International
Capital
Market
Association

ICMA

ICMA CSDR-Settlement Discipline Working Group

Meeting note from June 28 2018

Participating firms: *BAML, Citi, Credit Suisse, Goldman Sachs, JP Morgan, LCH, Market Axess, Nex, Nomura, SocGen, Swiss Re, Westpac*
Observers: *EDMA Europe*

1) Scope

It was generally agreed that the scope of CSDR settlement discipline (penalties and mandatory buy-ins) is determined by:

(i) transactions settled on an EU CSD [Articles 1(1) and 1(2)]; and
(ii) transactions in transferable securities, money market instruments, units in collective investment undertakings, and emission allowances [Article 5]; and
(iii) transactions admitted to trading or traded on a trading venue or cleared by a CCP [Article 7(10)].

It was further agreed that this applied irrespective of the domicile or jurisdiction of the trading level entities.

It was suggested that ICMA take this as a working assumption and that rather than ask ESMA for confirmation, leave it to ESMA to disagree in the event that this is the wrong interpretation.

Some felt that there would need to be follow-up with ESMA with respect to what is intended to be covered by 'admitted to trading on a trading venue'.

2) Awareness

It was broadly agreed that there is still a lack of awareness of CSDR-SD and its regulatory requirements, particularly among buy-side firms, as well as firms outside of Europe who may not realize that they are in scope. There may also be an assumption that in the case of buy-ins this will automatically be managed by firms' custodians, without realizing that the requirement falls on the trading entity.

From a buy-side perspective, ICMA noted that it would aim to raise awareness through its Asset Management and Investors Council (AMIC), and related meetings and events (including its annual conference in November).

The question of awareness among trading venues was raised, particularly with reference to OTFs. While it was felt that MTFs were very aware of the regulation, there was less certainty about OTFs.

It was agreed that ICMA should produce a short information note (maximum 2 pages) which would very neutrally set out the scope and requirements of the CSDR-SD regime, and which could be circulated among members, who in turn could share with their clients.

3) Implementation

Timing

The question was raised as to whether the mandatory buy-in process could be initiated before the end of the extension period. Most felt that the prescriptive wording of both the Level 1 and Level 2 seemed to suggest that the process was only intended to begin at the end of the extension period (4 or 7 business days). This also seemed to be consistent with the guidance provided by ESMA at the workshop on June 3 that alternative mechanisms to force settlement (such as the ICMA Buy-in Rules) could be used during the extension period.

Buy-in agents

The requirement to appoint a buy-in agent or the use of a buy-in auction is set out in Level 2 (RTS on SD, eg Articles, 24, 27, 29, 31) text seem to require the appointment of a buy-in agent or the use of a buy-in auction.

Participants discussed the requirement to appoint a buy-in agent. It was noted that the regulation does not provide detailed guidelines on who could or should be a buy-in agent. Article 24 of the RTS merely states that a buy-in agent “shall not have any conflict of interest in the execution of a buy-in”. This is similar to the legacy wording in the ICMA Buy-in Rules (prior to the removal of the requirement to appoint a buy-in agent). Some felt that more guidance on buy-in agents might be helpful.

The fact that the requirement to appoint a buy-in agent under the ICMA Rules was dropped in early 2017, and the motivation for this was raised. It was largely agreed that the flexibility not to appoint a buy-in agent would be helpful, particularly based on empirical experience in the non-cleared bond markets where finding firms wiling to act as buy-in agents is difficult. It was noted that AFME had already raised this with ESMA and were awaiting clarification on the necessity to appoint a buy-in agent.

Related to this, the question was raised as to what happens if a buy-in agent cannot be found. Would this mean that a buy-in is not possible? Article 21 of the RTS outlines the scenarios under which a buy-in is considered “not possible”, but this does not include the inability to find a buy-in agent. It was therefore felt that if the end of the buy-in timeframe was reached without the buy-in being completed, subject to the possibility of a deferral period, cash compensation would apply.

The issue of buy-in auctions was raised, and again it was noted that there is little guidance in the regulation on the mechanics of such an auction, other than referencing the possibility of auctions for CCPs [RTS: Recital (34); Article 27(1)]. It was pointed out that some CCPs already use auction processes for equity buy-ins, and so processes and procedures for this were already in existence. ICMA agreed that it would reach out to CCPs to find out more about how buy-in auctions are currently utilized.

Adapting the ICMA Buy-in Rules

Prior to the call, the possibility of addressing the asymmetry – seen to be one of the more problematic elements of the CSDR buy-in design – was suggested by means of a voluntary market protocol whereby firms agree to settle regulatory buy-ins (or cash compensation) symmetrically, or via the ICMA Buy-in Rules (which contractually provide for symmetrical settlement). Given that the ICMA Buy-in Rules already exist and are widely applied through firms' terms of business in the international non-cleared bond markets, it was suggested that this would be the easier means of potentially addressing the CSDR asymmetry.

ESMA has indicated that the ICMA Buy-in Rules, as currently written, could be used during the extension period, so long as the buy-in is settled by the end of the extension period. However, this would probably require a shorter buy-in notification period (currently between 4 and 10 days, at the discretion of the non-defaulting party).

The possibility of a 'second' set of Buy-in Rules was discussed, which would be consistent with the process and timings laid out in the RTS, but would provide for payments of the buy-in (or cash compensation) differential to be made in both directions, depending on whether the buy-in (or cash compensation reference) price is higher or lower than the original transaction price. This would not only help eliminate many of the additional risks that the regulation creates for liquidity providers that sell-short, or for firms that lend securities, but it could also facilitate extraterritorial application.

The point was made that ESMA or the Commission's willingness to agree to this could depend on whether the asymmetry in the regulation is intentional. The consensus market view, including that of those participating in the meeting, was that the asymmetry is the result of a very clear drafting error in the Level 1 text [Article 7(6)]. However, it was also pointed out that Article 35(2) in the RTS makes it very clear that in the event of the buy-in/cash compensation price being lower than the original transaction price, the differential "shall be deemed paid". Furthermore, at the recent ESMA workshop, it was suggested that the asymmetry was in fact intentional, and a further incentive to settle trades.

It was also noted that in some circumstances, some parties would prefer the option of the CSDR Buy-in, since this would generate windfall profits in a falling market. Therefore, there may be a conflict of interests between some firms wishing to use the ICMA Buy-in Rules and others the CSDR Buy-in framework, depending on the situation. However, it was also suggested that most, if not all, firms would voluntarily sign-up to any agreement or rules that acted in the best interests of a functioning market and served the 'common good'.

It was broadly agreed that ICMA should arrange a meeting with ESMA and the Commission to discuss the scope and possibility for adapting the ICMA Buy-in Rules to apply the regulatory buy-in requirements, but without the asymmetry. It may also be necessary for ICMA to seek external legal counsel.

‘Shares’ vs bonds

It was pointed out that Article 7(6) of the Level 1 regulation (which – incorrectly – outlines the buy-in differential payment) refers to “shares”, and the question was raised as to whether this could be interpreted as not applying to bonds (or other financial instruments). Views were mixed on this, particularly as the RTS is more careful in referring to “financial instruments” in Article 35(1) while Article 35 (2) refers to shares only. It was agreed that if ICMA was to explore this potential legal opening, it should not be until after the RTS are finalized and published in the Official Journal.

RTS on Settlement Discipline - 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.

CCP Netting

The issue of CCP netting pools was raised. Currently, CCPs net cash and repo transactions on a daily basis, including rolled-over fails. To comply with CSDR-SD, CCPs would need to separate in-scope and out-of-scope transactions, requiring separate netting pools for cash trades and term repo, and short-dated repo (which are the bulk of repo transactions). This requirement was confirmed at the recent ESMA workshop.

ICMA agreed to follow-up with EACH, who is very focused on this particular issue to understand better the potential costs and implications for CCP members.

Cash Penalties

It was roundly agreed that while the cash penalties for fixed income instruments outlined in the RTS were so low as to be meaningless, in light of mandatory buy-ins, cash penalties were merely academic, and so there was no point in raising this with ESMA.

4) Avoiding buy-ins

Rolling settlement

Article 7(3) of the regulation provides for the ability for parties, bilaterally, to agree to cancel a failing transaction. While ordinarily this would seem highly unlikely, since at least one party would always have an interest in the trade being honoured, it does provide a potential opportunity to allow for 'rolling settlement'. In essence, parties would agree to a trade, for standard settlement (T+2), but with the provision that the settlement date could roll from one day to the next, up to a certain cut-off point (say 30 days), by which time the expectation would be for the trade to settle. This would require the trade being canceled each day, and new instructions being submitted for settlement the following day. The price would be adjusted for each new instruction by a pre-agreed (or default) repo/borrow rate.

The question of whether this was in the spirit of the regulation was discussed. It was felt that Article 7(3) may be intended to allow parties to a trade this degree of flexibility, and from a technical perspective this would avoid settlement fails. It would also seem likely that buy-sides would embrace such a solution, since the alternative to a solution such as an offer with rolling-settlement could be 'no offer'.

However, the biggest challenge would seem to be the operational lift. Unless this process is automated, it is unlikely that firms have the capacity or manual resources to manage this process, particularly on any level of scale.

5) Advocacy

Liquid vs Illiquid

The suggestion was made to advocate for an exemption of illiquid bonds, as determined under the MiFID II/R assessments. This would be based on the assumption that by 2020 the MiFID II/R assessments will be functioning as intended and capturing truly liquid securities.

However, it was pointed out that there are a number of challenges to implementing such a change. Firstly, this would require amending the Level 1 text, which has proved impossible to date (even when addressing obvious errors). Secondly, it would be operationally ambitious to implement, given the regular updates of the assessments.

Data

Given that the review of CSDR is scheduled for September-October 2019, it was suggested that ICMA try to provide data-based evidence to support any advocacy effort. This could include running a similar exercise to the impact study conducted in 2015, surveying market-makers across a range of fixed income asset classes to determine the potential impact of mandatory buy-ins on bid-ask spreads or liquidity.

A further suggestion was to work with the ICSDs, or ECSDA, to source and analyze settlement efficiency data. If it could be shown that settlement rates had improved as a result of T2S and other post-trade initiatives, this may help support the case that mandatory buy-ins are a solution looking for a problem. It was suggested that the T2S Taskforce may be a good source for settlement data.

Buy-side engagement

It was broadly agreed that buy-side engagement in any qualitative advocacy work would be essential, since the regulatory authorities would most likely be more responsive to investor concerns. Ultimately it is investors who have the most to lose as a consequence of the mandatory buy-in regime, and this needs to be recognized by regulators and policy makers.

Ends

Author: Andy Hill, July 2018