

**Clearstream response to the  
consultation paper  
by ESMA on the  
Regulatory Technical Standards on the CSD  
Regulation – The Operation of the Buy-in Process**

6 August 2015

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## Introduction

The responses provided in this document convey the views and opinions of the Deutsche Börse Group of companies, which covers the entire process chain from securities and derivatives trading, clearing, settlement and custody, through to market data and the development and operation of electronic trading systems. More specifically of this response portrays the joint views and concerns of Deutsche Börse's Cash Market trading venues, its clearing house Eurex Clearing AG and its settlement arm Clearstream (which comprises Clearstream Banking Luxembourg S.A., Clearstream Banking Frankfurt AG, and LuxCSD S.A. jointly referred hereafter as "Clearstream").

Clearstream welcomes the opportunity to provide its comments to this ad-hoc ESMA consultation on the Operation of the Buy-in Process in the context of the Regulatory Technical Standards on the CSD Regulation, to which we had previously provided comments. We note that these previously provided comments remain relevant and complement the answers provided in this document.

The proposed level-2 options remain exceptionally prescriptive and unnecessarily impose on CSDs heavy technical functionalities for their systems, without considering that the objectives of the CSD-R could be achieved without the need to imposing technical blueprints for the CSDs systems and by letting the market to decide on the most effective and appropriate tools to prevent settlement fails in the EU.

Having said this, we welcome the concept of flexibility introduced by ESMA through the consultation of the options at hand. This constructive conciliatory approach should be further used in other areas in which we have identified majors concerns with regards to the RTS proposals, such as in the context of recordkeeping or reconciliation requirements.

## Executive Summary

Generally, as a result of the industry's efforts and the robust argumentation provided to ESMA, we note that the consultation has rightly taken the approach to maintain an inherent low risk profile for CSDs, moving away from an involvement in the execution of buy-ins (or the buy-in process as a whole) which is seen as a main responsibility of CCPs and/or the involved trading parties.

Therefore we appreciate that the discussion on the operation of the buy-in in the CSDR Settlement Discipline is finally shifting the role of the CSD away from risk-prone activities, to a largely notification and messaging related process in relation to "non-centrally cleared OTC" failed transactions. In relation to this, CSDs, depending on the buy-in model option ultimately selected by ESMA, will nevertheless be obliged to perform monitoring of failed settlement instructions and notifications receipt from trading parties or CSD participants. Any such

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functions should need to be very tightly shaped to avoid that any possible risks revert to the CSDs from the backdoor.

While from the wording of the consultative text, we tend to believe that ESMA would possibly be inclined to favour Option 2 (namely, the "fall-back" option in which the buy-in falls on the trading party level with a cash compensation triggered by CSD participant when necessary). We however continue to support Option 1 whereby buy-ins would be managed by the trading counterparties without that CSDs and their participants be required to play an active role (other than transmitting the necessary information). Despite some limitations and practical difficulties, we believe that this option is the least disruptive and that it would best preserve the efficiency of the settlement process, preventing CSDs and their participants from being exposed to new risks as a result of the buy-in procedure. Moreover, Option 1 is also preferable since it provides flexibility to the parties involved to jointly agree on what is further deemed necessary (e.g. in the cases of OTC master agreements to agree on the liquidation form or netting, or to introduce their mutually agreed tailor made buy-in arrangements, apply ICMA rules, etc.).

As a way to portray the inconsistent and unwarranted role that CSDs will continue to play under the different options under consultation, we would like to summarise the specific flawed activities demanded for CSDs or other parties by new draft text:

- a) Receiving "buy-in status" notifications from trading venues (Article 13(2)) and CCPs (Article 13(3)) and trading parties or CSD participants (Article 13(4))
- b) Transmission of "buy-in status" notifications from CSD participants to failing CSD participants (Article 13(4))
- c) Monitoring receipt of buy-in results under Option 2: (Article 15(3)); in absence of notification received until "the business day following the end of the buy-in process", and inform the failing CSD participant
- d) Apply partial settlement as from last day of extension period irrespective of customer order/ setting (Article 16)
- e) CSD rules to
  - (i) oblige CSD participants to collect and provide information about a) the buy-in deferral or cash compensation choice made by the receiving party or b) the buy-in agent appointment, buy-in results and buy-in deferral or cash compensation choice made by the receiving participant, and
  - (ii) requirement under Article 15(3) for CSD participants to recover the cash compensation amounts from their (= CSD participants') clients.

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## Specific comments to the consultative report 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 continue to strongly support Option 1 along with the majority of industry players. This is reasoned by the understanding that buy-ins would be managed by the trading counterparties without the need for CSDs and their participants to be required playing an active role (other than transmitting the necessary information). Despite some limitations and practical difficulties, we believe that this option is the least disruptive and that it would best preserve the efficiency of the settlement process, preventing CSDs and their participants from being exposed to new risks as a result of the buy-in procedure.

Having said this, all options would require a strong contractual framework between the CSD participants, their clients and most particularly with the trading counterparties. As enforceability and extraterritoriality are definitely the key difficulties that any of the players involved in the process will have to face. Irrespective of the final solution chosen, it is very important that any ESMA solution retained should impede any fall-back responsibility for the buy-in to the CSD.

In this regard, we would also like to mention that we also largely share the concerns raised in relation to Option 1 in the response document of our association ECSDA and especially with regards to the elements of enforceability, extraterritoriality and third country counterparts' implications.

We believe that Option 1 still has the following weaknesses:

**a) Enforceability**

A solid contractual framework should provide a proper and comprehensive wording to be applied by all parties in all contracts to ensure consistency and avoid an unlevelled playing field in this regard. We believe this could be achieved in coordination with the industry, particularly with ICMA rules existing today would be useless though they actually are means used and part of contractually binding obligations.

In any case, ESMA should define and provide a single set of rules that each Trading party, CSD participant and CSD shall apply in the buy-in execution contractual framework with its counterparts to ensure a consistent and reliable understanding of the responsibilities of each party involved. Hence avoiding any possibilities for unlevelled playing field in this regard.

Should ESMA define a single set of rules, it should consider defining the following elements during this process:

- Differentiate in its final text among the infrastructures involved in every stance.

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- Name the infrastructure that is ought to provide information in every stance.

**b) Links and extraterritoriality**

As an additional general point on enforceability and extraterritoriality we raise awareness to ESMA that any buy-in or cash penalty mechanism can only work and should therefore only apply when the two settlement counterparties make use of the same CSD or of two different CSDs (via a standard, customised or interoperable link), located in the European Union. ESMA should recognize that settlement fails on a link involving a CSD established outside the European Union should be out of scope, and will be governed by other bilateral agreements or legal provisions that define the conduct of those links.

In context of the above, ESMA should also clarify that (direct, indirect or any other type of) links between EU and non-EU CSDs can continue to exist even in case of CSDR non-compliance of the 3rd Country CSD/ depository/ market to avoid the threat of abandoning indirect links, specifically those with non-EU CSDs, thereby disconnecting European CSDs from global settlement flows.

**c) Communication flow**

All options would require a structured communication flow among the several parties involved. It is our understanding that ESMA considers the communication flow complex for Option 1, while we in fact believe the flow would be similar to at least Option 2.

Irrespective of the option ultimately selected by ESMA all options involve a rather large number of market participants, and the full role, responsibilities, obligations and rights for each party involved are rather unclear at this stage. For the sake of future certainty for the buy-in operation process, we would strongly recommend ESMA to establish a clear information flow, with clear allocation of duties and responsibilities at every step and for every party involved.

**d) Appointment of buy-in agent through the trading venue**

The requirement under Annex 2 Article 14 (1) for the appointment of a buy-in agent through the trading venue in case the trading member does not appoint itself such buy-in agent in time contradicts with the risk profile of trading venues outlined in Section 2 (4) of the draft RTS.

Introducing an additional buy-in variant by obliging trading venues to appoint a buy-in agent in case a trading member fails to do so, also contradicts Annex 2, Section 3, Article 14.1 of the draft RTS and adds unnecessary legal and processing complexity for the trading parties and trading venues.

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We therefore propose the following amendment to the draft RTS text as follows:

*Article 14*

*Appointment of the buy-in agent and execution*

*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.~~*

To avoid any gaps in the enforceability of this solution, the appointment of the buy-in agent should be the legal responsibility of the trading member himself. Having said this, the trading member should have the possibility to receive a service for this obligation from a third party. ESMA should consider to clearly separate the legal obligation to perform a buy-in from the implementation of a practical solution in this regard.

ESMA requirement to appoint a buy-in agent and monitor the buy-in process should therefore:

- Make the CSD participants liable to monitor the process, as this is common market practice today,
- Refrain to place CSDs in any position that is associated with more risks,
- Always focus first on the entity which provides the account service, and not the CSD itself, and
- Above all, follow the market chain and not bypass or omit any participants involved in the chain.

**e)** Notification, monitoring and process responsibilities (Annex 2 Article 13 and others)

Considering the trading venue will not be in a position to play an active role in the buy-in process, nor monitor or initiate any time critical elements of the procedure; some of the elements proposed under Option 3 could in fact be used for the benefit of streamlining Option 1 instead. Here for practical reasons, the CSD could eventually play a role in the distribution and collection of information about the buy-in process in a central place and under the responsibility and with the support of its CSD participants if needed (this is also our broader interpretation of Article 7 (10) of the CSDR). While for CCP cleared transactions, neither the trading venue members nor the clearing members should perform the buy-in transaction, as the CCPs have at their disposal all the necessary information and should therefore perform the buy-in directly.

Moreover, for the purpose to clarifying the Notification, monitoring and process responsibilities we propose amending Articles 12 and 13 as follows:

With regards to Article 12 (1): "*The buy-in process shall be initiated at the end of the business day following the elapse of the extension period.*", in order to avoid misunderstandings we would suggest rephrasing: "*The buy-in process shall be initiated at the end of the business day on which the extension period elapses following the elapse of the extension period.*" In

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practice the buy-in auction will start on the following business day and accordingly quotes will be collected subsequently.

With regards to Article 13 in general, we would like to suggest the following amendments:

*Amendment Article 13(1)(b):*

*(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; in case the buy-in is not executed via a buy-in auction."*

With regards to Article to 13(2), considering that as earlier mentioned, the trading venue will not be in a position to play an active role in the buy-in process, besides setting the framework in its rules and regulations for the trading members to operate the buy-in, we propose the following amendment to the reflect this in the draft RTS text:

*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 ensure that the CSD is informed of the initiation, execution and results of the buy-in.*

We would also like to point out that Article 13(3) requesting "*For transactions cleared by a CCP, the CCP shall provide the notifications referred to in paragraph 1 to the failing clearing member and to the CSD*", is redundant from an operational point of view. The provision to provide additional information on the buy-in to the CSD is not necessary since the buy-in process for transactions cleared by a CCP is completely managed by the CCP and no further action is required from the CSD side, because the CSD will settle the settlement instruction(s) resulting from the buy-in auction based on existing processing. Such instructions are not any different from a CSD point of view from other instructions received by a CCP. Therefore, there is no additional information requirement for the CSD in such a scenario, also to avoid duplicate information flows, possibly leading to confusion.

f) Level playing field for systemic internalisers / settlement internalisers.

Buy-in rules are only applicable for regulated markets and the opportunity has been missed in the Level 1 text to expand the regulation to all parties in which settlement takes place, and most particularly to settlement internalisers. Although settlement internalisers will potentially be integrated to the Settlement Discipline at a future stage, in the meantime this exclusion will de facto create an unlevelled playing field, and could work as an incentive for trading members to move trades outside of the trading venue and into the settlement internalisers service solutions, which are not bound to buy-in and penalties obligations.

ESMA should hence avoid combining additional obligations for trading members - who are trading on regulated markets - with complex buy-in processes at different levels (trading, clearing and settlement).

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**g) Partial settlement**

Here the proposed text forces CSDs to ignore its customer instructions. In particular, as stated in Recital 8, partial settlement should not apply to settlement instructions that have been put on hold by a participant, since this may indicate that the financial instruments in the account do not belong to the client for which the instruction has been entered into the system. In our opinion the sentence should be added also in Article 16 as "on hold" instructions should be clearly be put out of scope.

It is our understanding of the current text that CSDs would have to overrule a formal customer instruction (i.e. for both, receiving and delivering party) without any prior customer consent. This is an element which goes clearly against the guiding principle of the relation between CSDs and its participants to only act under instruction of the CSD participant, hence creating a serious disruption to this guiding principle, hence extreme caution should be applied by ESMA in this regard before adopting such an approach.

**h) Cash compensation rules**

For Options 1 and 2, and in line with our point a) on enforceability above, ESMA should clearly clarify which cash compensation rules should be applied by the CSD participant, as the parties to a trade may have agreed on a parallel cash compensation procedure in the underlying agreements (i.e. GMRA) which are not known to the CSD, to the CSD participants or to the other parties involved. In case the cash compensation impacts the agreement of the parties for the initial trade, it could be considered an undue enrichment of the receiving participant.

Further concerns in relation to Option 1:

On the requirement for a CSD to pass on the buy-in notification set under Annex 2, Recital (11), it should be noted that since a CSD has no contractual relation to (trading) parties but only its CSD participants, the text shall be rephrased based on the following elements:

- First, the term "allow" suggests that CSDs could prevent trading parties from passing on the buy-in notification which is not the case;
- Second, given that CSDs only have contractual relationships with their participants, and not with the "parties" to the transactions, the sentence is difficult;
- Third, for the notification process to be efficient and reach its ultimate recipient, it would make more sense to require all parties in the chain to pass on the notification, rather than to require CSDs or intermediaries to "allow" for the notification to be transmitted.

As a result, we suggest the following amendments to Recital 11:

*Recital 11 (options 1 and 2):*

*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 participants suffering from a fail should ~~allow the parties to~~ pass on the buy-in notification to CSD participants or other parties to whom they are due to deliver the same securities, while the CSD participants having failed to deliver should, where applicable, pass on the notification;*

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*~~which could be further passed on~~ to other parties involved in the cause of the settlement fail. The CSD should remain informed of the pass-on and of the identity of the party receiving that notification.*

In addition, the notification flow shall always go through the full chain (back and forth, no bypassing) of all parties and participants involved to ensure all parties/ participants are informed, i.e. direct interaction between CSD and trading party shall be avoided (also for the above mentioned reason of lacking contractual relation).

We therefore also support ECSDA's proposal for the notification process to be efficient and reach its ultimate recipient, it would make more sense to require all parties in the chain to pass on the notification, rather than to require CSDs or intermediaries to "allow" for the notification to be transmitted.

**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.

CSD participants are readily timely informed about any failed settlement instruction. CSD participants are therefore able to communicate this information to their own clients. While CSDs have no visibility on communication between the CSD participant and its own clients, it is our assumption that even in case of "intermediary failure" the information is already provided today along the chain. And therefore the source of the failure should not have an impact on the general information/notification flow.

In any event, we would expect that the settlement fail would need to be solved through the contractual arrangements among intermediaries, as we suggested under the enforceability point above.

Further on the Option 1 proposal, we would like to comment on the following consideration raised by ESMA in its consultative paper under paragraph 10: *"With this approach, the buy-in rules would have to apply throughout the settlement chain up to the trading parties. As the trading party could be the participant itself, the direct client of the participant or could involve several intermediaries, the rules of the CSDs and the contracts between the different intermediaries would have to ensure the application of the buy-in framework."*

ESMA should bear in mind that CSDs cannot oblige any party other than its own participants to take any actions. Accordingly, CSDs could only adopt rules that could require its own participant to ensure the compliance with the buy-in rules by its client, e.g. by adjusting its general terms and conditions.

ESMA should acknowledge that the likelihood to come to an agreement on such clauses with the participants is likely not to be enforceable or implementable.

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Similar conclusions can be drawn with regards to the consideration raised by ESMA in its consultative paper under paragraph 11: *“In the event of settlement fails, the status of the settlement instruction would have to be notified to the trading parties, through the chain of intermediaries. When the trading party is informed it would have to contact its counterparty, comply with the buy-in rules’ requirements and **keep the CSD and its counterparty informed at every key step as required by the rules.** An information flow would need to be set up through the chain of intermediaries.”*

Here the proposed solution suggests that the CSDs shall obtain information from trading parties with whom they have no legal or other relation. This element should be taken into account by ESMA not only from a legal and contractual perspective, but also from a compliance and data protection perspective. As confidential data might be required to be provided to parties which have no contractual solutions in place to cater for such requirements.

As a general rule, ESMA should acknowledge that CSD has no power to oblige parties with whom it has no contractual relationship.

**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.

**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 participants as fall back) compared to option 1, or please evidence the higher costs that option 2 would incur. Please provide details of these costs.

It is our understanding that Option 2 would require CSD participants to pay for the cost of a buy-in or for the cash compensation in case the failing trading counterparty does not fulfil its buy-in obligation. Hence we are not in a position to answer this question, CSD participants are best placed to provide and answer.

Moreover, from a CSD perspective, Options 2 and 3 have a disadvantage compared to Option 1 in that they could impose new risks and liabilities on CSDs acting as participants in other CSDs through the establishment of links. As when a CSD establishes a standard link with another CSD, it essentially becomes a participant in that CSD, and is hence subject to the same terms and conditions as all other participants, which would make CSDs subject to the whole set of the Settlement Discipline requirements.

Here we largely share the concerns raised in relation to Question 4 in the response document of our association ECSDA.

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Similarly to the concerns raised in our answer to question 1 above, on the communication flow, we fail to see the incentives to comply with the buy-in rules by all parties in the chain would be that much higher than for Option 1. On the enforceability of the process, should Option 2 be retained by ESMA, then the CSD liabilities would need to be clearly specified within all items under Article 14 and 15 that refer to CSDs.

As a final comment in the context of this question, under Article 15(3)(d) Option 2, reference is made to Article 13(3)(c) that does not exist; it is our assumption that ESMA is referring to Article 13(1)(c) instead.

**Question 5.** Please provide detailed quantitative evidence of the costs associated with the participants being fully responsible for the buy-in process and on the methodology used estimate these costs.

While under the new format, Option 3 does propose some efficient elements, it has the foremost disadvantage (like for option 2) that it could impose new risks and liabilities on the CSDs acting as participants in other CSDs though the establishment of links amongst other.

As a CSD operator, we agree with ESMA's analysis that this option is potentially the most costly because it will require CSD participants to fully collateralise settlement instructions, rendering settlement in the EU very complex and uncompetitive.

We believe that Option 3 still has the additional weaknesses, which is worth highlighting under point 33, where it should be noted that even the CSD would not know the "reason of the fail, the nature of the transaction and their counterparties".

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We hope our comments will be seen as a useful contribution to the discussion, and that the final issuance on the respective Settlement Discipline guideline will be reflecting the comments we have made.

Luxembourg and Eschborn, 6 August 2015