

CSDR Settlement Discipline

Mandatory buy-ins

European settlement regulation with global trading level implications



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What is the CSD Regulation?

The CSD Regulation¹ (CSDR) is an EU/EEA regulation which introduces measures for the authorisation and regulation of EU/EEA central securities depositories (CSDs). While much of the regulation focuses on the prudential, organisational, and business standards of CSDs, some of its requirements directly affect trading level entities that settle trades on EU/EEA CSDs. These **include measures to address settlement fails**.

Chapter III of the Regulation deals with **Settlement Discipline**. Article 7 provides for measures to address settlement fails, which include **cash penalties** for settlement fails and **mandatory buy-ins**.

Who is affected by CSDR settlement discipline provisions?

Settlement Discipline will apply to all transactions intended to settle on an EU/EEA CSD² in transferable securities, money-market instruments, units in collective investment undertakings, and emissions allowances,³ which are admitted to trading or traded on a trading venue or cleared by a CCP.⁴

This will apply to all **trading level entities, regardless of their domicile**, that enter into such transactions that settle on an EU/EEA CSD, whether directly as CSD participants, or indirectly via a settlement or clearing agent (who is a CSD participant). It is important to note that initiating the CSDR buy-in process is a regulatory requirement and not a right.

What is a buy-in?

Essentially, in the event of a settlement fail, conventional, non-centrally-cleared bond market buy-in mechanisms provide a buyer of securities the contractual right to source the securities elsewhere (usually for guaranteed delivery), cancel the original trade, 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 conventional, non-cleared bond market buy-in mechanisms, such as those provided under 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. It has to be remembered that standard buy-ins 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 entity, as a right and not an obligation.

Additionally, conventional buy-in mechanisms are usually mirrored by sell-out mechanisms which provide the seller of securities with a contractual remedy if settlement fails through the fault of the buyer.

What are the timeframes of the mandatory buy-in requirements?

The buy-in provisions are outlined in Sections 3 and 4 of the Regulatory Technical Standards⁵ (RTS) on Settlement Discipline. The regulation requires that in the event of a settlement fail, a buy-in process is initiated as follows:

- **four business days** after the intended settlement date (ISD) for liquid⁶ shares, and
- **seven business days** after ISD for bonds and all other instruments. This is referred to as **"the extension period"**.

Who executes the buy-in process?

With the exception of trades cleared by a CCP, where the CCP will be responsible for initiating the buy-in process, **the failed-to trading entity is responsible for initiating the buy-in process**. The failed-to trading entity is required to **appoint a buy-in agent** to execute the buy-in against the failing trading entity.

The buy-in is required to be completed (executed and settled) within **4 business days** for liquid shares and **7 business days** for all other instruments. Any costs arising from the buy-in, as well as the price differential between the buy-in execution price and the original transaction price, are paid by the failing trading entity to the failed-to trading entity.

What happens if the buy-in is unsuccessful?

If the buy-in is unsuccessful, the process will be settled by means of **cash compensation**. This will require the original trade being cancelled and a payment being made by the failing trading entity to the failed-to trading entity based on the difference between the current market price⁷ and the original transaction price. Before going to cash compensation, the failed-to party has the option of attempting the buy-in one more time using the same buy-in timelines (known as **the deferral period**).

¹ Regulation (EU) No 909/2014

² Articles 1(1) and 1(2)

³ Article 5(1)

⁴ Article 7(10)

⁵ Commission Delegated Regulation supplementing Regulation (EU) No 909/2014

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

⁷ The process for determining the appropriate reference price is outlined in Article 32 of the RTS

What are the key differentiating characteristics of CSDR mandatory buy-ins?

It is important to note that unlike conventional buy-ins:

- The payment of the difference between the buy-in price or cash compensation reference price and the original transaction price **is only made by the failing trading entity** to the failed-to trading entity (ie in the case that the buy-in or reference price is higher).
- In the event that the buy-in or reference price is lower than the original transaction price, the original transaction is cancelled and the payment of the difference is **“deemed paid”**.⁸ In other words, there is no payment from the failed-to trading entity to the failing trading entity.
- CSDR does not provide for a sell-out mechanism in the event that settlement fails through the buyer's fault.
- CSDR buy-ins are a regulatory requirement and not a discretionary right.

Do mandatory buy-ins apply to securities financing transactions?

Article 7(4)(b) of the Regulation and article 22(2) of the RTS effectively provide an exemption for securities financing transactions (SFTs) where the term of the SFT is less than 30 business days.⁹ This applies to both start and end legs. Longer term SFTs, however, will be in scope (again, both start and end legs).¹⁰

It is important to bear in mind the interconnectedness of SFT and cash markets, that fails in one transaction can cause fails in the other, and that the contractual provisions¹¹ for failing out-of-scope SFTs will not necessarily allow for the costs of a mandatory buy-in to be passed on.

How are mandatory buy-ins enforced if the trading entities are outside of the EU/EEA?

Article 25 of the RTS requires CCPs, clearing members, trading venue members, and trading parties to have procedures in place to execute the buy-in process, and to establish contractual arrangements with their clients to ensure that the buy-in requirements are enforceable in all jurisdictions to which parties in the settlement chain (including the relevant trading entities) belong.

Note: Firms should speak to their EU/EEA CSDs, settlement and clearing agents, and CCPs about these contractual arrangements which are likely to be introduced ahead of implementation.

When will CSDR mandatory buy-ins come into force?

CSDR was passed into law in August 2014. The draft RTS for mandatory buy-ins were submitted by ESMA in February 2016 and adopted by the European Commission in May 2018. The RTS on settlement discipline was published in the EU Official Journal and passed into law on 13 September 2018. The provisions for settlement discipline will then be applied after 24 months ie from **14 September 2020** (unless stated otherwise by European regulators).

What is ICMA doing about mandatory buy-ins?

ICMA has long supported and advocated for measures to improve settlement efficiency in the European fixed income and collateral markets. Notwithstanding this, ICMA has also long advocated against the implementation of a mandatory buy-in regime in the non-cleared bond markets and has raised concerns with the regulatory authorities with respect to the potential negative impacts it will have on market liquidity and stability. ICMA will continue to raise awareness of the likely unintended consequences of the regulation and question the need for a mandatory buy-in regime.¹²

ICMA is also working hard on ensuring the smooth implementation of the regulation. As well as raising market awareness of the regulatory requirements, it is looking to establish market standards and processes, primarily through its well established and widely utilised Buy-in Rules, to support implementation, while also attempting to address some of the regulation's more challenging provisions.

Where can I find further information?

More information on mandatory buy-ins, CSDR Settlement Discipline and ICMA's engagement can be found on the dedicated ICMA webpages:

<https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/secondary-market-practices-committee-smpc-and-related-working-groups/csd-sd-working-group/>

<https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/secondary-markets-regulation/csd-settlement-discipline/>

ICMA members can also contact the ICMA secretariat directly:

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⁸ See Article 35(2) of the RTS

⁹ Exempt SFTs will remain subject to the mini close-out provisions in the underlying GMRA or GMSLA contracts.

¹⁰ It is not clear whether this is intended to apply to 'open' SFTs that reach 30 business days

¹¹ Usually governed by a GMRA or GMSLA in the European SFT markets.

¹² The recognised risks and adverse behavioural incentives arising from the design of the CSDR buy-in framework are highlighted in ICMA's paper, **'How to survive in a mandatory buy-in world'**

