ICMA CSDR-SD Working Group
ICMA CSDR Legal Workstream

Updating the ICMA Buy-in Rules

Call: March 24, 2020

Meeting notes

Pre-Extension Period ("PEP") contractual buy-ins

It is proposed that the ICMA contractual buy-in framework further be modified to facilitate buy-ins during the extension period, and before the mandatory requirement. This would afford a greater amount of flexibility than the contractual buy-in following the extension period, which will need to be aligned with the CSDR provisions.

- Participants felt that the concept of the 'PEP' and the ability to execute a contractual buy-in before the end of the CSDR extension period was a useful risk management tool.
- In terms of PEP timelines, it was felt that the ability to issue a buy-in, as today, should be possible from ISD+1. It was noted that the current ICMA Rules required a minimum 4 business days' notice, which may be too long to ensure that the buy-in is completed within the extension period (working off an assumption of an applicable 7-day extension period for bonds). However, this would need to be balanced with enough time to facilitate an effective pass-on process. It was also noted that a minimum 2 days' notice would be necessary for the failing party to cover their position, given standard T+2 settlement.
- It was pointed out that in the case of liquid equities (with an extension period of 4 days), a PEP buy-in may be even more constrained.
- It was suggested that while the buy-in could technically be executed on ISD+5, and still settle by the last day of the extension period, it may be desirable to allow a window at the end of the extension period for parties to agree an alternative remedy, such as cash settlement.
- A question was raised as to whether the buy-in would need merely to be executed before the end of the extension period, in order to avoid going to a CSDR buy-in, or would it also need to be settled (possibly limiting execution to ISD+5). ICMA recalled that in the discussions with ESMA around the application of contractual mini close-outs under the GMRA, they suggested that the critical point was that the transaction had effectively been terminated by the end of the extension period, and was not contingent on any related subsequent payments between parties, which could be fulfilled after the termination date. This seemed to suggest that the original settlement instructions would need to be canceled before the end of the extension period, which may or may not be contingent on settlement of the buy-in [see later discussion].
- It was also flagged that it would be important to ensure that the PEP process did not overlap with the CSDR timelines, and that it would be important to avoid the possibility of two buy-in processes being actioned simultaneously.
- It was discussed as to how much the PEP buy-in framework should differ from the CSDR buy-in process, noting that in previous discussions there had been a desire from members to ensure as

much consistency as possible. While participants agreed that a high degree of consistency would be helpful, there was also the benefit of flexibility beyond the limitations of the regulation. In particular, the view was that being able to execute the buy-in without the need to appoint a buy-in agent could be valuable, not least given the current dearth of buy-in agents.

- Participants were reminded that the post-PEP (i.e. CSDR aligned) Rules would also ideally include additional feature such as symmetrical buy-in and cash compensation differential payments and a pass-on mechanism, intended to enhance (and in some cases compensate for) the regulatory provisions.

<u>Completing the buy-in: contractual vs settlement</u>

- It became apparent through the discussion that there were different considerations between existing contractual buy-ins and the CSDR buy-in when it came to 'completing' the buy-in.
- Under ICMA Rules, the view is that successful execution of the buy-in immediately relieves the delivering party of their obligation to deliver to the receiving party (i.e. the settlement instructions are canceled), and any differences between the original trade and buy-in price are settled between the parties. There is no consideration as to whether the buy-in settles (to be distinguished from a scenario where the buy-in is unsuccessful; i.e. no buy-in execution). If it does not settle, this (in theory) becomes an issue between the receiving party and the buy-in agent (and, in turn, the party selling into the buy-in).
- This eventuality suggested two possible scenarios: (i) the receiving party is now in a potential buy-in situation with the buy-in agent (and/or the party selling into the buy-in); or (ii) it is agreed that the failing buy-in is canceled, with the buy-in price effectively forming a reference price for cash settlement ('cash compensation') between the original delivering and receiving parties. But in either case, the buy-in would be 'successful' and the original delivering party would no longer have an obligation to make delivery.
- However, it is noted that unlike CSDR buy-ins, ICMA buy-ins are for guaranteed delivery, which significantly reduces the settlement risk of the buy-ins.
- It was pointed out that CSDR buy-ins do not take this approach. Here the settlement instructions are not canceled until the receiving party receives delivery of the securities from the buy-in agent.[1]
- This creates an additional, and not insignificant, risk consideration for the delivering party, since completion of the buy-in is contingent on settlement: the success of which, in most cases, will not be known until after the execution date (usually T+2). This would mean that the delivering party, in most cases, would run a two-day exposure in which they literally do not know their market position, and so are unable to hedge or offset. From a risk management perspective this is absurd.[2]

[1] See Articles 29(11) & 31(11) of the RTS

[2] While not discussed in the meeting, there is potentially a risk to the receiving party in the case that the buy-in is canceled (due to it failing), with this resulting in automatic cash settlement (referencing the buy-in price). The receiving party may need to repurchase the security (or similar), or unwind any contingent trades (such as hedges) in the case of cash settlement. This could create a potential market exposure between the time of the buy-in

- Furthermore, it was noted that there is no guaranteed delivery requirement under the regulation. However, it was suggested that this would likely remain a requirement in the ICMA Rules in the case of CSDR buy-ins, and therefore a significant enhancement to the regulatory provisions, as well as an essential risk mitigant.
- In the case of the CSDR buy-in settlement failing, the market best practice that has been proposed in other industry fora is that the buy-in is canceled. Again, a requirement for guaranteed delivery would significantly reduce this risk, providing protection to the delivering party and integrity to the process.
- Attention was drawn to the challenge of two different operational processes underlying the contractual (PEP) buy-in and the CSDR buy-in: with settlement instructions for the original trade being canceled in the case of the successful execution of the buy-in, in the case of the former, and only in the case of the successful settlement of the buy-in in the latter.

❖ **ICMA asked members to review their current operational processes for managing buy-ins and when the original settlement instructions are canceled.**

<u>Cash settlement under a PEP buy-in</u>

- It was noted that the current ICMA Rules allow parties to negotiate a cash settlement remedy as an alternative to a buy-in, which is particularly helpful in situations where the buy-in cannot be successfully executed. This is deliberately non-prescriptive to allow parties to reach a commercially acceptable remedy.
- Participants did not disagree with keeping a non-prescriptive provision for parties to agree cash settlement in the PEP buy-in.
- Participants were reminded that ICMA is currently facilitating a workstream focused on establishing an acceptable market approach to determining the appropriate cash compensation reference price for bond markets under the more prescriptive, but wholly inadequate, CSDR framework.

<u>Scope</u>

The ICMA Buy-in Rules (part of the Secondary Rules & Recommendations) apply to all transactions in international securities. [ICMA SMR&Rs Rule 2.1]

For the purposes of the Association's rules and recommendations, an international security is a security intended to be traded on an international, cross-border basis (i.e. between parties in different countries), and capable of settlement through an international central securities depository or equivalent. [ICMA SMR&Rs Rule 2.2]

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execution and confirmation of its settlement. Again, guaranteed delivery would go a long way to mitigating this risk.

- The ICMA Rules are widely used in the case of cross-border, non-cleared bond markets. Participants were asked whether they felt there was a case for the Rules being applied more broadly than bond markets.
- Some felt that firms would likely want to rely on contractual arrangements that were multi-asset, and that the Rules should therefore be as broad as possible in terms of scope.
- It was pointed out, however, that it may not be so clear cut in the case of non-cleared equity markets. Here the market is predominantly exchange based, and the exchanges tend to use very different buy-in frameworks, for instance applying an asymmetric differential payment (in many respects, the CSDR provisions replicate the equity exchange buy-in model). Given the close interaction between on- and off-exchange equity trading, which is not particularly relevant for bond markets, equity traders may prefer a more market-specific framework to the ICMA Rules.

<u>Jurisdictional coverage of the Rules</u>

- With respect to the possibility of obtaining legal opinions on the enforceability of the updated Rules, participants were asked to consider which jurisdictions would be most relevant in such an analysis.
- ICMA is an association under Swiss law and the Rules are governed by Swiss law. However, they may be incorporated into documents under a different governing law, leading to the applicability of conflict of law rules. It was suggested that a particular governing law – say English law- be agreed as a market standard for documents in which the Rules are incorporated by reference.
- The issue of current applicability of the Rules was raised, particularly in the extent that it applies automatically between ICMA members. It was clarified that the Rules were also broadly applied between members and non-members, as well as non-members and non-members, through incorporation by reference. This was also the case between some members, although it was suggested that this was not necessarily consistent.
- ICMA informed participants that the updated Rules would be made publicly available, rather than being restricted to members only.

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