



# CSD Regulation Settlement Discipline: mandatory buy-ins

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## Agenda

1. CSDR Settlement Discipline & mandatory buy-ins
2. Conventional buy-ins vs CSDR mandatory buy-ins
3. The CSDR mandatory buy-in asymmetry
4. Potential risks and adverse behavioural impacts of CSDR mandatory buy-ins
5. Challenges of applying CSDR mandatory buy-ins to SFTs
6. What is ICMA doing about CSDR-SD?
7. Conclusion

## 1. CSDR Settlement Discipline & mandatory buy-ins

## What is CSD Regulation & CSDR Settlement Discipline?

- CSD Regulation (CSDR) is an EU regulation which introduces measures for the authorization and regulation of EU central securities depositories (CSDs).
- While much of the regulation focuses on the prudential, organizational, and business standards of CSDs, some of its requirements directly affect trading level entities that settle trades on EU CSDs. This **includes measures to address settlement fails**.
- Chapter III of the Regulation deals with **Settlement Discipline**. Article 7 provides for measures to address settlement fails, which includes **cash penalties** for settlement fails and **mandatory buy-ins**.

## What is the scope of CSDR Settlement Discipline?

- Settlement Discipline will apply to all transactions intended to settle on an EU CSD<sup>1</sup> in transferable securities, money-market instruments, units in collective investment undertakings, and emissions allowances,<sup>2</sup> which are admitted to trading or traded on a trading venue or cleared by a CCP.<sup>3</sup>
- This will apply to all **trading level entities regardless of their domicile**, that enter into such transactions that settle on an EU CSD, whether directly as CSD members, or indirectly via a settlement or clearing agent (a “CSD participant”).
- It is important to note that initiating the CSDR buy-in process is a **regulatory requirement** and not a right.
- Securities financing transactions (SFTs) are in scope of settlement discipline.<sup>4</sup>
- SFTs with terms  $\geq 30$  business days are in scope of mandatory buy-ins.<sup>5</sup>

<sup>1</sup> Articles 1(1) and 1(2)

<sup>2</sup> Article 5(1)

<sup>3</sup> Article 7(10)

<sup>4</sup> Article 7(4)(b)

<sup>5</sup> RTS: Article 22(2)

## Ensuring extraterritorial scope of CSDR mandatory buy-ins

- The RTS outline provisions to ensure that all parties in the settlement chain are brought into scope of the CSDR mandatory buy-in requirements, regardless of their jurisdiction or domicile:

RTS: Article 25

### Contractual arrangements and procedures

1. **Parties in the settlement chain shall establish contractual arrangements with their relevant counterparties that incorporate the buy-in process requirements** specified in paragraph 2 and the procedures specified in paragraph 3.
2. The contractual arrangements referred to in paragraph 1 shall fully incorporate the applicable requirements set out in Article 7 of Regulation (EU) No 909/2014 and Articles 26 to 38 of this Regulation. **Each party in the settlement chain shall ensure that the contractual arrangements established with its relevant counterparties are enforceable in all relevant jurisdictions.**
3. **CCPs, clearing members, trading venue members or trading parties shall establish the necessary procedures to execute the buy-in, pay the cash compensation, the price difference and the buy-in costs within the required timeframes.** The contractual arrangements and the procedures referred to in this Article shall include the necessary provisions to ensure that the relevant parties in the settlement chain receive the information required to exercise their rights and obligations in accordance with the timeframes specified in Articles 26 to 35 of this Regulation.
4. **The participants shall establish the necessary contractual arrangements with their clients to ensure that the buy-in requirements set out in this Regulation are enforceable in all the jurisdictions to which parties in the settlement chain belong.**

## When does CSDR Settlement Discipline come into force?

- CSDR was passed into law in August 2014.
- The draft RTS for mandatory buy-ins were submitted by ESMA in February 2016 and adopted by the European Commission in May 2018.
- Following a three-month period for scrutiny by the European Parliament and EU Council, the RTS were published in the Official Journal in September 2018.
- The provisions for settlement discipline will be applied after 24 months, so **September 2020**.

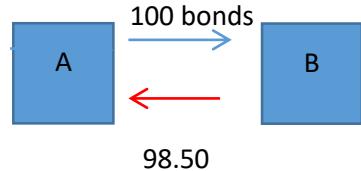
## 2. Conventional buy-ins vs CSDR mandatory buy-ins

## What is a buy-in?

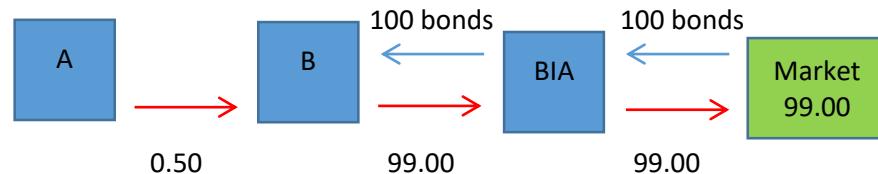
- In the event of a settlement fail, a buy-in mechanisms provide a buyer of securities the contractual right to source the securities elsewhere (usually for guaranteed delivery), cancel the original trade, and settle between the two original counterparties any differences arising from the net costs of the original transaction and the buy-in transaction.
- A key feature of conventional buy-ins (such as the ICMA Buy-in Rules, used in the cross-border non-cleared bond markets) is that the economics of the original transaction are preserved, and that neither party is inadvertently disadvantaged or advantaged as a result of the buy-in.
- Standard buy-ins are not a ‘penalty mechanism’, they are a contractual remedy to provide for physical settlement of a trade.
- They are also executed at the discretion of the failed-to (non-defaulting) entity, as a right and not an obligation.
- Traditionally the buy-in is executed by a buy-in agent: an independent 3<sup>rd</sup> party appointed by the non-defaulting party (although this requirement was recently removed from the ICMA Buy-in Rules).

## Conventional buy-in

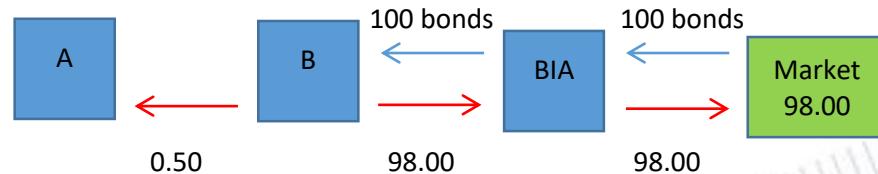
### Original trade



### Buy-in at a higher price



### Buy-in at a lower price



## What is a CSDR mandatory buy-in?

- Executed at trading level (similar to conventional buy-in mechanisms).
- For non-centrally cleared trades, requires the appointment of a buy-in agent.
- Buy-in process is automatically triggered 4 business days after intended settlement date (ISD) for liquid<sup>1</sup> equities, and 7 business days after ISD for all other instruments, including bonds (called the “extension period”).
- Buy-in must be completed (settled) within 4 business days<sup>1</sup> for liquid equities, and 7 business days for all other instruments.
- If buy-in is not possible, the non-defaulting party can initiate one more attempt (the “deferral period”). Otherwise the buy-in will result in “cash compensation”.
- SFTs with terms  $\geq$  30 business days are in scope.
- **The payment of the buy-in / cash compensation is asymmetrical and can only be paid in one direction.**

<sup>1</sup> As determined by Article 4(6)(b) of Regulation (EU) No 600/2014 (MiFIR)

## Key differences between ICMA Buy-in Rules and CSDR mandatory buy-ins

ICMA Buy-in Rules	CSDR
<b>Discretionary:</b> can be initiated at any time from ISD+1	Mandatory: must be initiated on ISD+4 (liquid equities) or ISD+7
<b>Non-defaulting party can elect time between notification and date of buy-in (4 to 10 days)</b>	No defaulting party must start buy-in process following the extension period
<b>Buy-in process can run indefinitely</b>	Buy-in must be completed in 4 or 7 days, with option to attempt ('defer') for one more attempt
<b>No requirement to appoint a buy-in agent</b>	Requirement to appoint a buy-in agent
<b>Buy-in differential (buy-in price vs original price) is paid in either direction between seller and buyer depending on which is higher/lower.</b>	Buy-in differential payment is asymmetrical, and is only paid by the seller to the buyer where the buy-in price is higher. Where it is lower, the differential is "deemed paid".
<b>Cash compensation is possible, but not prescribed.</b>	Cash compensation is prescribed.
<b>Pass-on mechanism to provide for single buy-in to settle settlement chains</b>	No pass-on mechanism
<b>Applies to all firms trading under ICMA Rules (usually members) in 'international securities'. The ICMA Rules form part of the contractual trading agreements between member firms.</b>	Applies to all transactions intended to settle on an EU/EEA CSD in transferable securities, money-market instruments, units in collective investment undertakings, and emissions allowances, which are admitted to trading or traded on a trading venue or cleared by a CCP.

<sup>[1]</sup> Defined as a security intended to be traded on an international, cross-border basis (ie between parties in different countries), and capable of settlement through an international central securities depository or equivalent.

### 3. The CSDR mandatory buy-in asymmetry

## The CSDR mandatory buy-in asymmetry

### Level 1: Article 7(6)

Without prejudice to the penalty mechanism referred to in paragraph 2, 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 no later than on the second business day after the financial instruments have been delivered following the buy-in.

### RTS: Article 35

#### Payment of the price difference

1. Where the price of financial instruments referred to in Article 5(1) of Regulation (EU) No 909/2014 agreed at the time of the trade is lower than the price effectively paid for those financial instruments pursuant to Articles 27(10), 29(10), and 31(10), the failing clearing members, failing trading venue members or failing trading parties shall pay the price difference to the CCP, receiving trading venue members or receiving trading parties, as applicable.

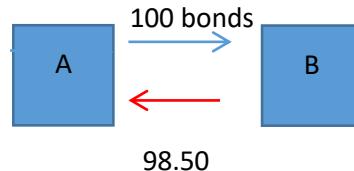
Where transactions are cleared by a CCP, the price difference referred to in the first subparagraph shall be collected from failing clearing members by the CCP and paid to the receiving clearing members.

2. Where the price of the shares agreed at the time of the trade is higher than the price effectively paid for those shares pursuant to Article 27(10), Article 29(10) and Article 31(10), the corresponding difference referred to in Article 7(6) of Regulation (EU) No 909/2014 shall be deemed paid.

\* Footnote added by ICMA. This would normally be expected to read “lower”, rather than “higher”, to be consistent with market practice. In the case that the price agreed at the time of the trade is *higher* than the price paid for the execution of the buy-in, the corresponding difference is normally paid **by** the receiving party **to** the failing party.

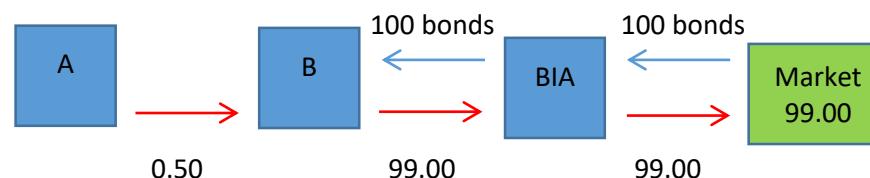
## CSDR mandatory buy-in

### Original trade



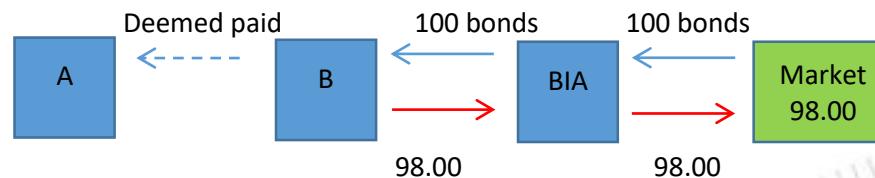
- In other words, the CSDR asymmetry has the potential to change the economics of the original trade

### Buy-in at a higher price



	A	B
P&L before buy-in	(0.50)	+0.50
P&L after buy-in	(0.50)	+0.50
P&L impact of buy-in	0	0

### Buy-in at a lower price \*



	A	B
P&L before buy-in	+0.50	(0.50)
P&L after buy-in	0	0
P&L impact of buy-in	(0.50)	+0.50

\* This is the economic equivalent of the seller of bonds also writing a 'free' at-the-money put option which becomes active in the event of a buy-in. The purchaser is effectively long the put.

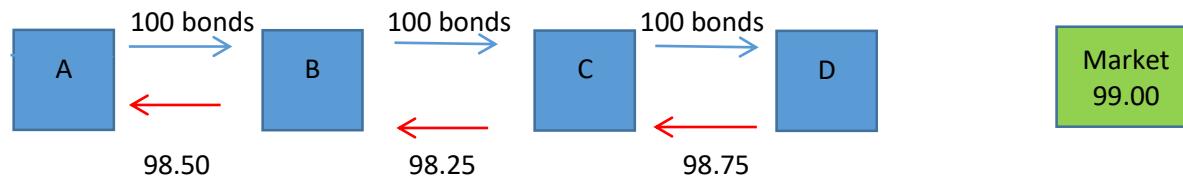
#### 4. Potential risks and adverse behavioral impacts of CSDR mandatory buy-ins

## Potential risks and adverse behavioral impacts of CSDR mandatory buy-ins

- Due to mandatory cash compensation investors can be certain that they 'own' the securities they purchase until they settle:
  - This creates economic risks for investors with respect to the reference price used to determine the cash compensation and also the possibility of having to unwind related positions (FX, IRS, CDS, govie hedges, etc.)
- Increased risk of being bought-in, as well as the **additional market risk created by the asymmetry**, is a disincentive to shorting and offer-side liquidity.
- Additional risks to lenders of securities:
  - If bonds are not returned in time to prevent a buy-in against an onward sale, the lender may not be able to pass-on any buy-in costs, particularly those caused by the **asymmetry**.
- Pass-ons may no longer be possible, leading to single fails triggering multiple buy-ins:
  - Since mandatory buy-ins are triggered on a prescribed timeline, each settlement date in a transaction chain will trigger its own buy-in.
  - Due to the **asymmetry**, even for transaction chains with the same settlement date, the additional risk to intermediaries will make initiating an immediate (contractual) buy-in optimal, rather than waiting for the mandatory buy-in to be triggered.

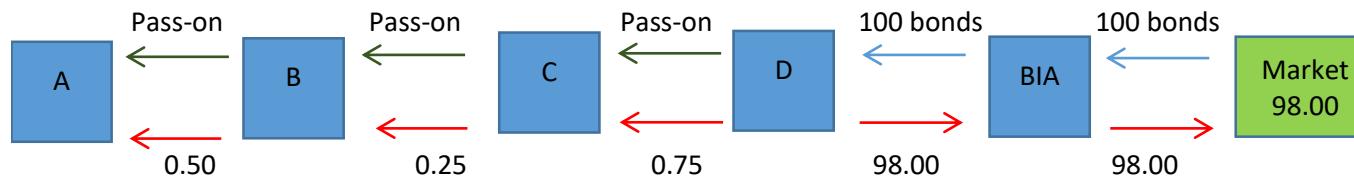
## The impact of the CSDR asymmetry on buy-in chains

### Original trade



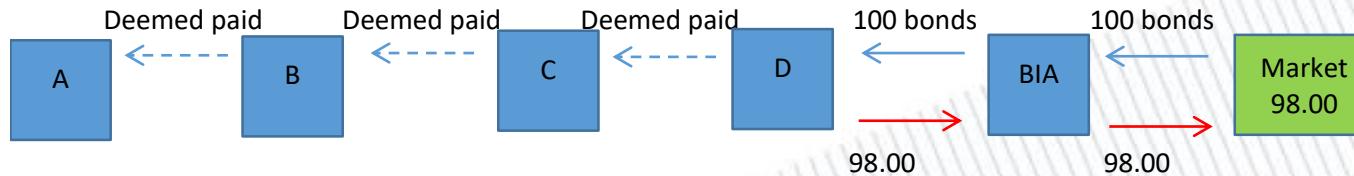
	A	B	C	D
P&L	(0.50)	(0.25)	+0.50	+0.25

### Conventional buy-in with 'pass-on'



	A	B	C	D
P&L before buy-in	0	(0.25)	+0.50	(0.25)
P&L after buy-in	0	(0.25)	+0.50	(0.25)
P&L impact of buy-in	0	0	0	0

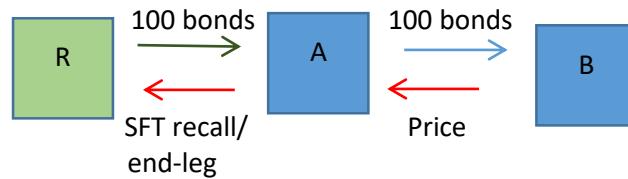
### CSDR buy-in



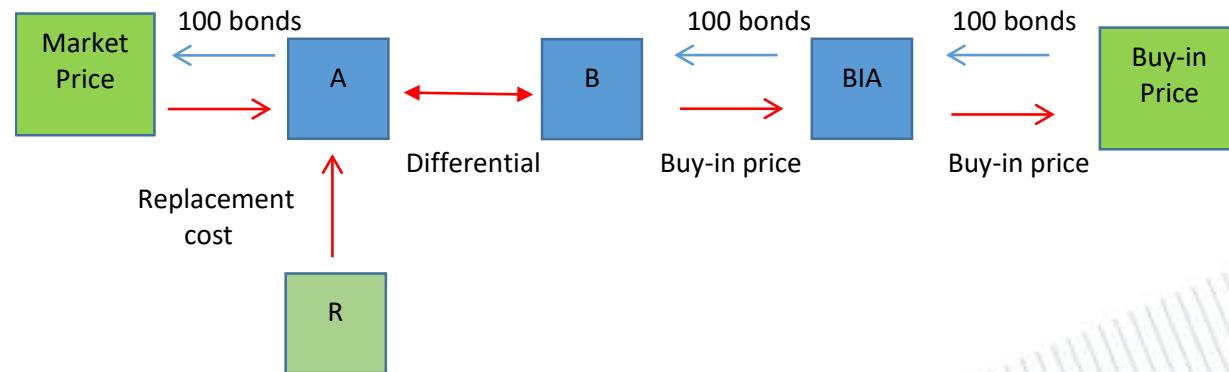
	A	B	C	D
P&L before buy-in	+0.50	(0.25)	+0.50	(0.75)
P&L after buy-in	0	0	0	0
P&L impact of buy-in	(0.50)	+0.25	(0.50)	+0.75

## The risks to lending securities

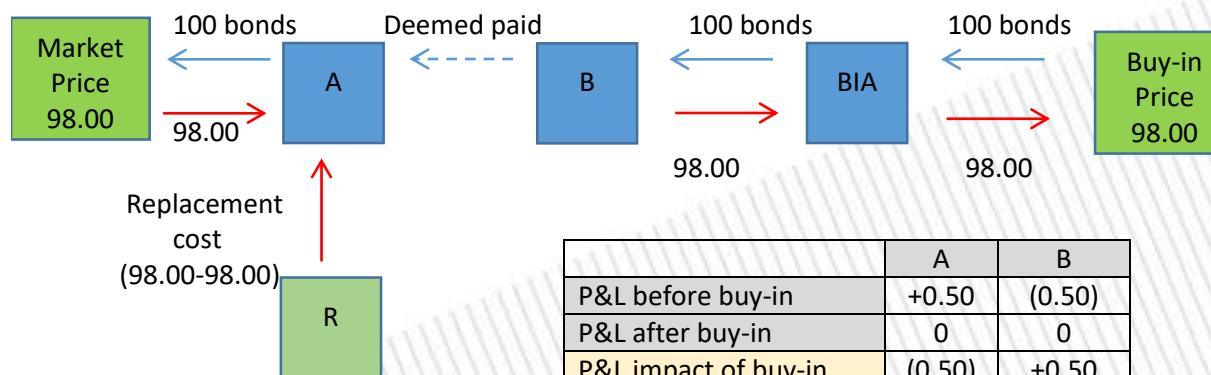
### Repo recall



### Passing on the buy-in costs (theory)



### Buy-in costs arising from the CSDR asymmetry



## 5. Challenges of applying CSDR mandatory buy-ins to SFTs

## Challenges of applying mandatory buy-ins to SFTs

- If you buy-in against the start-leg, does the end-leg remain valid?
- If a buy-in against the start-leg results in cash compensation, what happens to the end leg? Does that remain valid?
- How is the settlement of the buy-in/cash compensation determined? Is this based on the price assigned to the start-leg?
- How do you apply the asymmetry to buy-ins against SFTs?
- How do you account for haircuts in determining the appropriate buy-in/cash compensation differential payment? Does the asymmetry still apply in the case of haircuts?
- What happens to open trades if they reach 30 business days?
- Will CCPs require separate netting pools for in- and out-of-scope SFTs?
- How do you manage the buy-in risk in a matched-book with both in- and out-of-scope SFTs?

*These issues are discussed (and illustrated) in the forthcoming ICMA discussion paper: "CSDR mandatory buy-ins and securities financing transactions"*

## 6. What is ICMA doing about CSDR-SD?

## What is ICMA doing about CSDR-SD?

- Raising awareness of scope, details, and potential implications
- Working with ESMA, members, and other industry bodies to support implementation
  - In particular, ICMA is exploring the possibility of [aligning its Buy-in Rules with the CSDR framework](#), while also providing a contractual means to address the asymmetry
- Continuing advocacy with regulators and policy makers with a view to delaying/amending the CSDR mandatory buy-in provisions
  - ICMA's [position](#) is that cash penalties should be made more punitive as a less disruptive alternative to applying the mandatory buy-in regime

ICMA has established a [Working Group](#) focused on these aspects of CSDR-SD

## 7. Conclusion

## Conclusion

- CSDR Settlement Discipline (due to come into force from Sep/Oct 2020) creates a regulatory obligation for trading parties to buy-in failing (selling) counterparties.
- **The regulatory obligation to buy-in is based on the jurisdiction of the (I)CSD and the nature of the underlying security – regardless of the domicile or jurisdictions of the trading parties.**
- The regulation sets out very precise guidelines for the buy-in process, including timings.
- The buy-in mechanism has an asymmetry in how the buy-in cash flows are settled. In many cases this will create windfall profits for the failed-to party and additional market risks and losses for the failing party. This is broadly understood to be the unintended consequence a drafting error in the Level 1 text that cannot be changed.
- Mainly as a result of the asymmetry, the CSDR mandatory buy-in design is likely to create adverse behavioral incentives, including the likelihood of multiple buy-ins being triggered across transaction chains as a result of individual fails.
- Due to the inherent relationship between cash and SFT markets, the regulation will also have a significant indirect impact on repo and securities lending, mot least as a result of the asymmetry.
- The CSDR mandatory buy-in regime is widely expected to have disproportionate negative impacts with respect to European capital market efficiency, liquidity, and stability.

Related ICMA Papers:

[CSDR Settlement Discipline: mandatory buy-ins](#)  
July 2018 (Information Brochure)



CSDR Settlement Discipline  
Mandatory buy-ins  
European settlement regulation with global trading implications



[How to survive in a Mandatory Buy-in World](#)  
June 2018 (Discussion Paper)



How to Survive in a  
Mandatory Buy-in World  
An ICMA Discussion Paper by Michael Pyne and Christopher  
An executive copy of this document is available on request, or on download from the  
ICMA website at [www.icmagroup.org/mifid-ii-implementation-2/](http://www.icmagroup.org/mifid-ii-implementation-2/)



More information and resources can be found on the dedicated MiFID II landing page on the ICMA website:

<https://www.icmagroup.org/resources/other-information/mifid-ii-implementation-2/>

Regulatory texts:

[CSD- Regulation \(EU\) No 909/2014](#)

[Delegated Regulation \(“Level 2”\) 25.5.2018](#)

[CSDR Frequently Asked Questions \(September 2014\)](#)

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