Settlement Discipline Challenges under the current CSDR approach
A worked example for OTF trading venue intermediation

The CSDR settlement discipline regime as currently constructed would serve to erect barriers to the matched principal model unless specific mitigations are formulated and included. A matched principal broker will no longer be able to pass on a failed trade to the next party in the chain, to keep his position 'riskless'.

As noted above, the problem is that a matched principal transaction, although organised from an economic standpoint as a single transaction, consists of at least two trades back-to-back. The more widespread concerns that have been raised about settlement chains and the frictions around settlement discipline are therefore manifested in a single deal. Matched principal transactions may present as part of longer settlement chains, but they should be recognised as discrete settlement chains in their own right.

The failure of the selling client to deliver in the required timeline would automatically trigger two buy-ins; potentially leading to different results. The characterisation of matched principal trades as both "simultaneous" and "riskless," because the intermediary is transacting with a selling client and a buying client in a single transaction would therefore be put in doubt.

<u>The following example illustrates the possible impact:</u>

a. Broker A brings together two clients, Seller and Buyer, for a transaction of 100,000 units of a bond.
b. Seller agrees to sell the bonds to "OTF A" for EUR9.99.
c. Buyer agrees to buy the bonds from OTF A for EUR 10.01.
d. The Broker within OTF A sends confirmations to each client and settlement instructions on their behalf to their respective settlement agents, as well as its own.
e. On the intended settlement date, Seller fails to deliver. OTF A is therefore also unable to deliver to Buyer. The penalty regime begins to apply.
f. On ISD+7, Seller is still unable to deliver. The Broker within OTF A is therefore also unable to deliver to Buyer. The buy-in regime begins to apply to operator of OTF A (as the buyer in the first component trade) and to the underlying client buyer (as the buyer in the second component trade).
g. OTF A appoints Broker X as a buy-in agent. Broker X is able to source the bonds at EUR11, so Seller pays to Broker A EUR101,000 (i.e., (11-9.99) x 100,000).
h. Buyer appoints Broker B as a buy-in agent. Broker B is able to source the bonds at EUR11.50 and has costs of EUR1,000. Buyer submits an invoice to Broker B for EUR150,000 (i.e., [(11.5-10.01) x 100,000] + 1,000).

In this example, the operator of OTF A is out of pocket to the tune of EUR49,000 and has earned no implied commission in the transaction (i.e., lost commission of EUR2,000). In theory, if it has contractual indemnities in place with its clients which are effective to recover all costs arising from the settlement failure, it can pass the EUR49,000 on to Seller. The impact, then, would be that Seller's overall costs are the full EUR150,000. In that case, OTF A has earned no fee, neither Seller nor Buyer have paid for the transaction, and Seller's risks have increased because of the nature of the transaction.

If the Seller had been able to pay compensation to the Buyer, when Broker X was able to find a price of EUR11, then its exposure under the buy-in regime would only have been EUR90,000 at most (i.e., (11-10.1) x 100,000). However, since it does not know the Seller (i.e., it is an anonymous trade and it is facing only OTF A), Seller finds itself exposed to two buy-in arrangements, both with OTF A, directly; and with Buyer, indirectly.

If the operator of OTF A does not have contractual indemnities with Seller that are effective to pass on the costs incurred as a result of the settlement failure, then the EUR49,000 that it is exposed to is a loss incurred on a "riskless" transaction. To be economically neutral, OTF A will need to pass on those costs to clients generally, which will increase the costs of undertaking matched principal transactions subject to the buy-in regime.

Neither of these results will promote the continuation of matched principal broking. Sellers will have to reassess their risks and might well prefer to have direct relationships with buyers. This will encourage transactions on a name give-up model (where the broker exchanges counterparty names after arranging the trade and lets the counterparties execute directly with each other. The consequence of this is likely to be a reduction in liquidity (because there will be fewer combinations of willing buyers and sellers, given that they are no longer anonymous), changes to pricing (because counterparty-specific risks will be addressed in pricing), and potentially challenges for some participants to find willing counterparties.