected with fail risks for the buyer. Further, the custodians are not appointed to receive cash payments for clients or non-clients.

Higher costs arise due to the collateralisation costs shown in Q3 and due to the costs that cannot be passed to the failing party in the case of an actual fail (payment of cash compensation).

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.

The European Association of Public Banks (EAPB) represents the interests of 30 public banks, funding agencies and associations of public banks throughout Europe, which together represent some 100 public financial institutions. The latter have a combined balance sheet total of about EUR 3,500 billion and represent about 190,000 employees, i.e. covering a European market share of approximately 15%.