

ICMA CSDR-SD Working Group & Cross-Industry CSDR Working Group

Meeting/Call of December 10, 2019
Summary notes and action points

I. Finalizing the cross-industry pass-on proposal and next steps

- It was asked whether the pass-on proposal would cover in-scope SFTs. ICMA noted that whilst the pass-on mechanism could apply to in-scope SFTs, this would need to be provided for in any updates to potentially relevant master agreements (GMRA/GMSLA).
- The potential acceptability by the regulators of the multi-ISD chain approach in the proposal was discussed. It was noted that the principle had been discussed with ESMA on two occasions, and they seemed favourable to the idea. However, there was also recognition by the WG that it could be a stretch with respect to the interpretation of the regulation, and that ultimately it may be that any pass-on proposal would be limited to same-ISD chains. That said, a flexible ISD mechanism was seen as important by market participants, particularly in certain segments of the bond markets, and that it was important to put the argument to ESMA and the Commission.
- It was also noted that the recent redraft of the proposal was intended to ensure that in a worst-case scenario a same-ISD mechanism could be allowable, rather than the possibility for pass-ons being rejected completely.
- A point was raised regarding aligning buy-ins and pass-ons with out-of-scope buy-in processes such as FINRA. ICMA reminded the WG that one of the reasons for the 2017 revision to its Buy-in Rules to allow for flexibility in the timing of the buy-in was precisely to facilitate better alignment of timing between different buy-in frameworks. However, given the prescriptive timelines of the CSDR buy-in process this would likely be more difficult.
- It was asked whether there was any plan to include CCPs in a pass-on mechanism. It was explained that AFME is currently in discussion with the CCP community regarding aligning bilateral and collateral buy-in timings and processes, as well as exploring the potential for introducing CCP buy-ins into the buy-in chain. However, this was another layer of complexity and was beyond the scope of the current proposal.
- There were no additional edits or suggestions for the latest version of the proposal (v8.4).

- ❖ It was agreed that ICMA would recirculate the latest iteration (v8.4) and that members and other associations would have until the Christmas holidays to provide any fatal flaw edits (with members also asked to look closely at the dates used in the examples to ensure consistency and accuracy).
- ❖ In the meantime, ICMA would coordinate with AFME to organize a cross-industry delegation to meet with ESMA to present and discuss the proposal, ideally in January 2020.

II. Considerations for revising the ICMA Buy-in Rules to support CSDR implementation

- The WG was reminded that firms (sell-side and buy-side) widely use the ICMA [Secondary Market Rules & Recommendations](#), which include the ICMA Buy-in Rules, with respect to their secondary bond market trading. The Rules generally apply automatically to ICMA member firms, but are also applied between members and non-members, as well as between non-members, through incorporation by reference in firms' Terms of Business. Updating the Buy-in Rules to be compliant with the regulatory requirements, as well as providing for other contractual features, such as symmetrical settlement of the buy-in and cash compensation differential, would effectively update the existing terms of business between firms that currently reference the SMR&Rs.
- The ICMA secretariat informed the WG that there would be an industry-wide consultation on the proposed revisions to the Buy-in Rules in early 2020, but in the meantime it would be helpful to hear from the WG which features or provisions they felt would be important to support implementation and market best practice.
- The WG discussed the potential benefits of re-introducing a pre-advice notice to the Rules. While some felt that this could be superfluous, other suggested that it could be beneficial from the perspective of identifying chains before the end of the extension period. ICMA agreed that in the case of CSDR buy-ins, pre-advice notifications would most likely add value to the process. It was noted that the AFME PT group had already undertaken some work on the potential format and content of a pre-advice notice. To avoid duplication of effort, and to ensure cross-industry harmonization, ICMA committed to coordinate with AFME on this point.
- With the respect to the ongoing wait for ESMA to confirm that it is possible to resolve for the buy-in and cash compensation differential asymmetry, it was pointed out that at a recent CSDR event in Milan, a presentation by the Chair of the ESMA CSDR Taskforce suggested that the differential payments could be settled symmetrically, with the exception of shares in the case of buy-ins (seemingly an unintended consequence of the wording in the Level 1). This is the first public acknowledgement by the authorities that the payments can (in most cases) be made conventionally.
- It was flagged that AFME were looking to propose an ESMA Q&A with respect to buying-in unmatched trades. The AFME proposal is that in the case of unmatched trades, the receiving party should have the option to buy-in the delivering party if they can evidence that the failing

party (or their agent) is at fault. Otherwise, firms could avoid buy-ins against uncovered shorts by putting in the wrong settlement instructions. This would also have implications for the successful application of a pass-on mechanism. ICMA agreed with this proposal. It was further noted that under the current ICMA Rules the non-failing party could execute a buy-in or sell-out in this scenario (as well as claim for any interest costs resulting from the settlement delay).

- A point was raised about the establishment of the appropriate reference price in the event of cash compensation. The current understanding is that this will be determined by the receiving party, based on the procedures outlined in the RTS (Article 32). However, in the case of liquid bonds that may not have printed for some time, this created challenges for establishing the right reference price and could result in prices being used that are significantly far from 'fair value'. In such cases it would be helpful to have guidance, or market best practice, to establish a reference price as fairly, and independently, as possible. It was suggested that the ICMA WG explore a potential process, which could include a waterfall methodology for establishing the appropriate reference price.
- ICMA confirmed that they would need to reintroduce the original requirement in the Buy-in Rules to appoint a buy-in agent. It was likely that the previous rules pertaining to conflicts of interest were most likely consistent with the regulatory requirements, although it was noted that AFME are proposing possible ESMA Q&A to provide greater clarity on the definition of 'conflicts of interest' in the context of buy-in agents.
- The issue of timing, format, and content for various notifications in the buy-in and pass-on process was briefly discussed. It was suggested that in preparing the details for the projected revisions to the Buy-in Rules, ICMA and AFME coordinate potential cross-industry workshops to ensure consistency of processes and a harmonized approach to buy-ins across different asset classes.
- ICMA's Legal Team updated that it was in discussions with external counsel with respect to the contractual enforceability of the Buy-in Rules under CSDR. At this point it seemed likely that legal opinions would be required based on the jurisdictions in which the relevant transactions are concluded. ICMA's current thinking was that it may obtain legal opinions for a limited number of key jurisdictions. Ultimately it would be the responsibility of firms to ensure contractual enforceability of their terms of business. ICMA would continue to discuss this in its own Legal Working Group and would also update those of other associations (in particular AFME and ISLA).
- ❖ ICMA to coordinate with AFME on the work already undertaken with respect to buy-in pre-advice notices, to inform the revision of the Buy-in Rules.
- ❖ ICMA to create a subgroup focused on drawing up proposed best practice for establishing the reference price to be used in the case of cash compensation for fixed income.
- ❖ ICMA to reach out to AFME to explore the possibility of industry workshops in order to help inform some of the detail in the proposed revisions of the Buy-in Rules.

III. Outstanding SFT related issues

- The WG was reminded that in order to support the argument for exempting open (and open-like) SFTs from the scope of mandatory buy-ins, the industry would need to provide details of the accounting treatment of these transactions, either from a risk perspective or in terms of regulatory liquidity and capital treatments, or both. Despite attempts by ICMA to reach out to accountancy firms and members, this information has so far proved difficult to obtain.
- It was suggested that ICMA and ISLA formally survey their members on their accounting treatment of open SFTs, including the basis on which the treatments are applied. It was further suggested that ICMA run this past ESMA first, to ensure that it would indeed be helpful and also to refine the questions.
- The outstanding issue of the required exemption for basket trades was raised. ICMA confirmed that this had been discussed previously with ESMA, and that suggested Q&A guidance had been proposed, however, again, ESMA required more detailed information about the structure and operation of basket trades and why it was not possible to execute buy-ins against these transactions.
- It was suggested that it may be helpful to distinguish between basket trades where non-substitutable bonds are allocated post execution, and those where there is no specification of underlying bonds which are infinitely substitutable (such as triparty or DBV). Furthermore, in the case of triparty, it is the responsibility of a third-party agent to allocate and deliver the underlying collateral, not the 'delivering party'. It was felt that for these trades it should be fairly obvious that a buy-in is inoperable. ICMA resolved to redrafting proposed Q&A based on the WG's suggestions.
- ICMA flagged that it had circulated a draft proposal for best practice for buy-ins against an SFT (both start and end legs), including accounting for any haircuts applied to the transaction. While the general suggestion was that best practice for in-scope SFTs should be to utilize the relevant master agreement provisions for fails (i.e. mini close-outs) before the end of the extension period, it would still be necessary to outline the methodology and best practice in the case that such SFTs did go to a mandatory buy-in. Members were asked to review the proposal and report back with any suggested enhancements or edits.
- ICMA's Legal Team updated that as with the ICMA SMR&Rs and cash buy-ins, there would need to be updates to the GMRA (and in parallel the GMSLA) to support the implementation of the CSDR buy-in requirements. Again, ICMA was in discussions with external council on this point and would continue to discuss among its own Legal Working Group as well as liaising with ISLA.
- ❖ ICMA to reach out firstly to ESMA, then, in coordination with ISLA, to survey its members on the accounting treatment of open (and open-like) SFTs.
- ❖ ICMA to redraft proposed Q&A on exempting DBV and triparty trades.

Prepared by Andy Hill, December 2019