

Consultation on the ICMA Secondary Market Rules & Recommendations governing Buy-ins

Summary of results and proposals

November 2016

Background

In response to growing demand from ICMA's members, ICMA's Secondary Market Practices Committee (SMPC) authorized a review of the existing ICMA Buy-in Rules with a view to modifying the Rules to improve their efficiency and practicability, and to ensure that buy-ins remained an effective remedy available to all participants in the non-cleared, cross-border bond markets in the case of failed trades.¹

The survey was made available in an on-line format for ICMA members, between September 5 2016 and October 21 2016.

The key areas of focus of the survey were:

- Time between the buy-in notice and execution of the buy-in
- The requirement to appoint a buy-in agent
- The possibility for auctions to be executed by means of an on-venue auction
- The possibility for cash compensation where a buy-in is not possible

Summary of the results

74 respondents replied to the survey, representing 64 different entities.

The key results of the consultation are:

- 77% of respondents would like more flexible timing for the buy-in process
- 74% of respondents agree that the appointment of a buy-in agent should no longer be a requirement
- 93% of respondents approve of the possibility for a buy-in auction mechanism
- 79% of respondents agree that a cash compensation resolution should be possible
- 70% of respondents feel that cash compensation should be mandatory after a specified period

¹ When trading under ICMA 'Rules'

Analysis of the results and feedback

Respondents

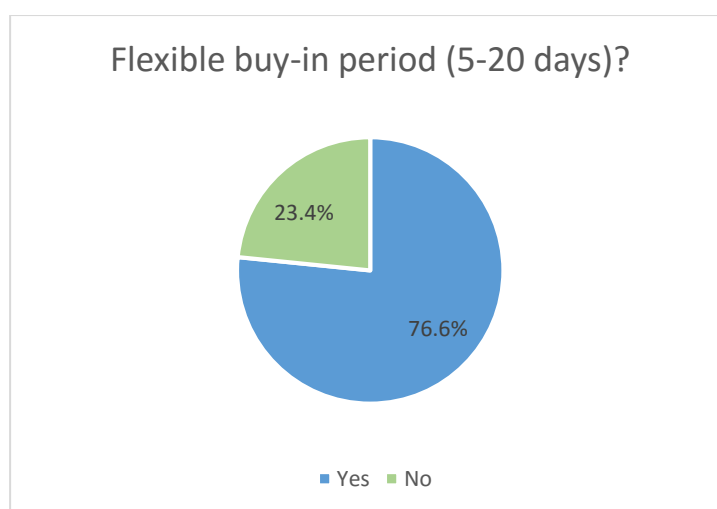
There were 74 completed responses to the survey, representing 64 entities. These are made up of a range of different types of firms, including broker-dealers, buy-side firms (both real-money and leveraged), and private banks.²

In terms of the individuals, there are a range of roles and functions represented, although the predominant respondent is in a trading capacity (in most cases, senior). Credit is the most prominent market covered, but rates and repo are also represented. A number of responses also come from senior operations, middle office, and compliance functions.

The timing for the buy-in

Do you agree that the time period between notification and buy-in execution should be anywhere from 5 to 20 business days from issuance of the buy-in notice?

Responses: 64



There is overwhelming support for a more flexible and potentially longer buy-in period between notification and execution. Most of the supporting responses point to a need for greater flexibility to align with non-ICMA buy-in rules. A number of comments, however, suggest that 20 days might be too long (essentially a calendar month) and that 15 days may be enough. Some respondents also call for the possibility of a shorter buy-in period, one noting that the possibility of a 4-day notice would help to provide for alignment buy-in notifications with Euroclear recall notices. Finally, a number of respondents emphasize the importance of ensuring that the buy-in notice period remain consistent through any pass-on chains.

² One CCP also responded, although CCPs are out of scope of the ICMA Buy-in Rules

Proposal

The Rules allow for the non-defaulting party initiating the buy-in to determine the date of the buy-in anywhere between 4 and 20 business days from the notification date of the buy-in.

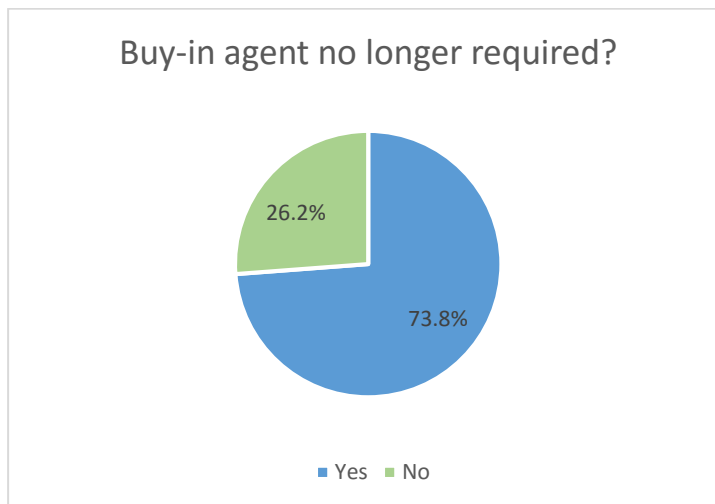
Discussion

This flexibility is designed to afford the non-defaulting party initiating the buy-in greater control over managing their risk, particularly in instances where they are trying to align the buy-in being initiated with a non-ICMA buy-in. However, it is important to note that this flexibility in determining the buy-in date is only available to the party initiating the buy-in, and that this flexibility does not apply to 'pass-ons'; i.e. the buy-in date, once determined by the initiating party, will remain consistent throughout the buy-in chain.

The requirement for buy-in agents

Do you agree that the appointment of a buy-in agent should no longer be a requirement, and that the non-defaulting party can execute the buy-in on their own behalf?

Responses: 61



Almost three-quarters of respondents support the proposal of eliminating the requirement to appoint a buy-in agent, so making it possible for the purchasing (non-defaulting) party to execute the buy-in themselves. A number of responses point to the difficulty in finding willing buy-in agents, which can make issuing and executing buy-ins difficult. However, a number of respondents raise concern about the potential for conflicts of interest, noting that a buy-in agent at least affords some degree of impartiality and greater likelihood of 'best execution'. One respondent queries whether

this would be consistent with MiFID II 'best execution' obligations.³ Some respondents suggest that without a buy-in agent, the potential for execution at 'far from market' prices would increase in the case of illiquid securities. Some respondents suggest the creation of a recognized, impartial buy-in function (possibly managed by a clearing-house or settlement depository), while two respondents suggest making lead managers obligated to act as buy-in agents for the issues they bring. Whether the buy-in is executed by a buy-in agent or not many respondents stress the need for transparency in the process, as well as the possibility for rules around how the buy-in price is determined.

Proposal

The Rules no longer require the appointment of a buy-in agent to execute the buy-in, allowing the non-defaulting party to execute the buy-in themselves, subject to executing at the best available price for guaranteed delivery.

Discussion

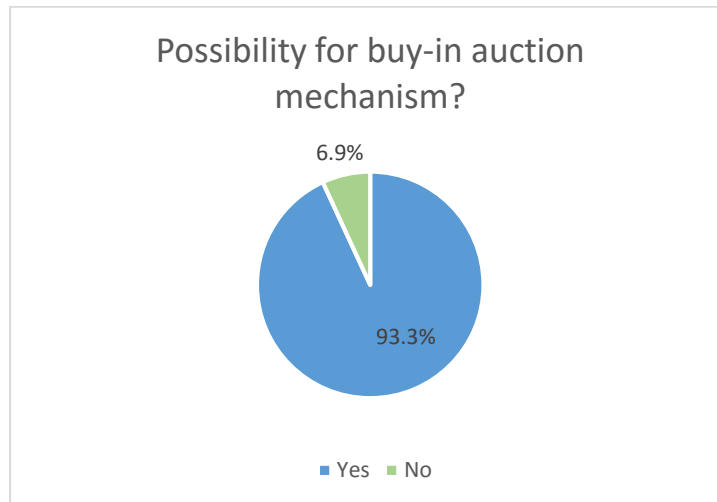
Removing the requirement to appoint a buy-in agent addresses what is perhaps the greatest frustration with the current buy-in process (essentially, the difficulty in finding a willing buy-in agent). However, there is a general perception of comfort for the defaulting party that a third-party executing the buy-in ensures neutrality of interests and greater likelihood of best execution.

³ ICMA's understanding is that any party executing a buy-in, where in scope of MiFID II/R, would be subject to the obligations of the regulation.

Buy-in auctions

Do you agree that it should be possible to execute a buy-in by means of an auction mechanism on a regulated electronic trading platform?

Responses: 60



While there is almost unanimous support for the ICMA Rules explicitly to allow for a buy-in auction process, there were relatively few comments. The main point raised is that any auction process should follow the ICMA rules for an orderly and fair buy-in process. It is also noted by one respondent that this would also provide for best execution. However, there are some concerns that for very illiquid securities, an auction process may still not work.

Proposal

The Rules to explicitly allow for the non-defaulting party to execute the buy-in by means of an auction process on a regulated exchange or trading venue, subject to the process complying with the ICMA Rules.

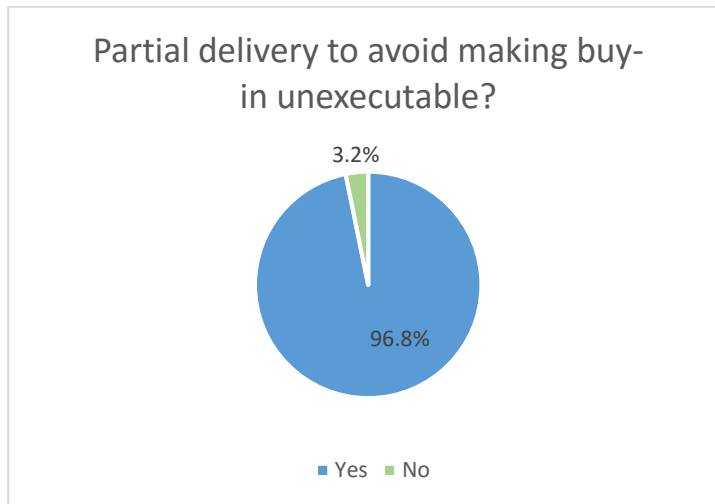
Discussion

A buy-in auction process could improve the transparency and efficiency of the buy-in process, including ensuring best execution in terms of the offers made available into the auction. However, it is also possible that potential sellers who do not have access to the auction venue (either directly or through agents), could be excluded.

Partial delivery shapes before the buy-in

Do you agree that any partial delivery before the buy-in execution date should not be in an amount that would render the outstanding portion of securities to be bought-in as an un-tradeable amount?

Responses: 62



Virtually all respondents agreed that any partial deliveries ahead of the buy-in should not render the buy-in amount an un-tradeable shape (where bonds have specified minimum tradable amounts). Only two respondents disagree with this, with one stating that any partial delivery should be acceptable.

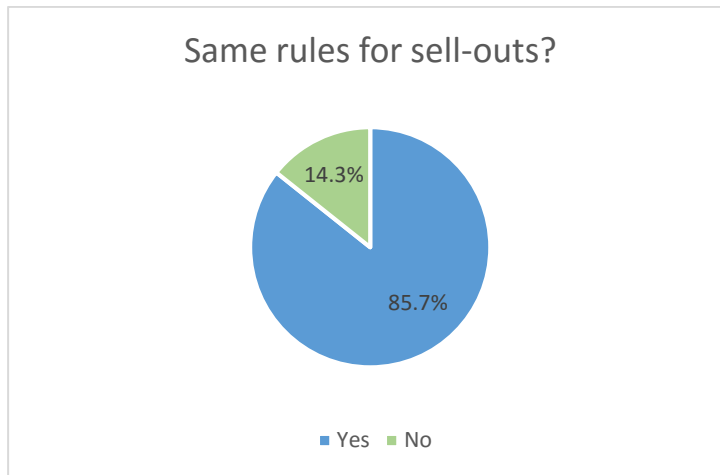
Proposal

The Rules to prohibit the partial delivery of shapes that would render the residual buy-in amount a non-tradeable shape.

Sell-outs

Do you agree that the same Rules applying to Buy-ins should also apply to Sell-outs?

Responses: 56



The majority of respondents agree that the rules should apply equally to sell-outs (where the defaulting party is the purchaser). It is not clear why some disagree with this, although one respondent states that it is 'impractical'. One response suggests that the Rules should outline procedures and practices for claims in the event that the purchasing party is insufficient.

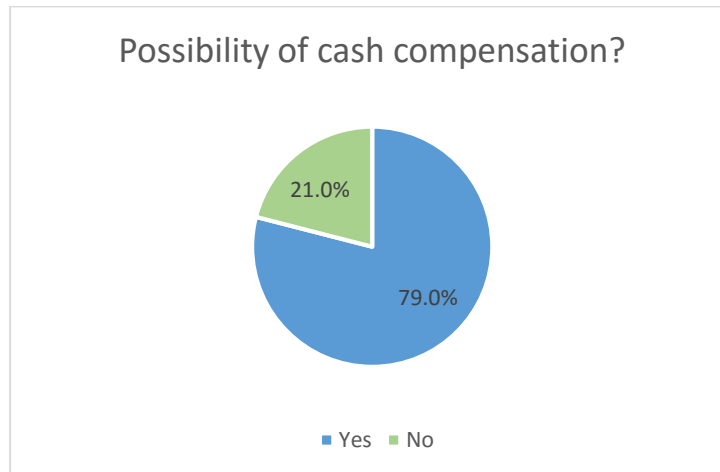
Proposal

To the extent that they are equally relevant or applicable, the Rules for sell-outs to be updated to be consistent with the Rules for buy-ins.

Cash compensation

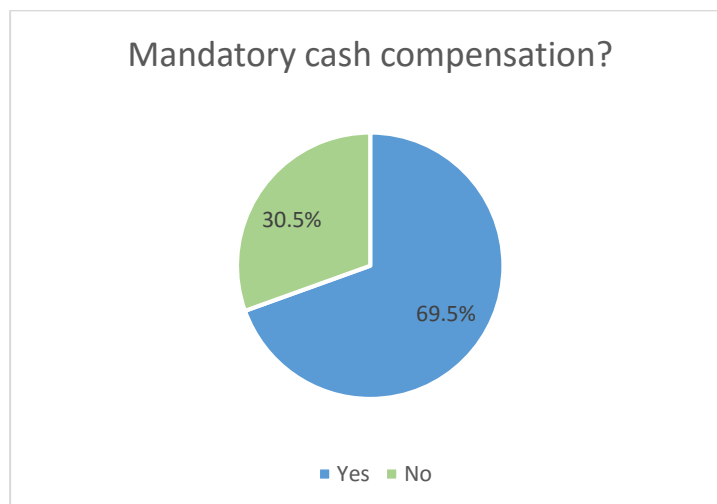
Do you think that the Rules should explicitly provide for the possibility to apply a cash compensation remedy in the event that the buy-in cannot be executed or is only partially executed? Please note that there is nothing in the existing Rules that precludes the possibility for the defaulting and non-defaulting parties to negotiate a cash compensation alternative

Responses: 57



Do you think that a cash compensation remedy should be mandatory after the buy-in has been unsuccessful for a specified period (e.g. 90 days)?

Responses: 59



While the majority of respondents feel that a cash compensation alternative should be provided, and many feeling that this should even be mandatory where the buy-in is unsuccessful, this question prompted the most comments, and concerns are mixed. The argument for a cash compensation alternative is broadly based on the need for a conclusive resolution, particularly where the buy-in process is proving unsuccessful. Furthermore, it is noted that this would also put pressure on the

defaulting counterparty to make good on their delivery. A number of respondents note that a defined period of time, after which cash compensation becomes the automatic remedy, is also desirable, although some respondents feel that 90 days is too long (from 30 to 60 days is suggested).

However, respondents flag a number of issues with cash compensation. The process for determining the appropriate cash compensation reference price is high among these, and there are a number of requests for ICMA to set out guidelines for how this should be done (similar to the draft CSDR buy-in rules). Some point out that if a buy-in is not possible, determining a reference price based on available screen quotes could be misleading. Using an independent party to determine the price is suggested by some respondents. Further issues cited relate to accounting issues, as well as the fact that some counterparties may not be willing to accept cash compensation as an alternative to delivery of securities. Another concern raised is that in situations where there is a market-wide delivery problem for certain securities, some counterparties could take advantage of a mandatory cash compensation alternative.

Common feedback seems to suggest that cash compensation should be an option, but one that is agreed bilaterally in the event that a buy-in is not possible.

Proposal

The Rules to provide explicitly that the non-defaulting and defaulting parties can negotiate a cash remedy settlement in the case that the buy-in is unsuccessful or as an alternative to the buy-in. Both parties will need to agree the appropriate reference price on a case-by-case basis.

Discussion

While a cash compensation alternative remedy is popular, the challenge lies in establishing the appropriate reference price to apply, or a consistent and robust process for this. This is one of the identified weaknesses in the projected CSDR buy-in mechanism. Similarly, mandating a cash compensation resolution after a set period of time is equally challenging, not least since this could create undue risk for the non-defaulting party. The proposal is therefore to provide explicitly for parties to negotiate a cash compensation resolution bilaterally.

CSDR

CSD Regulation will enforce an EU wide regime for buy-ins, expected to be in force from early 2019. Under CSDR, buy-ins will be mandatory (not discretionary), will not allow for flexibility in the timing, require the appointment of a buy-in agent, and provide for a mandatory cash compensation remedy in the event that the buy-in is not successful.

Only one respondent suggested that the ICMA Rules should be aligned with the framework provided for in CSDR. This is consistent with general membership feedback and market sentiment that the CSDR buy-in regime is an unwelcomed and unhelpful regulatory intervention, and that in the interim there is a need for a buy-in framework that addresses market concerns and provides for an orderly and effective remedy.

Discussion

It is expected that the CSDR mandatory buy-in regime will come into force sometime in early 2019. Once there is finalization of the technical and implementing standards, and closer to the eventual implementation date, it may be appropriate to conduct a further review and consultation of the ICMA Buy-in Rules with a view to potential closer alignment with the CSDR framework.

Section 450 Buy-in

This section shall apply to all transactions governed by the Association's rules and recommendations.

With the exception of a transaction to be settled in euro, a business day for the purpose of this section shall be a day when Clearstream, Euroclear and the cash market of the currency in which the relevant transaction is to be settled are open for business.

For a transaction to be settled in euro, a business day for the purpose of this section shall be a day when Clearstream, Euroclear and TARGET are open for business.

Rule 451 Buy-in notice

451.1 451.1.1 If a delivery is not made on the value date, the buyer shall have the right to issue the seller a buy-in notice in writing.

451.1.2 Where a delivery has been refused through the fault of the buyer or its clearing agent, the buyer shall have the right to issue the seller a buy-in notice in writing on the business day following the date on which instructions are corrected or re-submitted as per rule 404.

451.1.3 The buyer shall not lose its right to issue a buy-in notice after the expiration of the timing prescribed in this rule.

451.1.4 A pass-on situation exists where the seller is in turn a buyer of all or part of a corresponding amount of securities from a third party and passes on a buy-in notice in respect of those securities to that third party.

451.2 A buy-in notice shall be issued before 10.00 a.m. London time on the relevant date. Where a pass-on situation exists, a buy-in notice shall be issued immediately upon receipt of the previous buy-in notice.

451.3 A buy-in notice shall state:

451.3.1 the buyer's intention to close out the contract by means of a buy-in;

451.3.2 the date, as determined by the buyer, when the buy-in will be executed, which shall be five-at least four but not more than twenty business days following the date of such notice; and

451.3.3 full details of the contract and the principal amount of the bonds to be bought in; ~~and~~

~~451.3.4 the name of the buy-in agent which will be instructed to effect the buy-in.~~

451.4 A buy-in notice shall be in the following format:

To the international securities settlements manager

We hereby give you notice of our intention to close out the contract between us, of which details are given below, by means of a buy-in in application of the Association's buy-in rules. Unless delivery is made on or before [~~(date – in accordance with sub paragraph 451.3.2]fifth business day following the date of the buy-in notice)~~, the date of execution of the buy-in shall be that date. ~~The following firm will be instructed to effect the buy-in: (buy-in agent).~~

The details of the contract between us are as follows:

trade date:

settlement date:

nominal amount:

security description:

price:

net amount:

delivery details:

Please inform us immediately if you have any disagreement.

451.5 Where a pass-on situation exists, the following wording shall be added to the buy-in notice as given in paragraph 451.4:

This is a pass-on situation.

~~Rule 453 Buy-in agents~~

~~453.1 A buy-in agent must be a member of the Association.~~

~~453.2 The appointed buy-in agent may not purchase securities from the initiator of the buy-in for guaranteed delivery either directly or through an intermediary.~~

~~453.3 Where a pass-on situation exists, the buy in agent instructed to effect the buy-in shall be the same for the whole chain.~~

~~453.4 In no event shall the buy in agent be affiliated with the buyer.~~

~~"Affiliated" shall mean any situation where the buyer exercises direct or indirect control over the buy in agent or where the buyer is directly or indirectly controlled by the buy in agent (e.g., parent/subsidiary, main office/branch office) or where the buyer and the buy in agent are directly or indirectly controlled by the same parent (e.g., two subsidiaries of the same parent).~~

~~453.5 A buy-in agent should take all reasonable steps to achieve the overall best result for the buyer, taking into account such factors as price, cost of the trade, the liquidity of the market, and size, consistent with the buy-in agent's overriding obligations under rule 454.~~

~~The buy-in agent's remuneration in each instance should be reasonable and consistent with the level of risk, skill, costs, or effort undertaken.~~

Rule 454 Buy-in execution

454.1 On failure of the seller to effect delivery on or before the business day preceding the date of the buy-in, the buyer shall, acting in good faith, instruct the buy-in agent to purchase on the buy-in day, in the best available market for guaranteed delivery on the normal value date, all or any part of the securities. In executing the buy in, the buyer shall take into account such factors as price, cost of the trade, the liquidity of the market and size.

454.2 The buyer may hold the seller accountable for reasonable direct costs strictly related to the buy-in execution.

454.34

Recommendation to rule 454

~~In the event that a buy-in cannot be completed by the buy-in agent instructed to effect the buy-in on the buy-in date specified in the buy-in notice, this agent may be substituted by another buy-in agent by the buyer. Such substitution, which must be in accordance with rule 453, should be advised to the seller in advance.~~

~~Any buy-in agent the buyer may complete the buy-in of the securities on any subsequent business day until completed or until the buyer relieves it of its functions as buy-in agent such time as the parties agree to a settlement of the trade subject to the buy-in. Such settlement may be in the form of cash, alternative securities or in any other form as agreed by the parties.~~

Rule 456 Partial delivery

456.1 While a buy-in notice is in force, or an incomplete buy-in is in force, a partial settlement of the trade subject to the buy-in shall only be effected to the extent of any outstanding portion of the securities, provided that the seller must advise the buyer, in writing, 24 hours in advance of any partial delivery intended to be made on any execution date of the buy-in.

456.2 Such securities received shall be deducted from the principal amount of securities stated in the buy-in notice or from the balance of securities still to be bought in.

456.3 Settlement as prescribed in this rule will take place against payment of the pro rata countervalue depending on the terms of the original contract.

456.4 Partial deliveries shall not render the balance of securities still to be bought in an untradeable amount.

Rule 457 Confirmation of buy-in execution

The buyer shall immediately on ~~receipt of advice of~~ execution ~~from of~~ the buy-in agent notify the seller, in writing, of the quantity purchased and the price contracted, and shall promptly issue a contract note or confirmation note ~~to be accompanied by the buy-in agent's confirmation note, which shall state: "we have executed this trade for guaranteed delivery as nominated buy-in agent"~~. In the event of multiple executions, the above shall apply in respect of each individual execution.

Where a pass-on situation exists, a copy of the buy-in execution confirmation must be passed on through the entire chain to the final defaulting member as evidence of close-out proceedings. The price at which the buy-in is executed will apply equally to all transactions closed-out.

One execution ~~by the nominated buy-in agent~~ will satisfy the total chain.

Rule 458 Buy-in settlement

The money difference(s) between the original contract(s) and the close-out contract, taking into consideration possible costs as per paragraph 454.2 and possible interest coupon due dates, shall be settled in each case between the seller and the buyer without any delay.

Rule 459 Securities exempt from buy-in

The provisions of the buy-in procedure as set forth in this section shall not apply to contracts for any issue of securities which has been entirely called for redemption.