CSDR Settlement Discipline – Implications for trading and documentation in Asia-Pacific

Lisa Cleary
Senior Director
Associate Counsel
ICMA

Andy Hill
Senior Director, Market Practice and Regulatory Policy
ICMA

Mushtaq Kapasi
Managing Director, Market Practice and Regulatory Policy
ICMA

@ICMAgroup

CSDR-SD: implications for APAC

Agenda

- Existing market remedies for settlement fails in the non-cleared bond and repo markets
- CSDR Settlement Discipline: scope and provisions
- How is ICMA supporting implementation for its members?
- What are the potential implications for bond market functioning and liquidity?

CSDR-SD: implications for APAC

ICMA International Capital Market Association

Agenda

- **Existing market remedies for settlement fails in the non-cleared bond and repo markets**

CSDR-SD: implications for APAC

Existing remedies in the non-cleared bond and repo markets

- **ICMA Secondary Market Rules & Recommendations**
  - Interest claim against buyer (Rule 405)
  - Claim against seller (Rule 407)
  - Buy-in (Section 450)
  - Sell-out (Section 480)

- **Global Master Repurchase Agreement (GMRA 2000 & 2011)**
  - Default notice
  - Early termination
  - Mini close-out

CSDR-SD: implications for APAC

ICMA Buy-in Rules

- The ICMA Buy-in Rules are part of the ICMA Secondary Market Rules & Recommendations. The Rules apply between members and/or through incorporation by reference in firms' terms of business. The Buy-in (and Sell-out) Rules apply to transactions in international securities,[1] and are broadly applied in the case of bonds.
- In the event of a settlement fail the buyer of securities the contractual right to source the securities elsewhere (for guaranteed delivery), cancel the original trade instructions, 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 the ICMA Buy-in Rules 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.[2]
- Buy-ins, generally, 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: and independent 3rd party appointed by the non-defaulting party (although this requirement was removed from the ICMA Buy-in Rules in 2017).
- A 'pass-on' mechanism allows for a single buy-in to be passed along a chain of linked failing transactions.

[1] 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.
[2] There is often a cost incurred by the failing party due to the 'buy-in premium' (i.e. the difference between the buy-in price and where they subsequently re-sell or mark the securities)

CSDR-SD: implications for APAC

Agenda

- **CSDR Settlement Discipline: scope and provisions**

CSDR-SD: implications for APAC

EU CSD Regulation

- 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**.

CSDR-SD: implications for APAC

CSDR-SD Timeline

- CSDR was passed into law in August 2014.
- The draft Regulatory Technical Standards (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 was published in the EU Official Journal in September 2018.
- The provisions for settlement discipline (SD) were due to be applied after 24 months, i.e. **September 13 2020**.
- However, due to a technicality relating to the roll-out of a SWIFT messaging update required to support the implementation of cash penalties, as well as other SD implementation challenges, ESMA has proposed a delay until **February 1 2021**. This has been accepted by the European Commission and is expected to be ratified by the European Parliament and Council in the coming weeks.
- Following further concerns related to implementation, it is now anticipated that implementation of the SD package could be delayed by a further 12 months until February 1 2022.
- The necessary documentation work to support implementation is expected to be in place well in advance of implementation.

CSDR-SD: implications for APAC

CSDR-SD Scope

- Settlement Discipline will apply to all transactions intended to settle on an EU CSD[1] in transferable securities, money-market instruments, units in collective investment undertakings, and emissions allowances,[2] which are admitted to trading or traded on a trading venue or cleared by a CCP.[3]
- 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").
- **Article 25** of the RTS requires all parties in the transaction chain have contractual arrangements in place to enforce the regulatory provisions in all relevant jurisdictions.
- Custodians (and sub-custodians) are expected to put in place amendments to their terms of business that will affectively apply the cash penalty and mandatory buy-in provisions to their customers, regardless of their jurisdiction.

[1] Articles 1(1) and 1(2)

[2] Article 5(1)

[3] Article 7(10)

CSDR-SD: implications for APAC

Cash penalties

- Applies to all failed transactions on EU (I)CSDs
- The failing delivering CSD participant is charged the penalty by the CSD
- The failed-to receiving CSD participant receives the penalty as compensation
- Penalties/compensation are applied at the gross transaction level and credited/debited to participants' accounts monthly.
- CSDs are not permitted to profit directly from the penalty/compensation
- CCPs apply the penalty/compensation regime internally
- Penalty/compensation rates are calculated off the same reference price for each security (updated daily)
- Penalty/compensation rates are fixed by asset type [quoted as an ad valorem fee and applied on a business day basis]
- Penalty rates can be reviewed and revised by ESMA

CSDR-SD: implications for APAC

Cash penalties

Asset class	Daily penalty fee	Annualized equivalent rate
Liquid shares	1.0bp	2.50%
Illiquid shares, ETFs, others	0.5bp	1.25%
SME growth markets	0.25bp	0.62%
Corporate bonds	0.20bp	0.50%
SME bonds	0.15bp	0.37%
Government bonds & munis	0.10bp	0.25%

CSDR-SD: implications for APAC

Mandatory buy-ins

- Executed at trading level (similar to conventional buy-in mechanisms).
- For non-centrally cleared trades, the appointment of a buy-in agent is required.
- Buy-in process is automatically triggered **4 business days** after intended settlement date (ISD) for liquid[1] equities, and **7 business days after ISD** for all other instruments, including bonds (called the "extension period").
- Buy-in must be completed (i.e. settled) within **4 business days** for liquid[1] 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 > 30 business days are in scope.[2]
- The payment of the buy-in / cash compensation is asymmetrical and can only be paid in one direction (i.e. it has the potential to change the economics of the original trade in favour of the buyer).
- There is no pass-on mechanism.
- It is important to note that initiating the CSDR buy-in process is a **regulatory requirement** and not a right.

[1] As determined by Article 4(6)(b) of Regulation (EU) No 600/2014 (MiFIR)

[2] Article 7(4)(b) and RTS Article 22(2)

CSDR-SD: implications for APAC

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

ICMA Buy-in Rules	CSDR
Discretionary: can be initiated at any time from ISD+1	Mandatory: must be initiated following ISD+4 (liquid equities) or ISD+7
Non-defaulting party can elect time between notification and date of buy-in (4 to 10 days)	Non-defaulting party must start buy-in process following the extension period
Buy-in process can run indefinitely	Buy-in must be completed in 4 or 7 business days, with option to attempt ('defer') for one more attempt
No requirement to appoint a buy-in agent	Requirement to appoint a buy-in agent
Buy-in differential (buy-in price vs original price) is paid in either direction between seller and buyer depending on which is higher/lower.	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".
Requirement for Guaranteed Delivery, with completion based on successful execution of the buy-in.	No requirement for Guaranteed Delivery, with completion based on successful settlement of the buy-in.
Cash settlement ("compensation") is possible, but not prescribed	Cash compensation is prescribed (also asymmetrically)
Pass-on mechanism to provide for single buy-in to settle settlement chains	No pass-on mechanism
Applies to all firms trading under ICMA Rules (usually members) in 'international securities'.	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.

CSDR-SD: implications for APAC

Agenda

- **How is ICMA supporting implementation for its members?**

CSDR-SD: implications for APAC

Implementation: non-cleared Bond Markets

Updating the ICMA Buy-in & Sell-out Rules

- Providing a more efficient contractual buy-in process before the CSDR requirements apply
- Providing a contractual framework and markets best practice to support implementation, post-extension period
- Providing contractual solutions to some of the regulation’s more problematic challenges
- Applied through ICMA membership and/or incorporated by reference in Terms of Business

Pre-extension Period (‘PEP”) Buy-in

- Similar to existing ICMA Buy-in Rules
- Can be executed up until the end of the relevant extension period
- Symmetrical price differential payments
- Guaranteed delivery
- Pass-on mechanism
- Ability to negotiate cash settlement

CSDR Buy-in

- CSDR compliant (mirrors regulatory buy-in provisions)
- Intended to allow for contractual enhancements such as symmetrical price differential payments and pass-ons (subject to regulatory guidance)

CSDR-SD: implications for APAC

Implementation: non-cleared Repo Market

Developing a GMRA CSDR-SD Annex

- Annex intended to support compliance with CSDR-SD requirements in the case of in-scope repo transactions
- Developed in parallel with ISLA's work on a GMSLA CSDR-SD Annex
- Expected to be bilaterally applied (multilateral amendments mechanisms will also be considered)
- Original market request to include contractual enhancements (symmetrical payments, pass-ons, etc.) likely to be challenging due to time constraints and lack of regulatory guidance
- Contractual enhancements to support additional commercial considerations possibly to be supported in a second phase (could be after 2021 'go live').

Establishing market best practice

- Possible best practice to use existing contractual provisions before the end of the extension period (to avoid going to a CSDR buy-in)
- How to buy-in a SFT (start-leg/end-leg/cash compensation)
- Adjusting for hair-cuts in determining differential payments
- In March 2020, ICMA published FAQs on CSDR mandatory buy-ins and Securities Financing Transactions. The FAQs are intended to outline considerations and, where possible, to provide clarity with respect to the application of CSDR buy-ins in the case of repos and other SFTs. The FAQs will be updated in light of new guidance from ESMA and agreed market best practice.

CSDR-SD: implications for APAC

Advocacy

- **Raising awareness of scope, details, and potential implications**
- **Ensuring that ESMA is aware of industry implementation challenges**
  - Lack of clarity on outstanding critical issues (asymmetry, pass-ons, scope, etc.)
  - Other potential issues (lack of buy-in agents, cash compensation provisions)
- **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 undertook a 2nd Bond Market Impact Study in fall 2019 (following the previous study of 2015)
  - In January 2020, ICMA joined a cross-industry initiatives to request that the European Commission and co-legislators consider deferring implementation of the buy-in regime (until an assessment of the impact of penalties, as well as a detailed, quantitative analysis of potential impacts of the regime).
  - ICMA's Asset Management and Investors Council (AMIC) is also working with other buy-side associations to raise the concerns of the European and International asset management industry.
  - In May 2020, ICMA wrote to the Commission and ESMA again, outlining concerns related to a lack of Level 3 guidance and also to how the buy-in regime would have impacted the recent Covid-19 related market stresses.
  - In July 2020, ICMA responded to the ESMA Survey on Topics for the CSDR Review. The ICMA response focused on Article 7, calling for the authorities to delay and review MBIs.

CSDR-SD: implications for APAC

Agenda

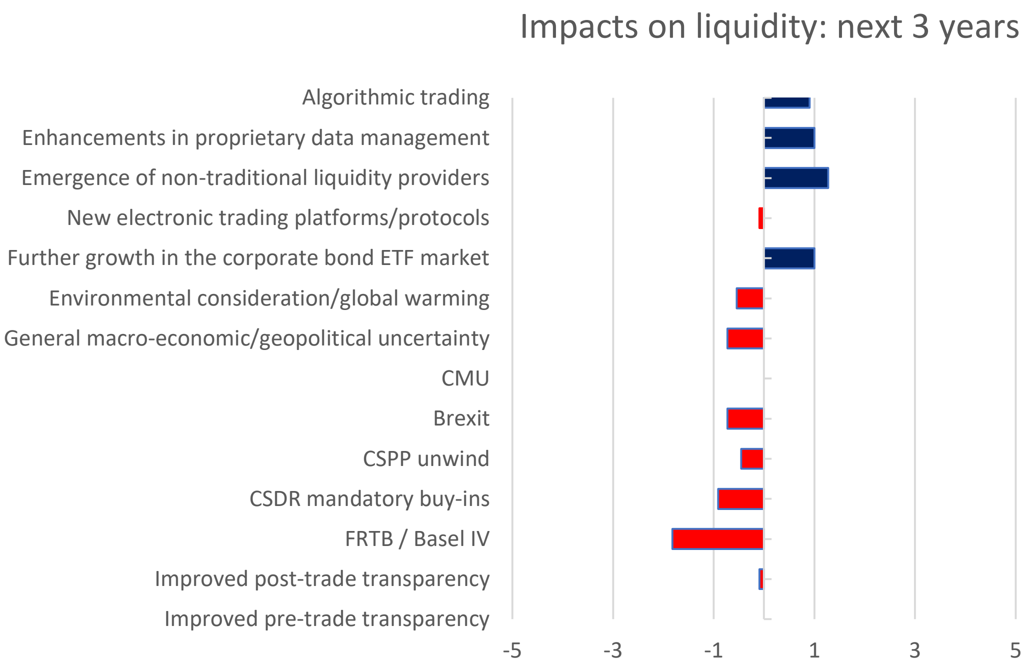
- **What are the potential implications for bond market functioning and liquidity?**

CSDR-SD: implications for APAC

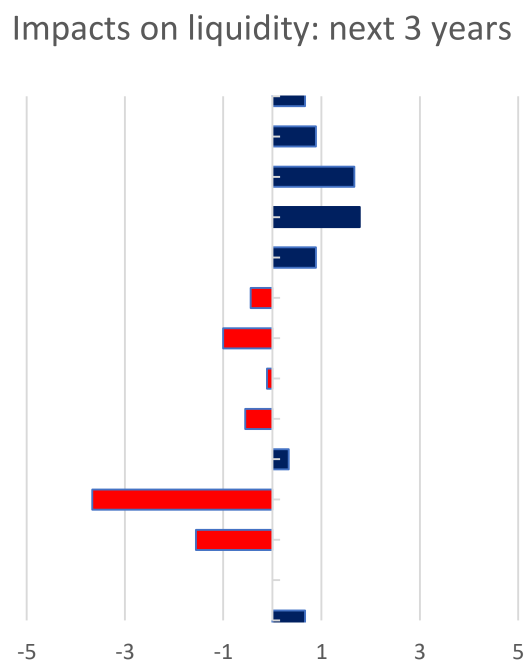
ICMA's 3rd study into the state and evolution of the European IG corporate bond secondary market*

In the next 3 years, what impact do you expect the following factors or initiatives to have on market liquidity, where -5 is very negative, +5 is very positive, and 0 is neutral?

Sell-side



Buy-side



* Final report published in March 2020

CSDR-SD: implications for APAC

ICMA Bond Market Impact Study (2019)

- Follows up on ICMA 2015 **Bond Market Impact Study**

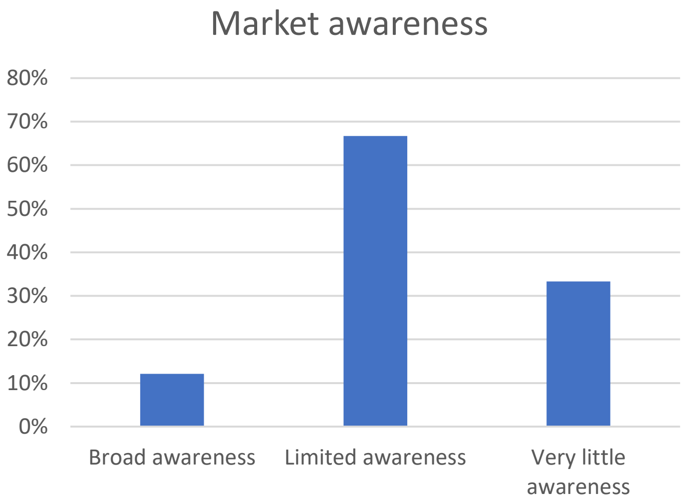
- **Study sets out to answer five questions with respect to the CSDR mandatory buy-in regime:**
  (i) What is the general preparedness of firms both from an operational and trading strategy perspective?
  (ii) How will sell-sides adjust their pricing and liquidity provision across a range of bond sub-classes?
  (iii) What are the expectations of buy-sides with respect to pricing and market liquidity?
  (iv) What are the likely impacts for repo and securities lending?
  (v) What possible refinements or enhancement to the framework could help to mitigate the risks of unintended consequences?

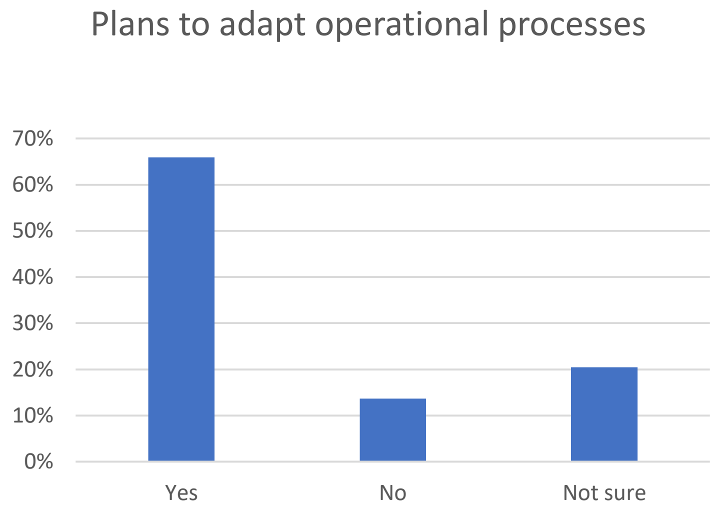
- **Methodology**
  - Survey based with three survey templates: sell-side, buy-side, repo and securities lending desks
  - 44 responses, representing buy-side firms (16), sell-side firms (16), and repo and securities lending desks (12).

- Focus is on euro bond markets, but impacts are expected to extend to all securities settled on EU (I)CSDs

CSDR-SD: implications for APAC

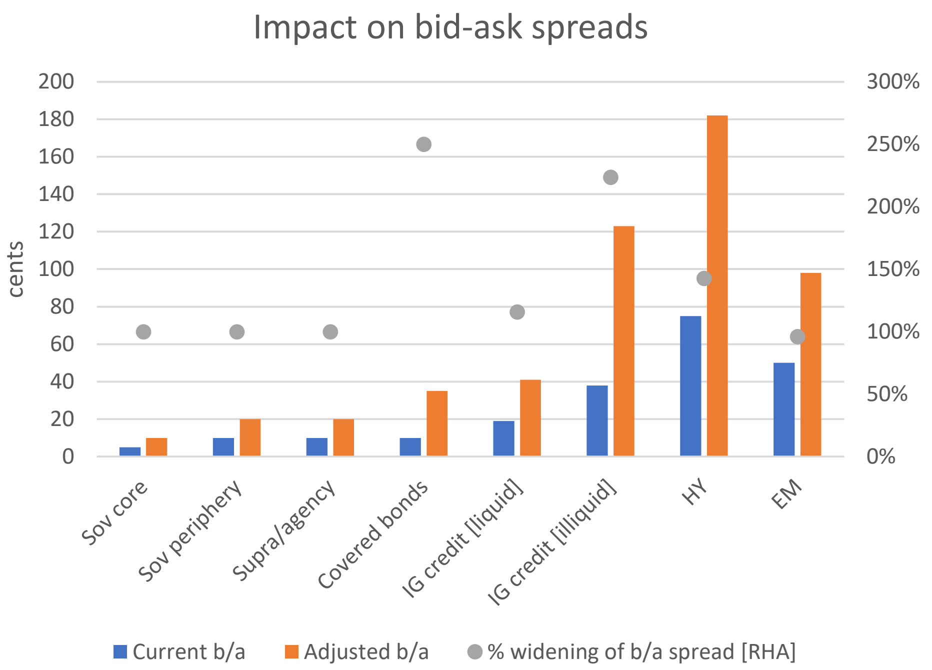
Awareness and preparedness

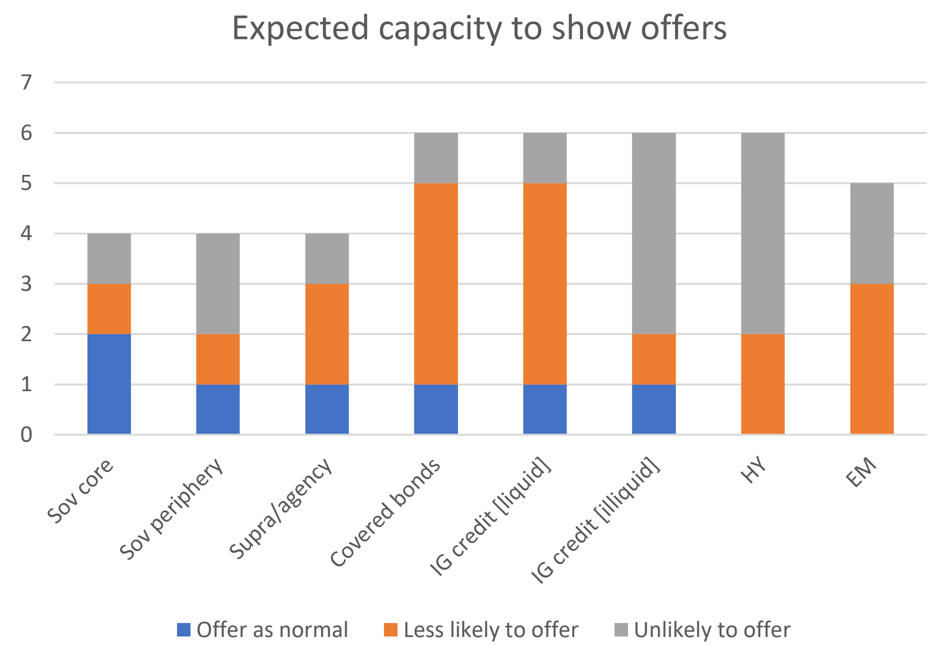




CSDR-SD: implications for APAC

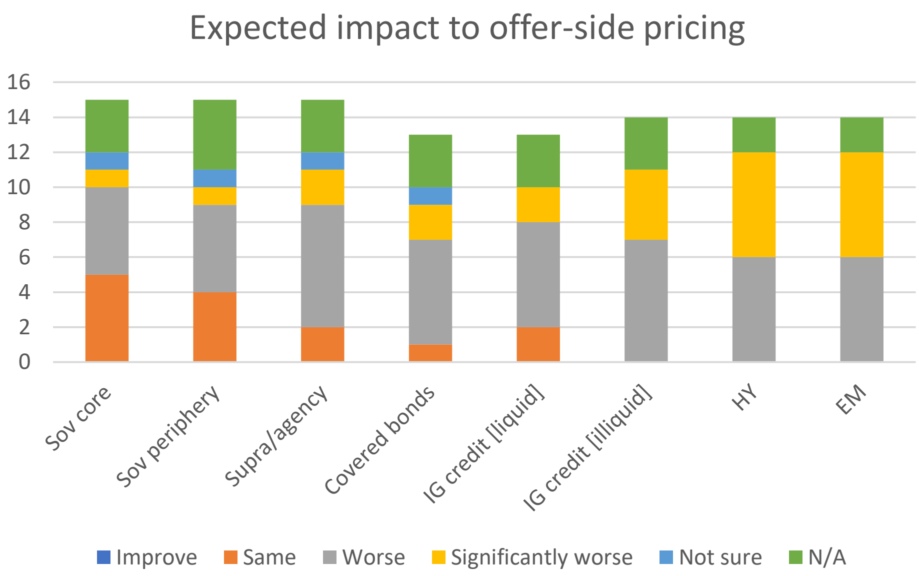
Sell-side pricing and liquidity

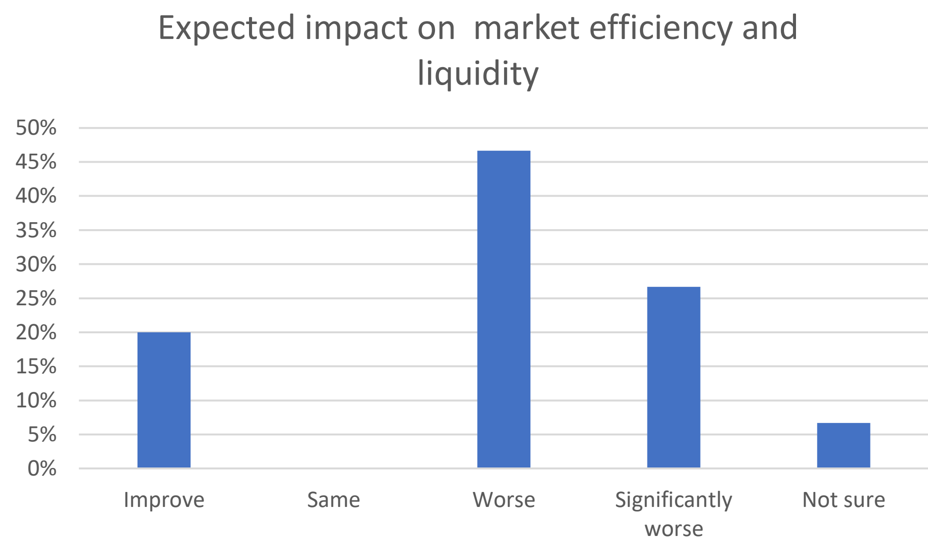




CSDR-SD: implications for APAC

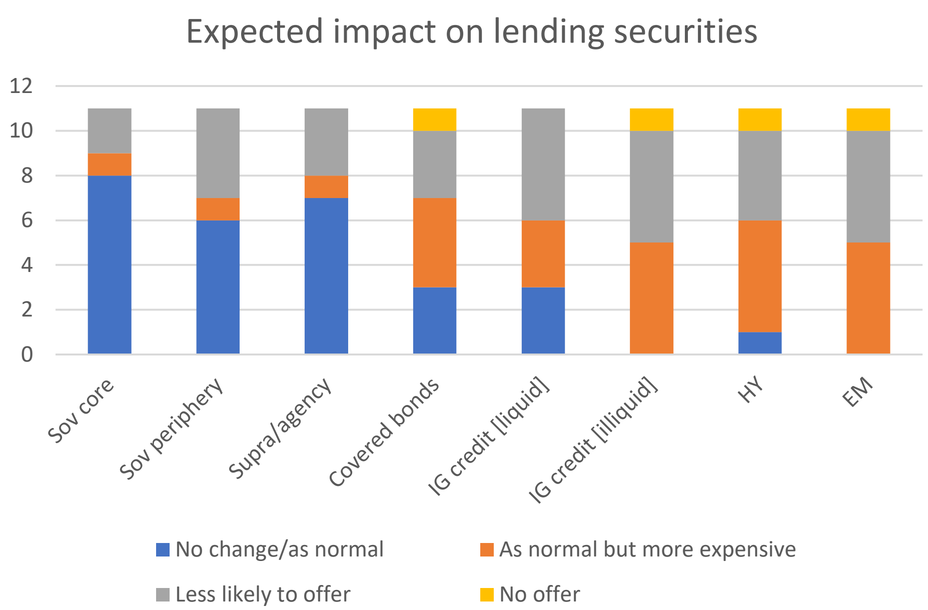
Buy-side expectations

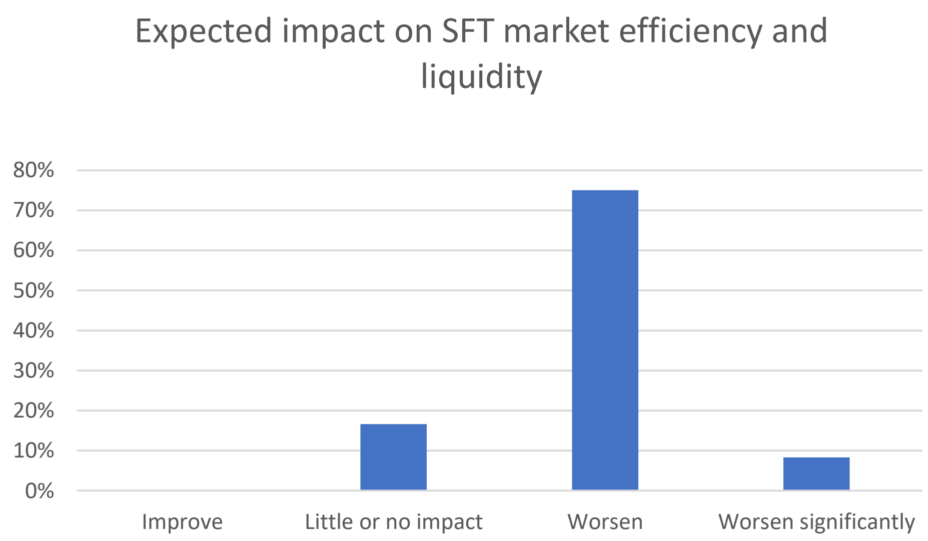




CSDR-SD: implications for APAC

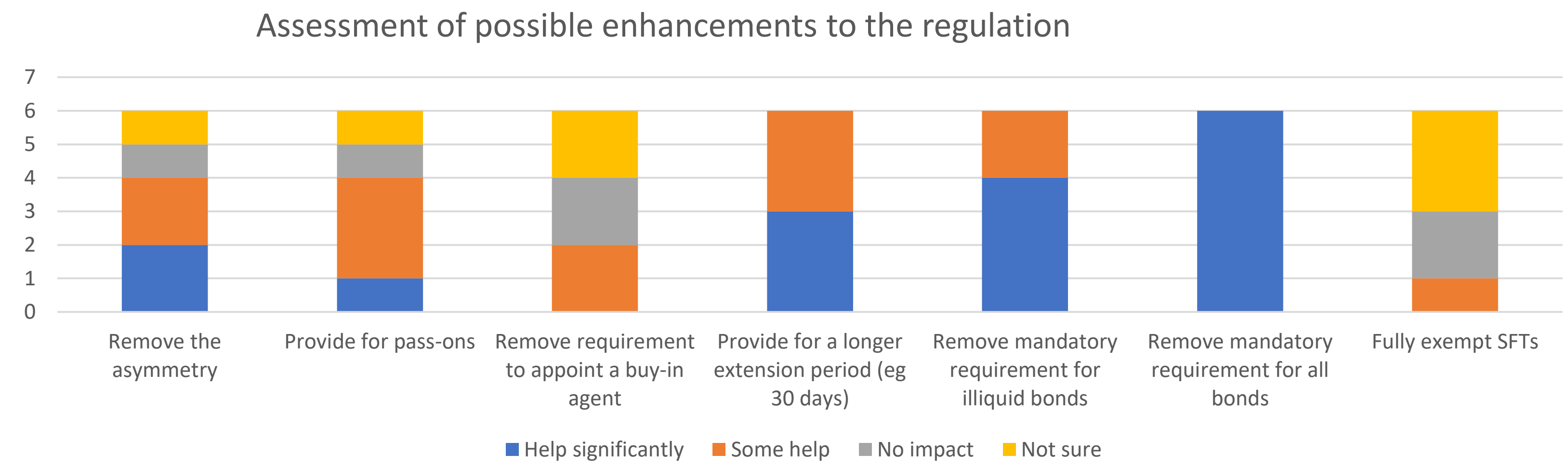
Repo and securities lending

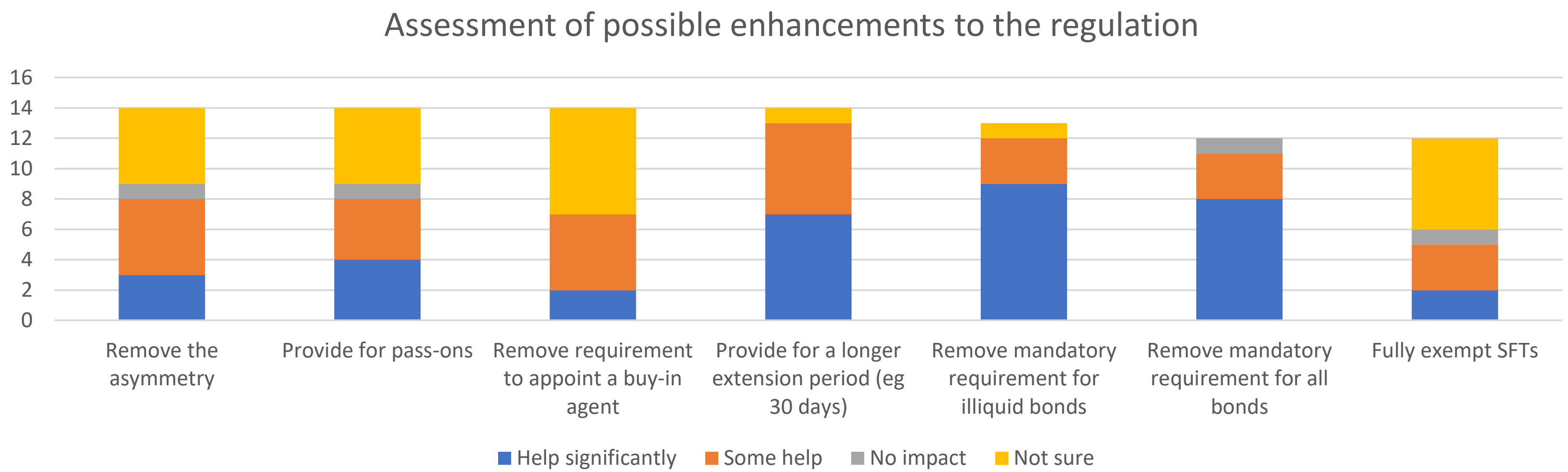




CSDR-SD: implications for APAC

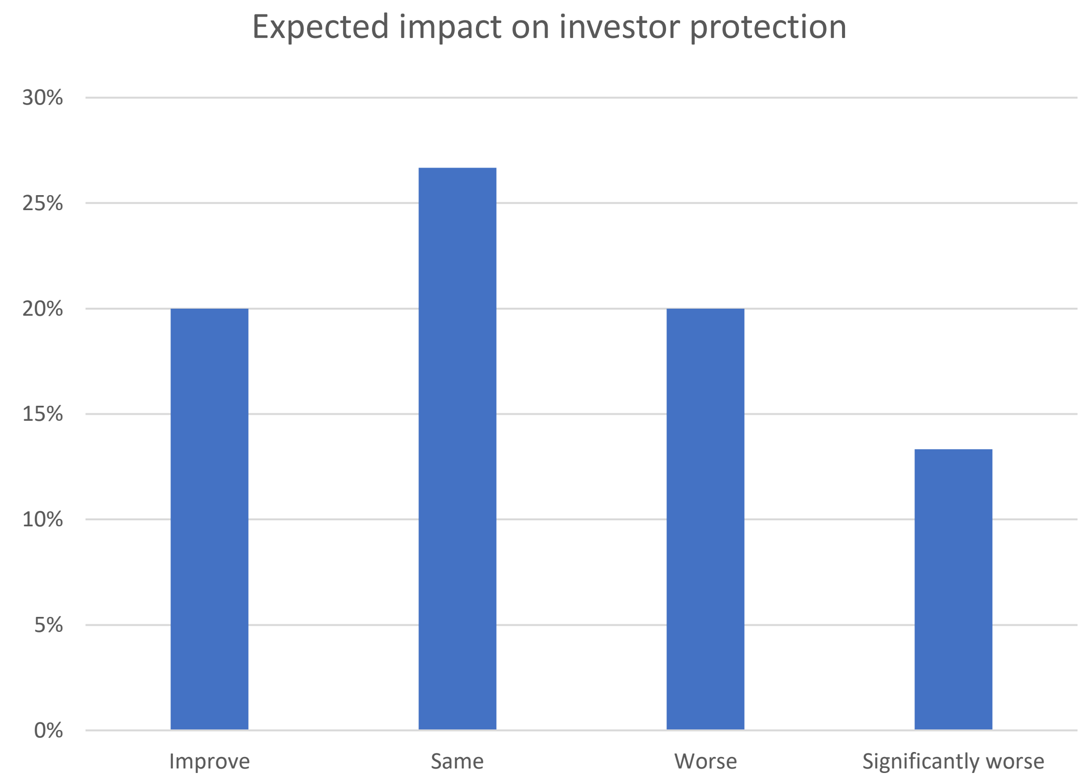
Possible enhancements





CSDR-SD: implications for APAC

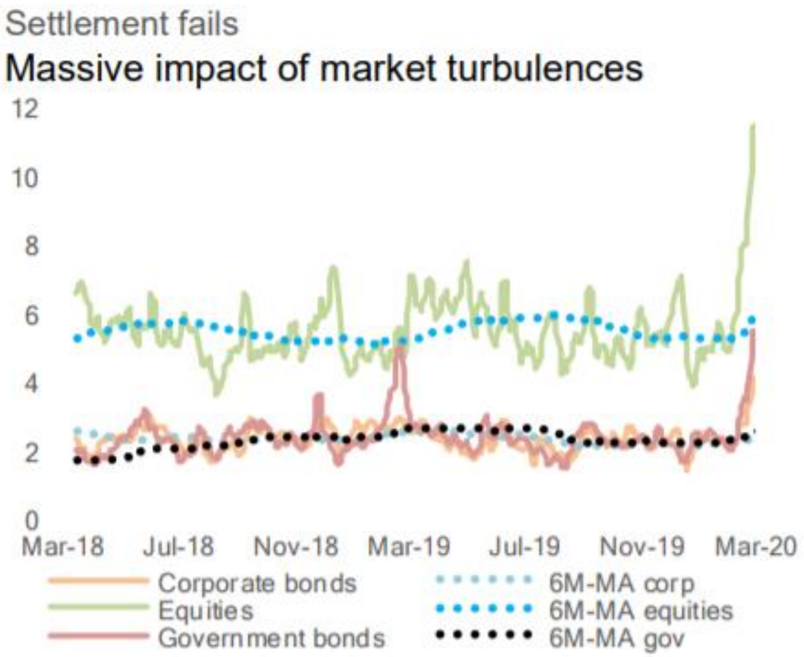
Expected impact on investor protection



CSDR-SD: implications for APAC

2020 Covid-19 Crisis

- It is noted by a number of buy-side and sell-side participants that there was a sizeable, albeit temporary, increase in settlement fails during the height of the crisis. This is largely attributed to operational challenges related to transitioning middle- and back-office teams to disaster off-sites and home-working, as well the impact of lockdowns on outsourced settlement teams (such as those based in India), at a time when overall trading volumes were significantly above average.
- The general view of participants is that mandatory buy-ins would have turned a crisis into a catastrophe.
  - Firstly, the time and resources required to manage the buy-in process (which requires operational, trading, and legal input) would have been a significant drain on already stretched staff.
  - Secondly, trying to buy-in illiquid securities in an already stressed and often chaotic market would only have exacerbated market volatility, while compromising market stability.
  - And thirdly, anything that further restricts market-maker capacity would have been an additional blow to liquidity at a time when it was most needed.



Source: ICMA, 2020, The European investment grade corporate bond secondary market & the COVID-19 crisis

CSDR-SD: implications for APAC

Resources

- May 2020: ICMA **Briefing note** on cash compensation provisions and bond markets
- March 2020: ICMA **FAQs** on CSDR mandatory buy-ins and SFTs
- November 2019: ICMA CSDR buy-in **impact study** for EU bond markets
- August 2019: ICMA **information brochure** on CSD Regulation mandatory buy-ins
- June 2018: **How to survive in a mandatory buy-in world**
- May 2017: ICMA **Position Paper** on CSDR Settlement Discipline

➢ ICMA CSDR settlement discipline: https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/secondary-markets-regulation/csdr-settlement-discipline/

➢ ICMA CSDR-SD Working Group: https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/secondary-market-practices-committee-smpc-and-related-working-groups/csdr-sd-working-group/

❖ REGULATION (EU) No 909/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

❖ COMMISSION DELEGATED REGULATION (EU) 2018/1229 of 25 May 2018 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on settlement discipline

CSDR Settlement Discipline – Implications for trading and documentation in Asia-Pacific

Contacts

Mushtaq Kapasi
Managing Director, Head of ICMA's Asia Pacific Region; Member of the ICMA Executive Committee
mushtaq.kapasi@icmagroup.org
+852 2531 6590

Lisa Cleary
Senior Director, Associate Counsel
lisa.cleary@icmagroup.org
+44 20 7213 0330

Andy Hill
Senior Director, Market Practice and Regulatory Policy; secretary to the Secondary Market Practices Committee and also responsible for overseeing repo policy.
andy.hill@icmagroup.org
+44 20 7213 0335