CSDR Mandatory Buy-ins
Final Regulatory Technical Standards: an overview
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ICMA International Capital Market Association

Conclusion

ESMA has clearly made every effort to negate the adverse market impacts and the inherent flaws of a deeply contentious and widely opposed regulatory initiative. ESMA should be commended for pushing the interpretation and papering over the flaws of the Level 1 as far as legally possible, and for recognizing the potentially negative impacts of mandatory buy-ins on the smooth and orderly functioning of Europe's capital markets.

However, despite the good work by ESMA, the regulation still remains highly problematic. Firstly, the RTS do not correct an explicit asymmetry in the direction of the payment of the price differential for the buy-in or cash-compensation. This creates unpredictable and unmanageable risks for liquidity providers and intermediaries and in many instances would render the buy-in process unfit for purpose. Secondly, turning buy-ins into an obligation rather than a right, particularly with a cash compensation resolution, not only creates additional risks for liquidity providers and intermediaries, but it also creates unpredictable and unmanageable risks for investors. Therefore, it remains highly questionable whether the adverse market impacts of mandatory buy-ins will justify any potential benefit.

Ultimately, settlement inefficiencies in the European capital markets are primarily the result of fragmented and inefficient settlement systems and processes, rather than the behavior of dealers and other liquidity providers. Accordingly, fixing Europe's back-office should be the primary focus of market and regulatory initiatives, while the implementation of mandatory buy-ins is postponed for as long as possible.

Background

CSD-Regulation, which was passed into law in 2014, provides for a mandatory buy-in regime which will make the initiation and execution of a buy-in process a legal requirement in the event of a settlement fail across a broad range of securities transactions intended to settle in an in-scope EU CSD. The provision has been highly contentious for a number of reasons: (i) 'mandating' a buy-in process is seen as infringing on the discretionary right of a purchasing counterparty; (ii) the regulation introduces a mandatory cash-compensation mechanism in the event that the buy-in cannot be executed, which is not only another infringement on the purchaser's right to demand receipt of the securities, but also introduces an additional level of market risk; (iii) the Level 1 seems to put the responsibility for initiating and executing the buy-in on entities other than the trading counterparties (in particular settlement agents, custodians, and trading venues); (iv) the Level 1 prescribes an asymmetric treatment of the cash settlement of the mandatory buy-in or cash-compensation that would in many circumstances unfairly enrich the purchaser, while unfairly penalizing the seller.

Given the highly problematic nature of the Level 1 text that was widely highlighted in the ESMA consultation paper on CSDR Level 2 in December 2014, ESMA issued a third consultation, specifically on the operation of the buy-in process, in June 2015. Following the conclusion of this consultation in August 2015, the final draft regulatory technical standards were expected to be published as part of the draft CSDR Level 2 in September 2015. However, the RTS for settlement discipline, including mandatory buy-ins, were delayed, initially until October 2015, then subsequently December 2015, and finally until February 2016.

Initial overview of the draft RTS

ESMA published the long-awaited draft RTS for mandatory buy-ins on February 1st 2016. Given the limitations (and potential flaws) of the Level 1 text, and the concerns raised by earlier draft RTS, the final draft RTS are a marked improvement, and clearly attempt to strike a balance between consistency with the Regulation and limiting the potential for negative impacts to European capital markets.

Accordingly, EMSA has proposed what is essentially **a trading level buy-in process**, and so limiting (though not fully negating) risks to participants[1]. Furthermore, within the limitations of the Regulation, ESMA proposes the **longest possible extension period** (i.e. the duration of the fail before a buy-in is initiated) **of seven business days for all fixed income securities**.

With respect to securities financing transactions, which, somewhat contentiously, are also brought in scope of the regulation, ESMA proposes **an exemption for any SFTs with a term of less than 30 business days**. This exemption appears to apply to both start- and end-legs.

In terms of the **asymmetry in the payment of the buy-in or cash compensation**, ESMA is unfortunately limited by the Level 1, and so t**his extremely problematic component of the Regulation is not fully addressed**. Ultimately, this alone undermines the integrity of the regulation, and is likely to cause significant operational and risk management issues for liquidity providers and intermediaries once implemented.

To the extent that 'participants' remain liable for risks arising from the buy-in process, **this still creates additional and unwarranted risks for non-trading entities** (essentially the custodian or settlement agent of the failing trading party). It is not unusual for a buy-in price to be contested, particularly where it is deemed to be executed 'off-market'[2]. In a mandatory buy-in regime, where the volume of buy-ins is likely to be considerably higher than present, such disputes should increase exponentially. According to the draft RTS, such disputes will now become the problem, and risk, of the receiving participant, and not the purchasing trading party, since they will be liable to pay any buy-in price differential in the event that the trading party does not.

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[1] 'Participant' in the context of CSDR refers to the settlement agent or custodian of the relevant trading parties.
[2] Buy-in prices are often above market due to the fact that the buy-in is executed for 'guaranteed delivery' and also due to the signalling mechanism of the buy-in process that announces a 'distressed buyer'

A further challenge to the regulation will be enforceability, particularly in jurisdictions outside of the EU. The RTS stipulate that CSD participants are liable for ensuring through their contractual arrangements with their clients that the buy-in requirements are enforceable in all relevant jurisdictions in respect of the relevant parties through the settlement chain. Creating such a binding contractual framework, particularly with trading parties and settlement participants outside of the EU, is unlikely to be straightforward and will create yet another competitive disadvantage for EU investment firms, participants, and CSDs.

With regards to implementation, ESMA once again reiterates its proposal for **a phased-in approach for implementation** (essentially a 24 month delay) to all ow for the necessary IT development across the industry to support the process.

A summary of the key RTS and recitals are provided below:

Summary of the draft RTS for CSDR mandatory buy-ins

Execution level

- For transactions not cleared by a CCP, the **trading parties** that originally concluded the relevant transaction should be responsible for executing the buy-in.
- The failing trading party is responsible for paying the buy-in price differential or cash compensation, and associated costs.
- In the event of **a buy-in**, where the failing trading party does not pay the price difference or costs related to the **buy-in**, **the failing participant will be liable**[3]**.**
- **In the event of cash compensation**, where the failing trading party does not pay the price difference or costs related to the cash compensation, **the failing participant will not be liable.**
- To avoid unnecessarily increasing risk, trading venues and CSDs are not actively involved in the execution of buy-ins.
- The text explicitly allows parties in a settlement chain to "coordinate their actions" in order to avoid multiple buy-ins, which seems to provide for a **pass-on mechanism**.

Timeframes for the buy-in process

- The buy-in process shall be triggered **7 business days after intended settlement date** for all financial instruments except equities. Buy-ins for equities will be triggered either 4 business days (liquid) or 7 business days (illiquid) after intended settlement date, as determined by MiFID II liquidity calibrations.

[3] This is specified in the recitals (36), rather than in the draft RTS

- The timeframe to deliver the instruments being bought-in (i.e. the time from the start of the buy-in process to settlement of the buy-in) is also **7 business days**, except for liquid equities (4 business days).
- Where the buy-in fails or is not possible, and where the **receiving trading party** chooses to defer the buy-in, the timeframe outlined for the original buy-in process will also apply (7 business days for all instruments other than liquid equities).

Payment of the buy-in or cash compensation price difference and costs

- Where the buy-in is successful, the difference between the buy-in price and the original transaction price is paid by the failing trading party, but only in the event that the buy-in price is higher than the original transaction price.
- In the case that the buy-in price is lower than the original transaction price, the corresponding difference "shall be deemed paid".
- This partially addresses the error in the Level 1 text[4] which outlines the direction of payment in the opposite direction. However, it still creates an unresolvable asymmetry in the event that the buy-in price is lower than the original transaction price.
- Where the failing trading party does not pay the price difference, the failing participant will reimburse the receiving trading party.
- The failing trading party will also be responsible for any related costs (including execution fees). Where the failing trading party does not pay these, the failing participant will reimburse the receiving trading party[5].
- The same asymmetric treatment of the payment of the differential also applies to cash compensation, with payment being made by the failing trading party only in the case where the cash compensation reference price is higher than the original transaction price[6].

Cash compensation

- Where the buy-in is not successful and the receiving trading party does not elect to defer the buy-in, or where a deferred buy-in is not successful, the process will default to cash compensation.
- The cash compensation payable is the difference between the market value of the relevant instrument the day before the compensation is due to be paid and the original transaction value

[4] Article 7(6) of the CSDR (Level 1) states: *'where the price of the shares agreed at the time of the trade is higher than the price paid for the execution of the buy-in, the corresponding difference shall be paid to the receiving participant by the failing participant…'.* This is the opposite direction of the normal buy-in process, although it has been suggested that the drafters of the regulation assumed that the bought-in securities would be delivered to the failing party/participant, rather than to the receiving party/participant.
[5] According to Recital 36 of the draft RTS
[6] This asymmetric treatment is more explicitly provided for in Article 7(7) of the Level 1 regulation

(or market value on trade day in case of FoP instructions), as determined by the buy-in agent (for non-cleared transactions) or CCP (for cleared transactions).

- Where the settlement amount is equal or higher than the market value on the day before the compensation is due, cash compensation is null, i.e. it again applies only in one direction (see *footnote 2* below).
- The reference price for the cash compensation is determined by:
    - The closing price of the most relevant market in terms of liquidity (where traded on an EU venue), as defined by MiFID II[7]
    - The closing price of the EU trading venue with the highest turnover
    - A pre-determined methodology based on available data
- The reference value and methodology must be disclosed in detail to the relevant trading parties or clearing members.
- For non-cleared transactions, where the failing trading party does not pay the cash compensation, **the failing participants will not be liable to cover the obligation**.

Contractual arrangements and extraterritoriality

- All parties in the settlement chain shall be bound by appropriate contractual arrangement to enforce the buy-in obligations.
- CSD participants are responsible for ensuring, through their contractual arrangements with clients, that the buy-ins requirements are enforceable in all relevant jurisditctions.

The buy-in agent

- The buy-in agent should have no conflict of interest and should act in the best interest of the failing trading party (or participant).

Exemption for SFTS

- Mandatory buy-ins will not apply to SFTs of fixed terms less than 30 business days. This exemption appears to apply to both the start- and end-legs.
- It is not clear whether this exemption will also apply to open trades.

[7] See Article 16 of ESMA's draft RTS 22

Non-cleared transactions executed on trading venues

- The buy-in process is executed by the relevant trading venue members (i.e. the trading parties), not the trading venue. Importantly, trading venue members (i.e. the trading parties) are responsible for appointing a buy-in agent, not the trading venue.
- Where there is no direct feed between the trading venue and the CSD, the participant shall identify the trading venue in its settlement instructions. Where this information is not available, the transaction shall be treated as OTC.

Mandatory partialing and delivery

- Mandatory partialing should apply on the last day of the extension period, except for the situation where the delivering participant has put instructions on hold.
- The failing party or participant should be able to deliver the relevant instruments to the receiving party or participant up until they are informed that a buy-in agent has been appointed or buy-in auction launched.
- After notification of the buy-in, it is possible for the failing party to deliver the relevant instruments directly to the buy-in agent, or into the buy-in auction, with express consent.

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