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YOUR INPUT - CONSULTATIONS

ESMA Consultation on Draft Regulatory Technical Standards on the CSD Regulation

Introduction

The French Association of Securities Professionals (AFTI) is the leading association representing the post-trade businesses in France and Europe. AFTI represents through its 83 members a wide range of activities : market infrastructures, account-keepers and depositaries, issuer services, reporting and data management services which employ about 28 , 000 people in Europe of which 16, 000 in France.

Our members acting as financial intermediaries represent 26 % of the European custody activity with 55,600 billion € in safekeeping. In 2014, our two market infrastructures have managed respectively 29 millions of settlements and 186 millions of operations cleared.

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

General comments

We want to thanks ESMA for this consultation on the Regulatory Technical Standards on the CSD Regulation focusing on the buy-in process.

Indeed, as it is recognized by ESMA in this Consultation Paper (CP) many respondents to the previous CP, including AFTI 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's, on this topic, takes into account market participants concerns and proposals.

In a nutshell, we really believe that only Option 1 is practicable and should be put in pace. 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 represents among 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).

To avoid any misunderstanding we would like to first define some terms:

- **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 is only 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 characterized 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 a 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.

For any queries relating to our contribution, please feel free to contact our AFTI expert Marc Tibi who will be pleased to bring you further details : marc.tibi@bnpparibas.com
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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 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.

In our view, the actual goal of the buy-in requirement and in fact of the settlement disciplines regime in its whole is to avoid bad behaviors and not simply eliminate too old outstanding settlements. The settlement discipline regime by essence shall educate the right players, i.e. trading parties and education goes with responsibility

Option 1 is therefore a real step in the right direction and is over welcomed. However ESMA should go further in helping CSD's participants educate their clients who in turn will educate their own clients until the trading level. But this will not be achieved via a fall back principle as envisaged in option 2, (see our answer to Q4).

Moreover 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 recognize that some additional improvements are to be made: as well as controls and follow up to be set up in order to allow for option 1.

1. The contractual framework

Better than a fall back principle, a strong and uniform contractual framework is on our opinion a mean to achieve the objective of education.

It is not about building something from scratch; contractual agreements already exist. There are contract for each type of chain (trading, custody, settlement): between two trading entities in a transaction, between intermediaries or between CSD's participants and the CSD itself. In essence there is no contractual agreement and no reason to have one between CSD's participants.

Contracts need to be amended to include buy-in requirements. The only new contract will be for the relationship with the buy-in agent.

Our suggestion is to benefit from a clear statement in the contracts signed between the CSD participants (should the participant be a CSD itself or not) and the various CSDs that would specify the obligations to settle by all means the instructions, including the buy in possibility (this would be added to what is already foreseen in Article 14(3) for option 1 in the proposed RTS).

This statement should then give rise to the CSD participants to cascade it down to their clients (until the trading parties) in order to force them to accept the buy in process and costs should they be unable to deliver the required quantity of securities before a certain date (requirement to perform and to pay).

In our view and to prevent from any arbitrage or competition between CSDs on this item, this legal provision should be common to all CSDs (in fact, as CSDs may be participant of another CSD and thus submitted to the requirement of the CSD, it would be in their interest to apply the same statement in their own rules). Therefore we strongly recommend that ESMA provides a standard contract that will impose to all CSDs and thus to all their participants and underlying clients. Regarding the application of this provision to third country CSDs, one possibility could be to add this to the conditions ESMA is required to specify (article 48(10) of level 1).

In fact this contractual framework is needed irrespective of the option. But combined to the option 1 we strongly believe that it would be the best mean to achieve the goal to avoid bad behaviors and to address the "third country entity issue" (should the entity be a trading party, a CSD or any intermediary in the chain).

Indeed, this framework will make the link with the buy-in requirements themselves that apply to the trading entities due to option 1. Moreover, having the principal requirement at the trading level will incentive trading entities to include such statement in their contractual agreements with their counterparties to prevent any risk to not receive the securities they bought or to pay the costs when not being the real defaulter.

We are deeply convinced that these regulatory requirements to which the vast majority of actors will be submitted will lead to new market practices thus covering cases where an entity (a trading party,

a CSD or any other intermediary in the custody chain) will be a third country one. Moreover these market practices will be standard enough to be the same whatever the type of transaction is.

At the end this will be a natural and smoother way to impose CSDR requirements beyond the normal scope of the regulation. At least this will be an easier way than by trying to work on extra-territoriality and regulatory equivalence.

2. Information flow and information process

One point must be kept in mind is that having the buy-in at the trading level does not mean at all that information from the trading level to the settlement level will be very limited (what is foreseen in Article 14(3)). Indeed the execution (successful or not) of a buy-in triggered at the trading level will lead to several actions at the settlement requiring clear flows of information and clear process.

Thus the consequences of the buy-in requirement on information flow and process should not be underestimated even if the burden would be heavier in option 3. Indeed we would like to highlight that option 1 allows for a simple flow of information since it is consistent with the contractual relationship between a client and its intermediary (CSD's participant or someone else in the custody chain) where the latter could not act without being firstly requested by the former. At the opposite option 3 will mean a double flow of information: upstream until the trading party and downstream back to the participant.

If we take the process as described in the RTS:

- Notifications (article 13)

The receiving trading party sends until 5 notifications (all along the process)

Each notification should be also transmitted to the CSD so that the CSD is informed of the initiation, execution and results of the buy-in

- Appointment of the buy-in agent and execution (article 14)

The participant should get the information of the choice of the receiving party if the buy-in has not been fully successful (this information should go downstream the custody chain). It is likely that at the time the buy-in is launched settlement instructions should be put on hold to avoid any double settlement (as written in article 14(5), the failing party should then deliver directly the buy-in agent).

- Completion of the buy-in process (article 15)

If the buy-in has been successful, failing and receiving parties shall ensure that the settlement instruction is cancelled. In fact they will both (and each trading party in the trading chain?) ask their intermediary to cancel their client instruction.

Fortunately information flows and process are already part of the contracts through Annex or Service Level Agreement ... As for contracts this will be more about inclusion of new cases. By the way this

will also cover the one where the trading party will need to check with its intermediary to find the real trading defaulter behind it (another client of the same intermediary, for example).

The only information that is clearly new is the one to be given to the CSD on the initiation, execution and result of the buy-in. For this one we would like to suggest ESMA to require buy-in agents to inform the CSD. Indeed they have all the details, know exactly where the buy-in process stands so are able to deliver accurate and updated information.

- Regarding the process itself we believe that some points would deserve to be more detailed and framed. The failing party is allowed (article 14(5)) to deliver the securities until the receipt of the notification and then is allowed to deliver them to the buy-in agent; would all the trading parties have to instruct to put their client instruction on hold to avoid any double settlement as of the notification is received?
- The buy-in agent should deliver, in our understanding, the receiving party all the securities bought-in (article 15(3)). ESMA should precise how this will be done (does the buy-in agent expect any cash from the receiving party?)
- What do the costs reimbursed by the failing party to the buy-in agent will embrace?
- What happens to the amount of the original transaction (the one owed by the receiving party)?

3. **Four prerequisites are to be met:**

- Buy in agents must be appointed well in advance

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.

- This buy in agent must be rightly controlled to prevent any bad behavior

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.

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

In effect this CSD needs to be informed about the settlement of a pending transaction resulting from a buy in Process

- Another recommendation lies in the fact that buy in on OTC transactions should mimic to the larger possible extent the framework existing for cleared transactions . In order to avoid any distortion of competition, the framework of the buy in must be reflected in the coming RTS

Below you will find the LCH Clearnet SA current framework as an example

- The tender price is deemed to be a maximum price above which no offer of buy in will be accepted.
- The tender price is defined as follows :
 - 120% of the last adjusted closing price
 - LCH.Clearnet SA will take into account the last known adjusted price before the Buy In.
 - **Due to the non-delivery of the shares:** they proceed for a cash compensation equivalent of the value of the stocks non delivered **by debiting the seller and crediting the buyer.**
- **The Buyer always receives the cash compensation of which they do not keep anything.**
- **Calculation of the cash compensation:** 120% of the last adjusted closing
- When there is high price volatility they apply a **cash adjustment** above the cash indemnity, in order for the receiver counterparty not to be damaged.
- This only occurs when the cash indemnity is lower than the cash value of the non-delivered shares

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.

Yes because it is 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.

Regarding the second part of the question, we would like to highlight that what could happen more likely is the case where the defaulting trading party (the last one in the trading chain) is not the real defaulter (the real one being another client of the same intermediary). But even there the responsibility remains at the trading level.

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, ...).

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.

As we are speaking about OTC deals, as long as there is no buy intervention, they will be no novation from the participant/CSD.

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 to his client collateral to guaranty the pending trades (the ones that have not settled in theoretical settlement date)

This collateralization cost could be important depending upon the size of the transaction

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.

As said we believe that option 1 if it can rely on a strong, unique contractual framework should ensure the applicability of the buy-in provisions. However this could not lead to the conclusion that adding a fall back provision (namely option 2) will change nothing and thus could be used equally.

Indeed the fall back process 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's 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.

For us the fall back is more a mean to close a too old failing settlement. **In other words it cure the consequence rather than the problem itself.**

- **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. For example:

A sold 1000 shares to B

C sold 2500 shares to A

P1 is a CSD's participant representing A at the CSD level

P2 is a CSD's participant representing B and C at the CSD level

P1 is instructed to deliver 1000 shares to P2 coming from A
P2 is instructed to receive 1000 shares from P2 coming from B
P1 is instructed to receive 2500 shares from P2 coming from A
P2 is instructed to deliver 2500 shares to P1 coming from C

P1 and P2 use a netting set-up so that P1 should receive 1500 securities from P2. The delivery from P2 to P1 is failing. Note that from a strict CSD's perspective, P2 would have been the one to be bought-in if needed.

B has not performed any buy-in meaning that the fall back principle will apply.
A has performed a buy-in against C

What will happen? In this case the failing settlement between P1 and P2 is even not in the same way as the contract between A and B. How can the CSD detect that cash compensation should be paid by P1 to P2?

To be fair the fall back will need to rely on analysis, exchange of information between the CSD and its participants, between the latter and their clients Again we are not in the case of an issue within the buy-in process (as a failing trading party unwilling to pay), we are in the case of no buy-in process started at the trading level (no buy-in agent appointed).

- **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 collateralization**

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's 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's participants and their clients and lead to additional costs for the latter.

It must be kept in mind too that CSDs may also be participants of another CSD and treated as such, meaning they will be concerned by the fall back.

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.

- **Transaction versus settlement instruction**

Option 3 corresponds to the buy-in required at the settlement level (i.e. the CSD's participant is responsible) **but still to be applied to an OTC transaction** (by the way it shows clearly that ESMA considers that the defaulter are at the trading level) whereas CSD's participants only handle settlement instructions (please refer to our paragraph "definitions").

Without asking its clients for more information a CSD's participant could simply not distinguish between a settlement instruction resulting from an OTC transaction or from a traded/cleared transaction except if its counterparty is known as a CCP. This is utmost true for transactions concluded on a trading venue but not cleared by a CCP. Indeed since the trading venue does not interpose itself between the buyer and the seller, the trading venue is not part of the settlement process. The custodian of the seller will deliver directly the custodian of the buyer, thus the settlement will be linked to a "100% OTC transaction like".

In other words, option 3 will lead to additional costs just to get the information needed to start any buy-in process.

- **Relationship between a client and a CSD's participant**

We would like to recall ESMA that a CSD's participant (as well as the CSD itself in relation to its participants) will send / cancel instructions only when requested by its client.

It means that when article 15(3)(b) states, for option 3, that a participant shall communicate **its choice** in case the buy-in failed it should be understood as "a participant shall communicate **the choice of its client** in case the buy-in failed". **Indeed the CSD's participant is not the one who decided to buy / sell securities; it is only the one who processes the settlement on behalf of its client.**

Operationally it means that the CSD's participant at **each stage of the buy-in process** will need to pass on the information to its client all along the custody chain until the trading entity. Decisions of the latter will then go downstream until the CSD's participant for action.

- **Need for collateralization**

As explained in Q4 since a participant may be exposed to financial risk although not being directly linked, it will ask for collateral.

Due to the fact that the failing participant 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 participant will be required by the buy-in agent to post collateral in order to cover the counterparty risk. As for

option 2 the participant will in this case 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's 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's participants and their clients and lead to additional costs for the latter.

At the end the failing party should post collateral to the buy-in agent either directly or in an intermediated way through a CSD's participant.

- **CSD's specific case**

Option 3 means that CSDs that are participants of another CSD will be fully responsible for the buy-in process.

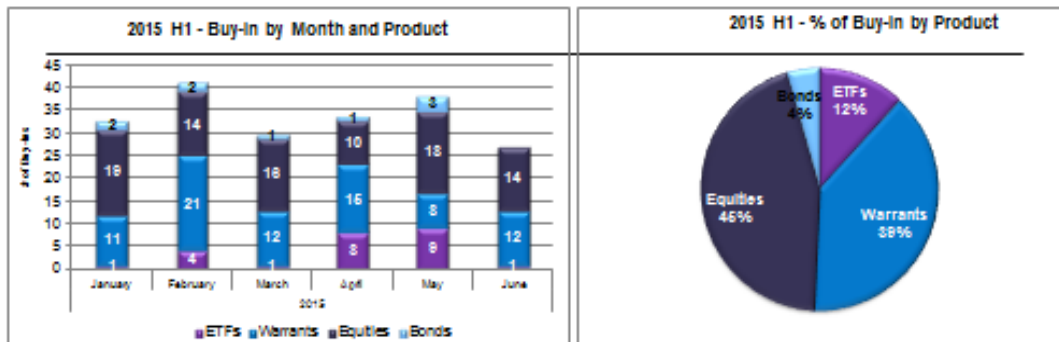
Annexes

Statistics of buy in triggered by LCH Clearnet SA first semester 2015

On a separate document, you will also find the level of fails in the French market (provided by Euroclear France)

Business Overview

Buy-In Overview Q1 & Q2 2015



Buy-in highlights

- Average monthly executed buy-in in between 30 to 40 instructions, versus an average of 100 buy-in per quarter
- High buy-in activity on February and May in line with global clearing volumes trend
- About 7/8 buy-in executed on a daily basis, among which 1 cash compensation every 2 days as an average
- Products most concerned by buy-in are Warrants and Equities, less the case for ETFs even if number of buy-in triggered could be high for this type of products but are hardly executed.