EVIA European Venues & Intermediaries Association

CSDR POSITION – EVIA

The Merits of Matched Principal Broking

Matched principal broking is an important and long-established feature of the wholesale securities markets in the European Union, virtually all non-cleared multilateral liquidity pools are arranged under this market protocol. Interdealer brokers support anonymous trading by market participants inside OTFs and arrange similar transactions for submission to other trading venues, often as package components. By acting as the intermediary between buyers and sellers for matched principal transactions, interdealer brokers:

- Enhance market liquidity, by simplifying credit risk decision-making
- Stabilise pricing of securities, by removing counterparty-specific pricing considerations
- Bring together dealers and other market participants on a non-discriminatory (anonymous) basis
- Provide organised trading venue compliant requirements and rulebooks

Under the matched principal model, the OTF acts as the buyer to the seller and the seller to the buyer. By working to arrange transactions between market participants, interdealer brokers make it easier for component trades to be done under pertaining rules and protocols, which brings a level of organisation to markets that promotes orderly trading. More details concerning the benefits of the matched principal model are available on the EVIA website[1].

Settlement Discipline Challenges

The CSDR settlement discipline regime will erect barriers to matched principal broking, going forward, unless a specific solution is found. EVIA has identified four particular areas of concern:

i) Cancellation of trades. There needs to be three-way agreement in order to cancel both legs
ii) Absence of an appropriate pass-on protocol
iii) Contractual buy-in mechanism which only works before expiry of statutory period and requires repapering
iv) Elaborate questions of scope with differential outcomes along the settlement chain. These apply not only to the specification of an EU CSD, but also whether the transaction is it traded on or admitted to trading on an EU trading venue, if the same instrument is traded or admitted to trading on any EU trading venue and whether it is cleared at an EU CCP
v) Indistinct prescription of the horizontal settlement chain. EVIA have submitted a Q&A to better specify application of the relevant entities.

The source of the problem is that a matched principal transaction, although organised as a single transaction, consists of at least two trades in a chain. All of the concerns that have

[1] MiFID II/R: The Benefits of Matched Principal over Name Give Up for the Fixed Income Markets

been raised about settlement chains are therefore manifested in a single deal. The failure of the selling client to deliver in the required timeline will automatically trigger two buy-ins; potentially leading to different results. The characterisation of matched principal trades as "riskless"—because the intermediary is transacting with a selling client and a buying client at a single price (or, in practice, two close prices with an implied commission in the spread between the selling and buying prices)—is therefore put in doubt.

The following example illustrates the possible impact:

(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 Broker A for EUR9.99.
(c) Buyer agrees to buy the bonds from Broker A for EUR 10.01.
(d) Broker 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. Broker 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. Broker A is therefore also unable to deliver to Buyer. The buy-in regime begins to apply to Broker A (as the buyer in the first component trade) and Buyer (as the buyer in the second component trade).
(g) Broker 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, Broker 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, Broker 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 Broker A), Seller finds itself exposed to two buy-in arrangements: with Broker A, directly; and with Buyer, indirectly.

If Broker 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, Broker 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, which could be pre- or post-trade. The consequence of this is likely to be a reduction in liquidity (because there will be fewer combinations of willing buyers and sellers), changes to pricing (because counterparty-specific risks will be addressed in pricing), and potentially challenges for some participants to find willing counterparties.

Solutions

To address these issues, EVIA strongly supports the solutions proposed by ICMA in its July 2020 ESMA CSDR consultation response with regards to:

i) Payments Asymmetry (*allowing the price component of both the buy-in and the cash settlement differential to be settled symmetrically between the trading parties*) and
ii) Pass-on Mechanisms.

In the event that ESMA decided not to follow ICMA's proposed solutions, at a minimum the regulation should be amended to the effect that the two components of the matched principal trade are treated as one. In the example given above, where there is a failure of settlement by Seller, Broker A should step out of the transaction for the purposes of the buy-in regime, and Buyer should execute one buy-in. That would be consistent with the approach under CSDR that the trading venue members should be responsible for the buy-in arrangements; Broker A being a part of the venue rather than a member of it.