EDMA EUROPE

Mairead McGuinness
Commissioner, Financial Services, Financial Stability and Capital Markets Union
European Commission
1049 Brussels
Belgium

2nd February 2021

Dear Commissioner McGuinness,

Re: European Commission's Targeted Consultation on the Review of CSDR

Electronic Debt Markets Association – Europe (EDMA) represents the interests of companies whose primary business is the operation of regulated electronic fixed income multilateral trading facilities in Europe (regulated markets and/or trading venues) and act as a source of consultation between the members in their roles as operators of such venues in order to project collective views on regulatory, compliance and market structure topics for the benefit of the electronic fixed income markets.

EDMA welcomes the opportunity to input to the Commission's review of CSDR submitted separately. We support the objective of improving settlement efficiency in European capital markets and believe that two aspects of CSDR's Settlement Discipline regime, namely cash penalties and rules on confirmation processes, will contribute to achieving that goal. However, the mandatory buy-in regime, as currently constituted, risks having significant negative implications from a trading and liquidity perspective. In the vast majority of cases liquidity providers are able to locate sellers or lenders to fill purchase orders. However, in certain cases they provide liquidity based on their reasonable expectation of sourcing the relevant securities. This is particularly apparent in less liquid instruments, such as corporate bonds. It seems highly likely that the cost and risks associated with mandatory buy-ins will impact offer side pricing, particularly in relation to less liquid securities. With respect to bond markets, the 2019 ICMA Impact Study indicates that 100% of sell-side responders and 80% of buy-side responders expect that mandatory buy-ins will negatively impact overall efficiency and liquidity. Further evidence is also available in ICMA's 2015 impact Study available here. There is also a risk that lenders will become less willing to make their portfolios available, in order to ensure they themselves avoid mandatory buy-ins in relation to those securities. Given the economic uncertainty emanating from the Covid-19 pandemic, we do not believe that introducing the mandatory buy-in regime is ultimately in the best interests of investors or market participants. Rather, we consider that the proposed penalty regime should of itself be sufficient to encourage appropriate settlement discipline amongst market participants and believe that its impact should be evaluated before considering whether a mandatory buy-in regime is necessary or desirable.

Should the Commission determine that a mandatory buy-in regime is ultimately desirable for the operation of EU markets, we would recommend a phased approach, to allow a proper and robust assessment on the impact on liquidity of the regime. For example, the length of the extension period could be increased significantly, initially to levels appropriate to each asset class and then reduced over time, but to a suitable level that does not cause a mismatch with settlement regimes within third countries. In any event, there are a number of practical obstacles to the successful operation of the regime that need to be tackled prior to its implementation. These are explained further below:

Electronic Debt Markets Association – Europe
60 Gresham Street, London, EC2V 7BB
Office: +44 (0) 20 3440 9615
Email: david.bullen@edmae.org

1. Pass on Mechanism

Recital 19 of CSDR and Recital 34 of the SDR RTS suggest “minimising the number of buy-ins” where possible. However, CSDR and the SDR RTS portray a single, discrete transaction between two parties, whereas in reality the settlement landscape is a complex network of interlinked transactions involving a multitude of market participants. There is a high probability that multiple parties will each be obligated to execute a buy-in for what is ultimately a single settlement fail. The impact of this will be a shortage of liquidity leading to a potential distortion in prices and an artificial increase in the cost of the security, which may only compound an existing liquidity issue, as the failure to settle is likely caused by illiquidity in the first place. Where a settlement fail results in the failure of a ‘linked’ onward delivery of the same securities, the most efficient and secure method of achieving the objective of the buy-in rules would be a ‘pass-on’ mechanism under which trading counterparties in a settlement chain are able to pass on the buy-in notification (typically received from the final receiving party in the chain) until it reaches the original failing party, although even this would not solve the issue of interaction with third country counterparties and settlement regimes, which we outline in 6, below.

2. Buy-in agents

EDMA members are concerned about the practical consequences of the need to appoint a buy-in agent to manage mandatory buy-ins. So far only one potential option has emerged for the fixed income market, raising concerns as to how practicable operating this requirement will be. We believe it may be sensible to make the appointment of a buy-in agent discretionary, especially as market participants are more than capable of placing a replacement buying instruction themselves and evidencing the actual costs of doing so should be relatively straightforward.

3. Payment asymmetry

A not insignificant risk to the seller arises from the seemingly asymmetric provisions for the payment of the cash compensation between the parties, which only provides for the payment to be made from the seller to the buyer in the case that the market value has increased; and not from the buyer to the seller where the market value has decreased. This is widely interpreted to be the result of a drafting error in the Level 1 regulation and is expected to be remedied by contractual arrangements between trading parties that will facilitate symmetrical differential payments in the case of both buy-ins and cash compensation. It is essential that the price component of both the buy-in and the cash settlement (“cash compensation” differential) can be settled symmetrically between the trading parties. This is important to minimise risks to the selling party, to improve predictably of economic outcomes, to avoid incentivising adverse behaviour of trading parties and to facilitate a pass-on mechanism.

4. Calculation of cash compensation in fixed income markets

The Regulatory Technical Standards provide a methodology for determining the market reference price to calculate the “market value” for the transaction at the end of the buy-in timeline in cases where a buy-in not executed; and therefore the differential (or “cash compensation”) to be settled between the parties. For the majority of trades on EDMA member’s venues, Article 31(3)(b) of Commission Delegated Regulation (EU) 2018 1229 will determine the methodology by which cash compensation should be calculated. It provides that the value should be determined on the basis of the closing price of the trading venue within the Union with the highest turnover.

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This provision will prove very difficult to work in practice. Firstly, it may be difficult to establish what is the trading venue with the highest turnover. Bonds are traded across multiple venues, as well as off-venue, which could include Systematic Internalisers (SIs) and non-SIs. From this perspective, how does one determine the appropriate venue, and on what basis? Secondly, even if one could establish the appropriate venue, in all probability there is not likely to be a closing price, given that the underlying security is almost certainly highly illiquid. Given the infrequency with which illiquid bonds trade, especially for securities where a buy-in could not be completed, there may also be few historical prints that can be referenced. In fact, it may be that the last recorded transaction in the security is the one between the parties that they are now trying to cash settle. Should policy makers consider it is still desirable to have a cash compensation framework in those instances where a buy-in cannot be executed, market participants will need to be given some further discretion to determine an a-priori framework, perhaps by reference to an agreed methodology (as Article 31(3)c provides in relation to instruments not traded on a trading venue). In practice, market participants tend to use composite price services to determine the value of bonds for which there is not relevant pricing information and in practical terms using these is likely to be the best solution. Given the concerns we have already raised with Commission staff regarding providers of trading systems who are not regulated as trading venues, we feel that this issue is also pertinent to the need to maintain a level playing field. In their search for liquidity, market participants can easily be discouraged from trading on-venue and revert back to customary trading behaviour, i.e. leveraging bilateral relationships off-venue. Mandatory buy-in may further incentivise trading to occur off-venue which runs contrary to the stated aims of other regulatory policy goals. Again, if it is not possible to derive an appropriate value for cash settlement, the receiving trading party should be able to choose to continue to defer the buy-in until it is completed or such a time that deriving the appropriate value for cash settlement is possible.

5. Scope

The scope of the CSDR-SD provisions needs to be clarified, for example, clarifying beyond doubt that SFTs and margin transfers are out of scope. We believe that these categories of transactions should be excluded as they are not of a trading nature. The purpose of the buy-in, cash compensation and penalty regime is to discourage poor settlement discipline and to re-dress commercial losses caused thereby. However, the commercial nature of SFT transactions and margin movements is not suitably addressed by cash compensation or penalty, being a loan mechanism and collateral respectively. It might be advisable to have SFTs included in the scope of mandatory buy-ins provisions only when a chain of fails exists and with an applicable pass-on mechanism as described in 1 above. In such instances, inclusion of SFTs would allow a chain of fails not to break every time there is a failing SFT, reducing overall the number of executed buy-ins.

6. Interaction with Third Country Regimes/Matched Principal Trading

As noted above, the reality of the settlement landscape is that it consists of multiple linked transactions. Theses settlement chains often cross borders and often involve settlements taking place in Third Countries (notably the US and the UK). The proposed mandatory buy-in regime creates significant risk for parties trading cross border with third countries. For example, a party acting as matched principal, which is expecting delivery of securities in DTCC or Euroclear UK and then intends to onward deliver those securities to a counterparty within the EU faces significant new risks under the new regime. Generally, regimes outside of the EU have only discretionary buy-in frameworks and no defined end point where cash settlement must take place. A party acting as matched principal in the above circumstances is therefore highly likely to have to cash fund the EU leg of the transaction (and is thus exposed to market risk on that leg). We are concerned that this

situation may act as significant deterrent to cross-border activity and effectively place the matched principal trader in breach of the regulatory basis of its trading activity. These risks have now been exacerbated by the UK's decision not to implement the regime. We believe these problems can, to a large extent, be addressed by allowing counterparties to defer cash settlement until the buy-in process in the relevant third country is completed. Alternatively, the adoption of a significantly increased extension period could alleviate the mismatch of settlement regimes and the potential need for an EU leg of a trading chain to be settled or compensated out of sync with the cross-border leg.

Similar considerations apply in relation to the penalties regime where matched principal traders face incurring significant fines as a result of the failure of a counterparty to deliver in a third country CSD. We believe that passing on such fines to third countries is unlikely to be commercially viable (particularly in relation to US securities) thus creating a disincentive to intermediaries to provide liquidity in third country securities to European investors. Consequently, we believe that securities for which the issuer CSD is in a third country should be excluded from the regime and that greater consideration should be given, generally, to the viability of exporting CSDR buy-in, cash compensation and penalty regimes to third countries and the regulatory and industry practice friction this will cause.

Finally, we note that the current design of the buy-in regime also poses a fundamental problem to the matched principal model for trades that are settled within the EU. The above-mentioned problems with payment asymmetry and pass-on mechanisms mean that the matched principal (who, by definition, is always 'riskless') is put at market risk. This would have the unintended consequence of making the continuation of this important model of market intermediation impossible. The problem can be solved by addressing the payment asymmetry and enabling pass-ons.

There is also a lack of clarity as to the territorial scope of CSDR (for example, does it apply to Cross Border deliveries across a CSD link to an EU CSD from a non-EU CSD?). We also encourage the Commission to work with other third countries to align the regimes where possible.

Having regard for the format provided by the Commission, please find attached EDMA's response to your consultation. EDMA would very much welcome the opportunity to elaborate these points with the Commission and I shall be in contact shortly to that end.

Kind regards,

David Bullen
Secretary-General, EDMA Europe

Cc: John Berrigan, Director-General, DG FISMA
Tilman Lüder, Head of Securities Markets, DG FISMA
Patrick Pearson, Head of Financial Market Infrastructures and Derivatives, DG FISMA

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