

Mandatory buy in provision of the EU CSDR

Overview

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Outline

- What is CSDR, Settlement Discipline, the mandatory buy-in regime, and its scope?
- What are the challenges for firms caught under the buy-in regime, and what are ICMA and others doing about it?
- What are the potential implications for bond market functioning and liquidity?

Outline

- What is CSDR, Settlement Discipline, the mandatory buy-in regime, and its scope?

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**.
- CSDR entered into force in September 2014.
- The Settlement Discipline measures (including mandatory buy-ins) are due to come into force from **September 2020** (but are now expected to be delayed until November 2020, or possibly even January 2021).

What are CSDR penalties for late settlement?

- The penalty mechanism will be administered by all EU (I)CSDs and apply to all settlement fails on those CSDs.
- CSDs will apply penalties against failing participants and then pass this on to the failed-to participant. The charges themselves are flat, ad valorem fees (expressed as a % of the market value of the relevant security). All CSDs will use the same daily reference price to calculate the market value of the relevant securities (to ensure consistency).
- The charges are applied on a daily basis (per business day, rather than calendar day), and there are different charges depending on security type/asset class, and (in the case of shares) liquidity (as determined by MiFIR).¹ The CSDs will apply the penalties/awards on a net basis at the end of each month.

Type of fail/security	Penalty Rate	Equivalent repo rate cost
Liquid shares	1.00 bp	2.50%
Illiquid shares	0.50 bp	1.25%
SME growth instruments (non-debt)	0.25 bp	0.625%
SSA bonds	0.10 bp	0.25%
Non-SSA bonds	0.20 bp	0.50%
SME debt instruments	0.15 bp	0.375%
All other financial instruments	0.50 bp	1.25%
Fail due to lack of cash	Official overnight rate	Official overnight rate (≥0%)

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

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 liquid¹ 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 days¹ 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 ≥ 30 business days are in scope.
- The payment of the buy-in / cash compensation is asymmetrical and can only be paid in one direction.

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

How is cash compensation determined?

- If the buy-in is not successfully executed within the prescribed timeline (4 business days for liquid equities and seven business days for all other securities), the receiving (non-failing) party can opt to attempt the buy-in one more time (called “the deferral period”).
- If the receiving party either chooses not to opt for deferral or the buy-in still cannot be executed successfully during the deferral period, the buy-in will be settled through “cash compensation” (i.e. cash settlement).
- The original trade will be canceled, and a cash payment is settled between the parties¹ based on a “market value”.
- The market value is determined in one of three ways:
 - on the basis of the closing price of the most relevant market in terms of liquidity;
 - the value determined on the basis of the closing price of the trading venue within the EU with the highest turnover;
 - on the basis of a price calculated using a pre-determined methodology approved by the competent authority of the CSD that refers to criteria related to market data, including market prices available across trading venues or investment firms

¹ The regulation suggests that this payment is asymmetric and can only be paid from the failing delivering party to the non-failing receiving party

What is the scope of CSDR Settlement Discipline?

- 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”).
- 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.⁴
- SFTs with terms ≤ 30 business days are out of scope of mandatory buy-ins.⁵

¹ Articles 1(1) and 1(2)

² Article 5(1)

³ Article 7(10)

⁴ Article 7(4)(b)

⁵ RTS: Article 22(2)

Ensuring enforcement 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.**

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".
Cash 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'. The ICMA Rules form part of the contractual trading agreements between member firms.	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.

¹¹ 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.

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.

Outline

- What are the challenges for firms caught under the buy-in regime, and what are ICMA and others doing about it?

Challenges

- Scope and application
 - Certain SFTs (open, basket trades)?
 - How to buy-in an SFT?
 - Margin/collateral movements?
 - Finding a buy-in agent?
 - Pass-ons / multiple buy-ins?
 - Establishing the appropriate reference price (“market value”) for cash compensation?
 - Dispute resolution?

- Enforceability
 - Contractual arrangements (Article 25)?
 - Extraterritorial application?
 - Monitoring and sanctions?

- Impacts for market liquidity
 - Bond markets?
 - Repo and securities lending markets?

What is ICMA doing about CSDR buy-ins?

Implementation

- Updating the **ICMA buy-in rules** to be CSDR compliant:*
 - Providing a contractual framework and market best practice to support implementation
 - Providing contractual solutions to some of the regulation's more problematic challenges
- **Addressing the asymmetric payment provisions** for buy-in and cash compensation
 - Working with ESMA to provide Q&A that allows for symmetrical payments through contractual agreements (such as the ICMA buy-in rules)
- Working with the broader industry to design and propose a workable [pass-on mechanism](#)
- Creating a workstream to explore possible best practice for establishing the appropriate reference price for cash compensation
- Working with ISLA to establish **best practice for SFTs** in the case of fails
- Updating the GMRA to cover in-scope SFTs*
- Working with ISLA to propose appropriate **exemptions for certain SFTs**:
 - Open trades (including once they have reached 30 business days)
 - Basket trades (including triparty and DBV)

* ICMA has created a CSDR Legal Workstream to facilitate the necessary contractual revisions for cash and SFTs

What is ICMA doing about CSDR buy-ins?

Advocacy

- Raising awareness of scope, details, and potential implications.
 - In particular non-EU entities and smaller buy-sides
- 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)
 - ICMA is supporting 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 Buy-in Rules

- ICMA will [update](#) its Buy-in Rules (part of the ICMA [Secondary Market Rules & Recommendations](#)) to align with the regulatory requirements
- The ICMA Rules cover transactions in international securities (i.e. securities intended to be traded on a cross-border basis and capable of being settled on an ICSD)
- The ICMA Rules apply automatically between members and/or are incorporated by reference in firms' terms of business
- The updated ICMA Buy-in Rules will serve as a contractual framework and market best practice to support implementation in the international bond markets
- The Buy-in Rules will also seek to solve for a number of shortcomings in the regulatory provisions (e.g. allowing for symmetrical payments of the buy-in/cash compensation differential and the possibility of a 'pass-on' mechanism)

ICMA intends to consult with members and the broader industry on the proposed revisions to the Buy-in Rules in early 2020 (following further clarifications from ESMA)

Outline

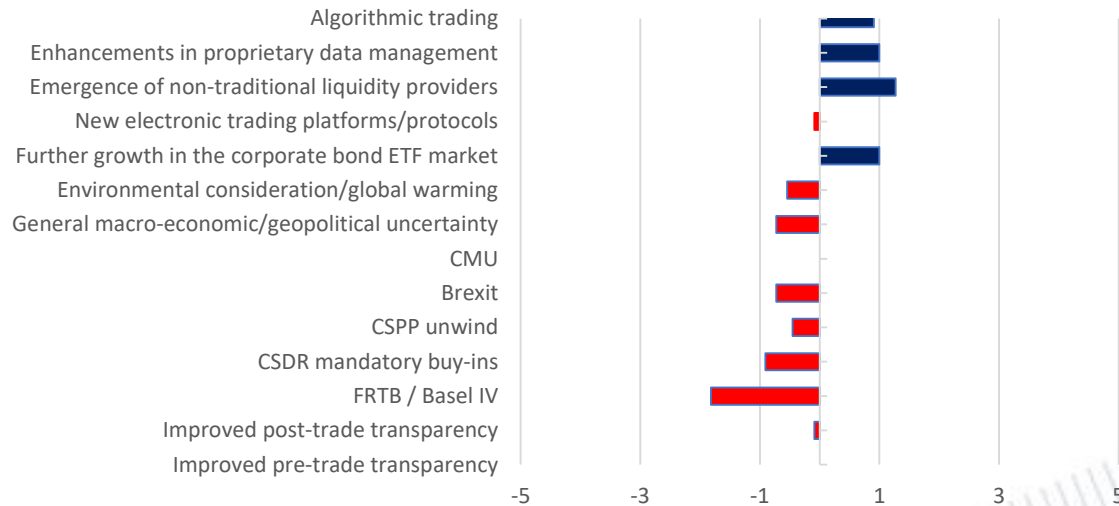
- What are the potential implications for bond market functioning and liquidity?

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?

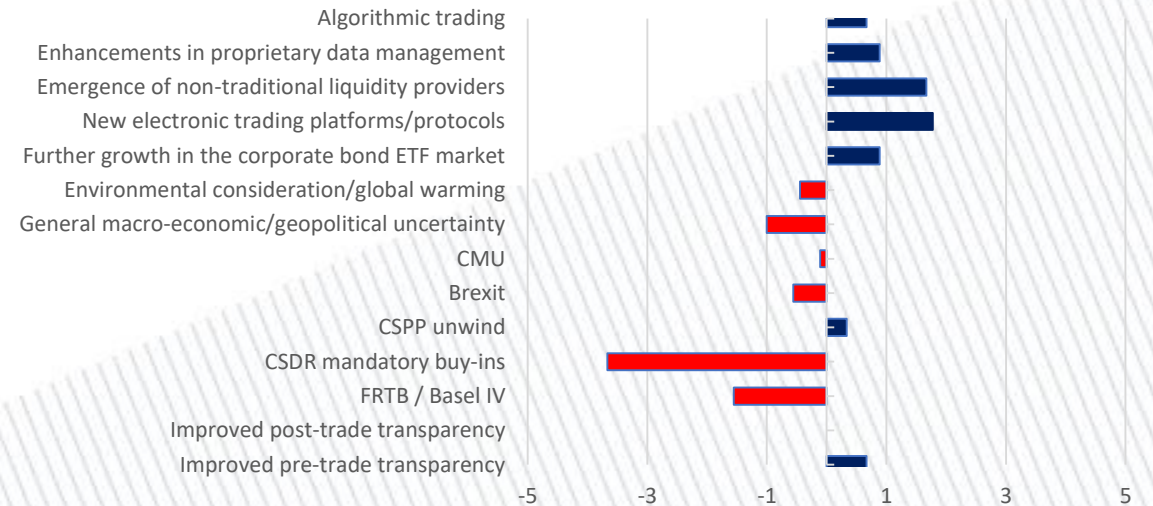
Sell-side

Impacts on liquidity: next 3 years



Buy-side

Impacts on liquidity: next 3 years



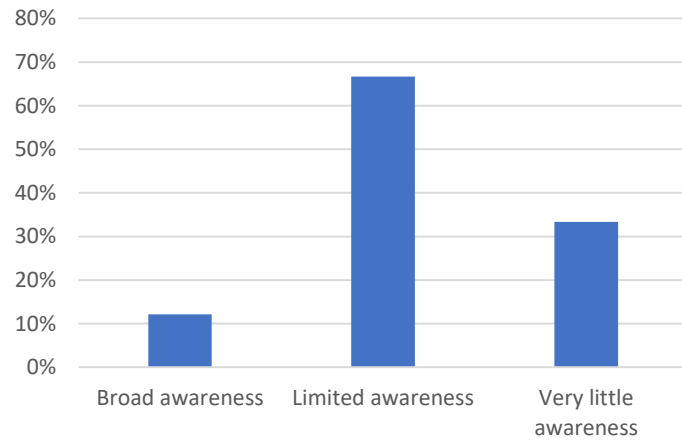
* Due to be published in Q1 2020 (survey data 2019)

ICMA Bond Market Impact Study (2019)

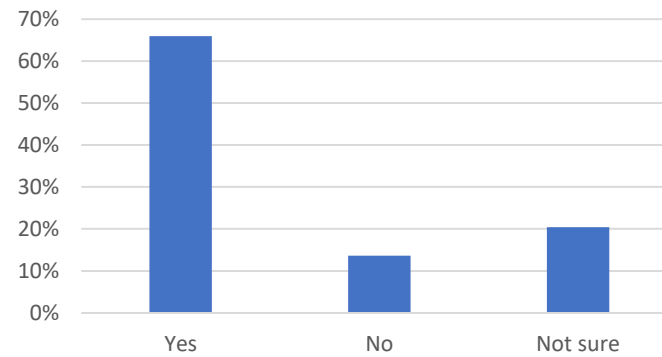
- Follows up on ICMA's [2015](#) Bond Market Impact Study
- **Study sets out to answer five questions with respect to the CSDR mandatory buy-in regime:**
 - (i) What is the general preparedness of firms both from an operational and trading strategy perspective?
 - (ii) How will sell-sides adjust their 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

Awareness and preparedness

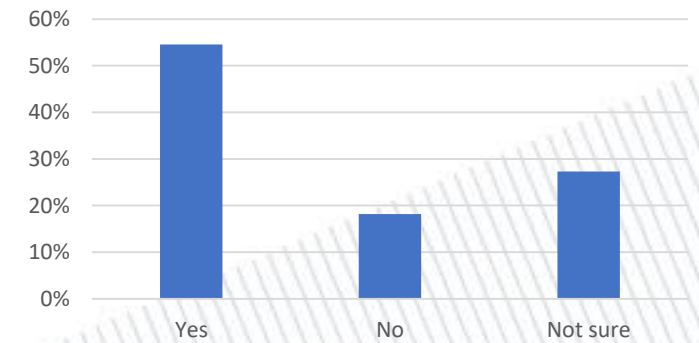
Market awareness



Plans to adapt operational processes

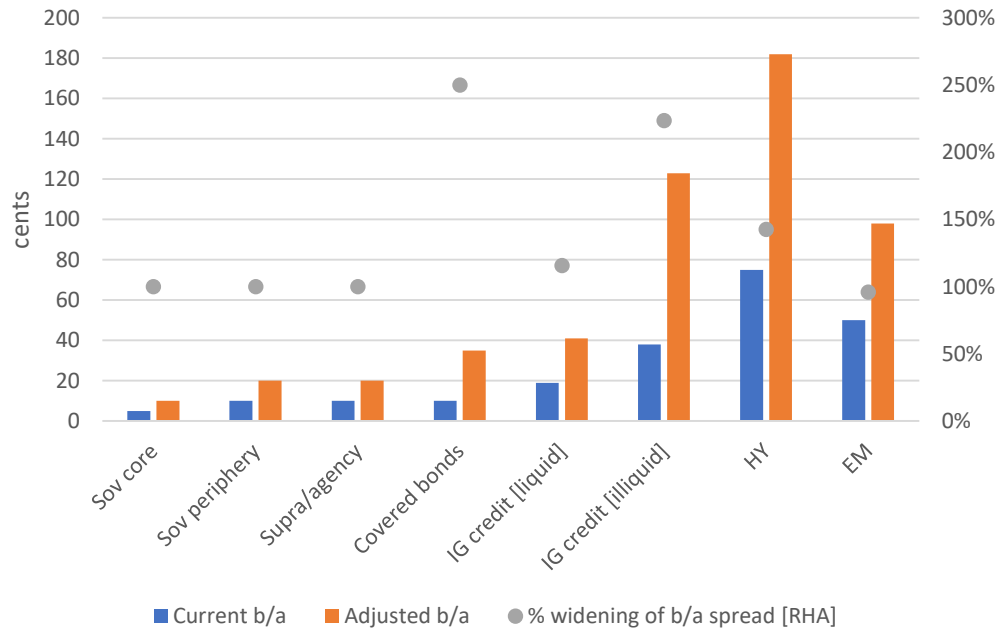


Plans to adapt risk management and trading

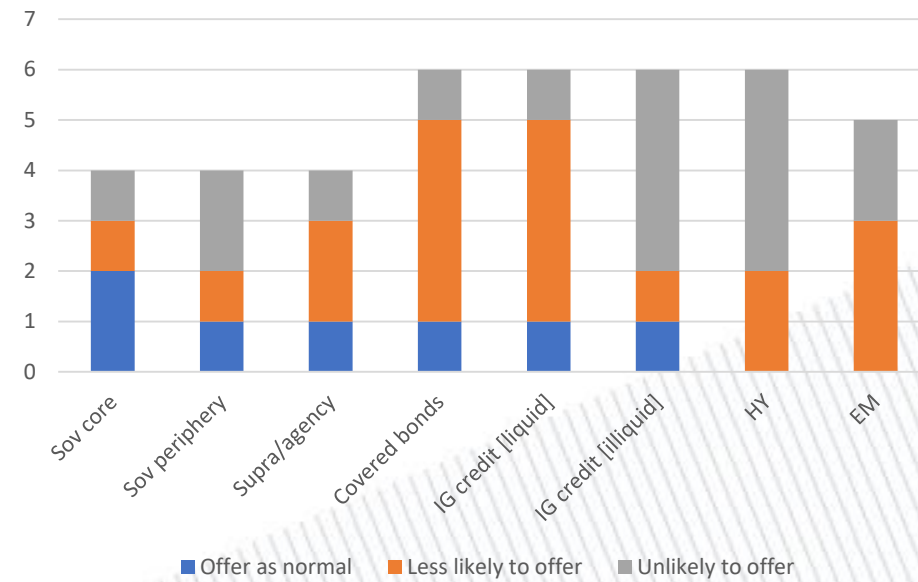


Sell-side pricing and liquidity

Impact on bid-ask spreads

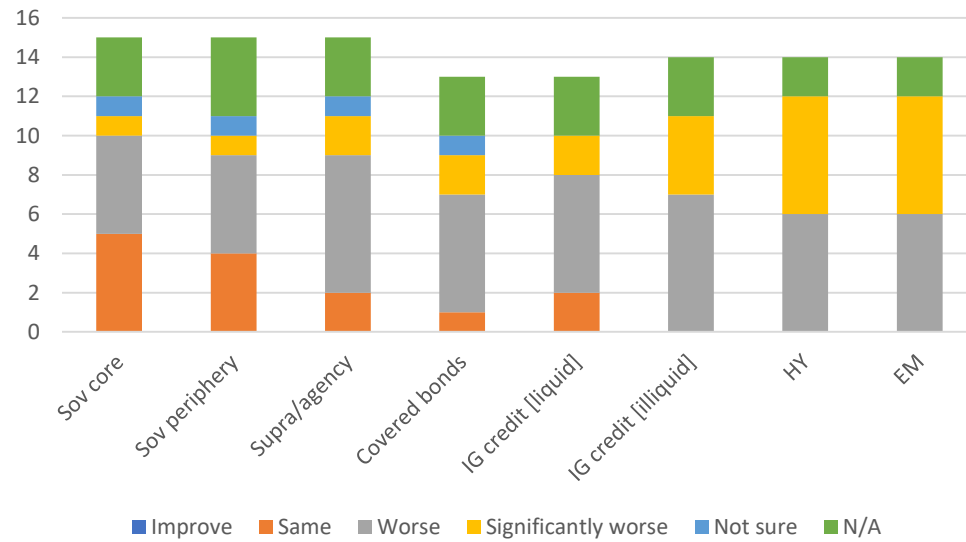


Expected capacity to show offers

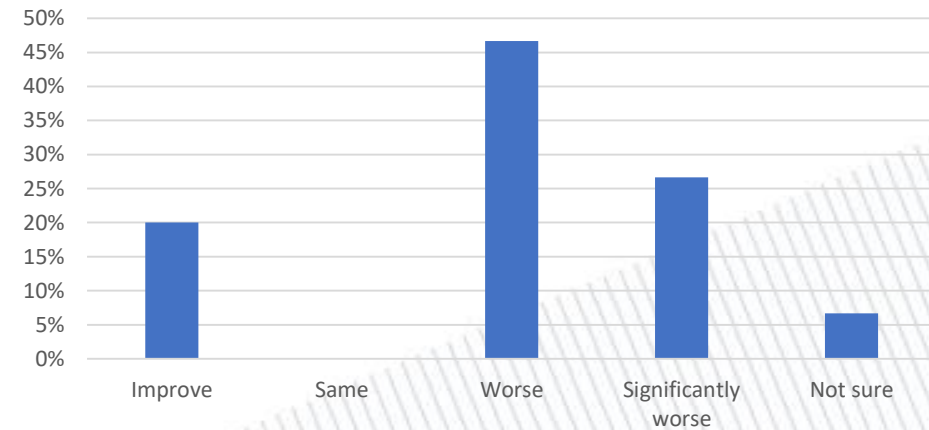


Buy-side expectations

Expected impact to offer-side pricing

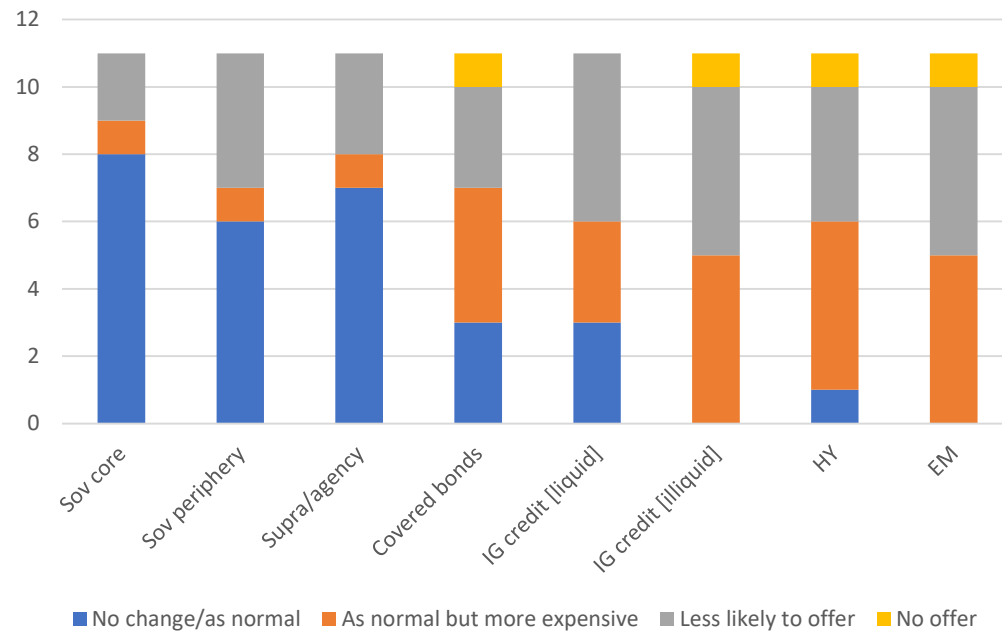


Expected impact on market efficiency and liquidity

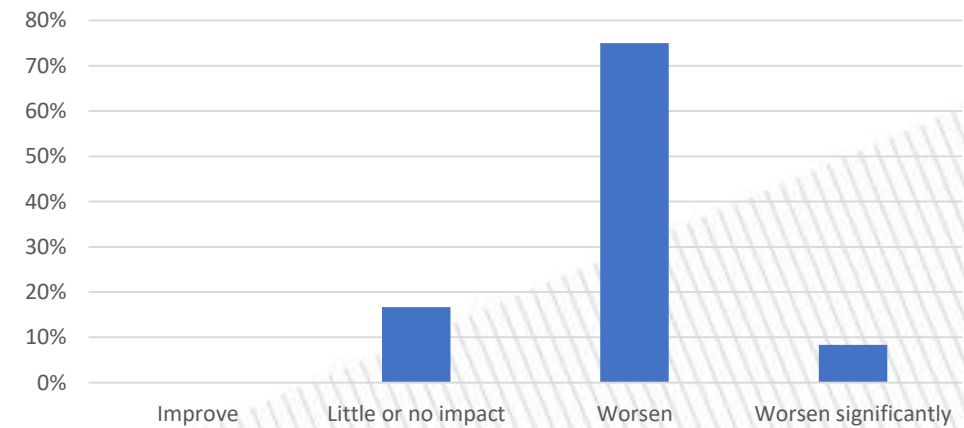


Repo and securities lending

Expected impact on lending securities



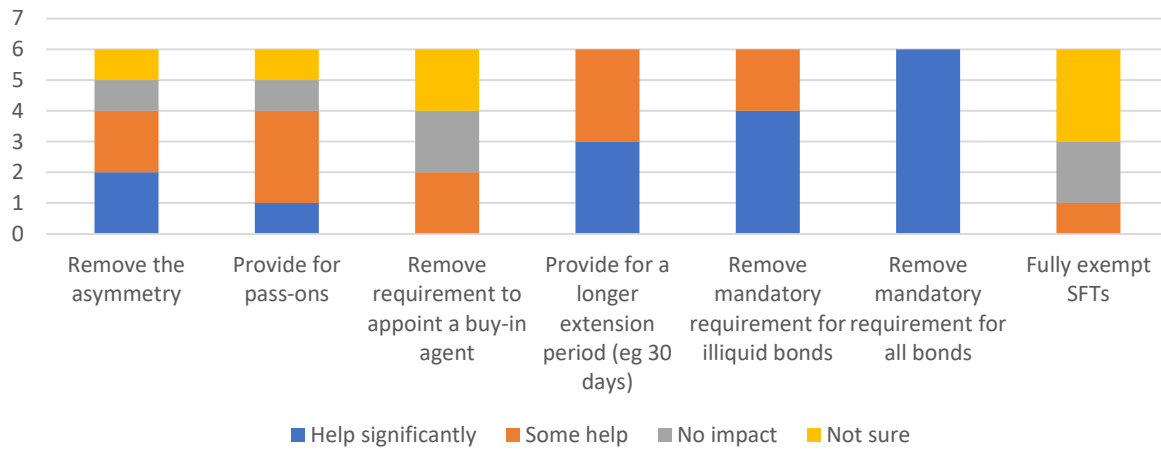
Expected impact on SFT market efficiency and liquidity



Possible enhancements

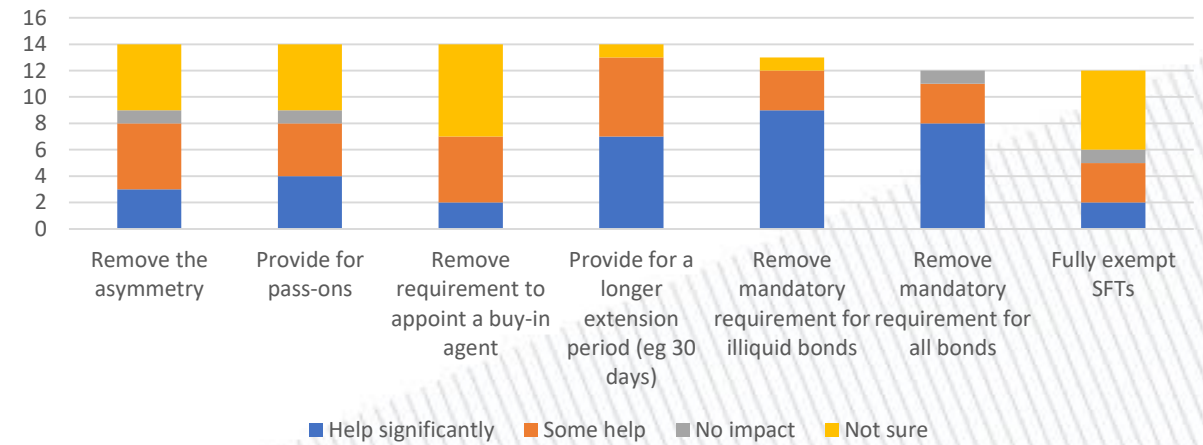
Sell-side

Assessment of possible enhancements to the regulation

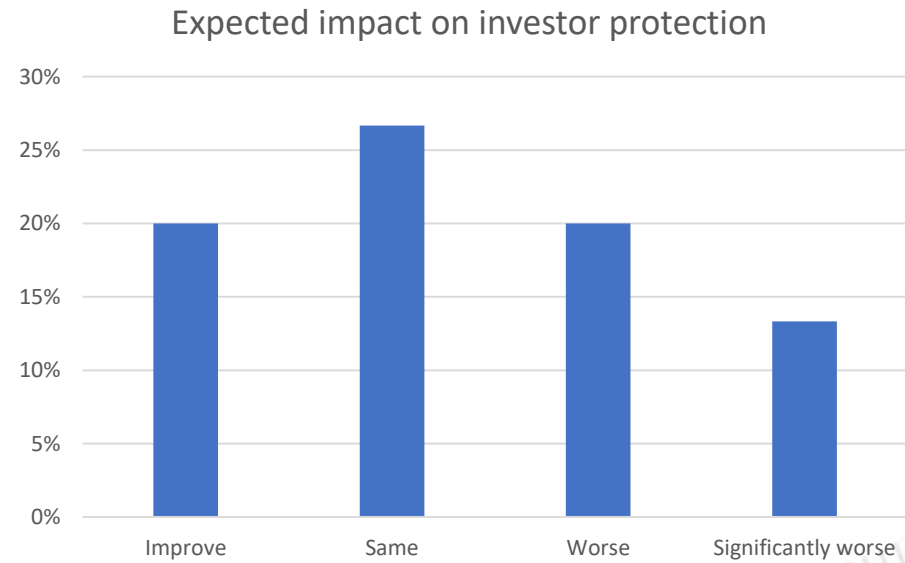


Buy-side

Assessment of possible enhancements to the regulation



Expected impact on investor protection



Conclusions

- CSDR focuses on the authorization and regulation of EU (I)CSDs, however the Settlement Discipline measures extend to firms settling trades on EU (I)CSDs. These include cash penalties for fails and a mandatory buy-in regime.
- The CSDR mandatory buy-in regime imposes a legal obligation for trading level entities to issue buy-ins against failing parties (following a specified extension period).
- The buy-in regime is intended to apply to all trading level parties regardless of location or jurisdiction. This includes any non-EU firm settling trades on EU (I)CSDs. The regulation requires that firms have in place contractual arrangements to ensure that the regulatory provisions are enforceable in all relevant jurisdictions.
- ICMA (and other industry bodies) are working on solutions and enhancements to support implementation. ICMA will update its Buy-in Rules to provide a contractual framework and best practice for implementation in the international bond markets.
- The regime is expected to have significant negative implications for bond market functioning, liquidity, and stability.
- The Settlement Discipline regime is currently due to come into force in September 2020 (but may be slightly delayed).

Resources

- 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/csd-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](#)



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