ISLA

30 June 2020

CSDR Mandatory Buy-in & Cash Penalties Regimes

Frequently Asked Questions (FAQs)

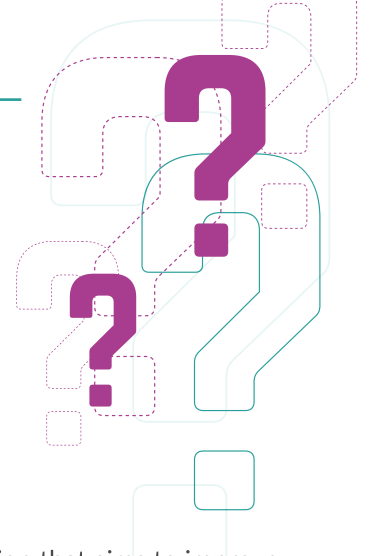
Purpose of these FAQs

These FAQs explain the legislative background to and requirements of the mandatory buy-in and cash penalties regimes under the EU Central Securities Depositories Regulation (CSDR), focusing on how these requirements apply in respect of securities lending transactions entered into under a Global Master Securities Lending Agreement (GMSLA).

(Please note that this document has been drafted to support the full GMSLA documentation suite, however it could be adapted by ISLA members to use with legacy documentation if required.)

They are intended for use by ISLA members, for example, when seeking agreement from clients and counterparties to the terms of the CSDR Annex amending the GMSLA.

ISLA members should note that these FAQs are not intended to provide legal advice, nor do they provide an exhaustive description of the CSDR settlement discipline requirements, or address commercial issues or market practices that may develop in response to the mandatory buy-in rules under CSDR.



Background -
CSDR Settlement Discipline Regime

1. What is the Central Securities Depositories Regulation?

The Central Securities Depositories Regulation (CSDR)[1] is a piece of EU legislation that aims to improve securities settlement across the EEA, and which establishes a harmonised framework for regulating central securities depositories (CSDs) and the securities settlement systems that they operate.

CSDR also has important implications for banks, broker dealers and other firms that execute, clear and/or settle transactions in EEA securities for themselves and their clients.

CSDR entered into force on 17 September 2014 but the new rules under CSDR are being phased in gradually over a number of years.

2. What is the CSDR settlement discipline regime?

CSDR will introduce a new settlement discipline regime that aims to reduce the number of settlement fails that occur in EEA CSDs.

The new regime comprises:

- measures to prevent settlement fails (under Article 6 CSDR); and
- measures to address settlement fails that do occur (under Article 7 CSDR), including cash penalties and a mandatory buy-in regime.

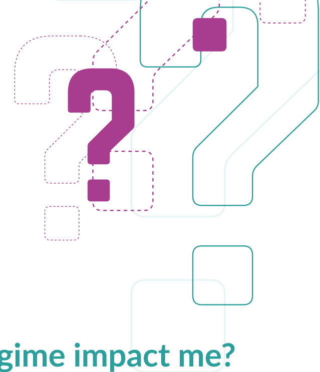
Further detailed requirements are set out in related regulatory technical standards on settlement discipline[2] (SD RTS).

These FAQs focus on the mandatory buy-in regime and cash penalties requirements as they apply to securities lending transactions.

3. When does the CSDR settlement discipline regime start to apply?

The CSDR settlement discipline regime, including the mandatory buy-in regime and cash penalties requirements, is expected to apply from 1 February 2021.

1. *Regulation (EU) No 909/2014*
2. *Commission Delegated Regulation (EU) 2018/1229*



4. I'm not based in the EU so why does the CSDR settlement discipline regime impact me?

The CSDR mandatory buy-in regime and cash penalties requirements will have a broad extraterritorial impact on non-EEA firms trading, clearing or settling financial instruments, where the transaction involves settlement in an EEA CSD (such as Euroclear or Clearstream).

This is because the territorial scope of these requirements is linked to where settlement takes place (i.e. whether settlement occurs on an EEA CSD).

In particular, CSDR requires EEA CSDs, CCPs and trading venues to amend their rulebooks to give effect to the settlement discipline regime. Therefore, non-EEA participants or members of EEA CSDs, CCPs and trading venues will be directly impacted by rulebook changes.

In addition, as explained at question 18 below, Article 25 of the SD RTS requires all parties in the settlement chain to establish a chain of contractual arrangements giving effect to the mandatory buy-in process all the way up to the trading parties, regardless of where those parties are located.

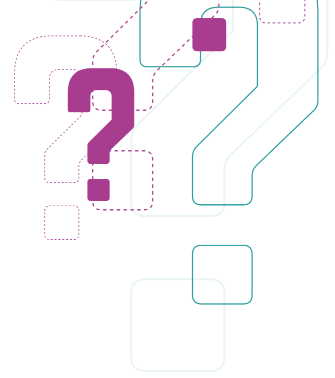
5. Will Brexit impact the application of the mandatory buy-in and cash penalties requirements?

The impact of Brexit on the CSDR mandatory buy-in regime and cash penalties requirements will be limited.

This is because, as noted above, the territorial scope of these requirements is linked to whether settlement takes place on an EEA CSD and so it has an extraterritorial impact on non-EEA firms that execute, clear or settle transactions in securities settled in EEA CSDs.

The CSDR mandatory buy-in regime and cash penalties requirements will not however be automatically "onshored" to form part of domestic UK law at the end of the Brexit transition period (based on the current expectation that these requirements will not have started to apply on 31 December 2020, when the transition period is due to end).

The UK government has also indicated that it does not intend to implement CSDR mandatory buy-in and cash penalties requirements from February 2021 in relation to securities settled in CREST, and that any future UK legislative changes in this area will be developed through dialogue with the financial services industry. In the meantime, the existing industry-led framework will continue to apply in respect of securities settled in CREST.



Scope - Mandatory Buy-in Regime

6. What types of financial instruments does the buy-in regime apply to?

The CSDR mandatory regime applies to transactions relating to the following types of financial instruments:

- transferable securities (such as bonds and shares);
- money market instruments;
- fund units; and
- emission allowances,

which are settled via an EEA CSD.

In order to be in scope of the mandatory buy-in requirements, the financial instruments must also be admitted to trading or traded on an EEA trading venue or cleared by an EEA CCP. Note that this condition applies at the financial instrument level and not at the level of the particular transaction.

These financial instruments are referred to as "in-scope financial instruments" in these FAQs.

7. What if the transaction doesn't involve settlement in an EEA CSD?

If the transaction doesn't involve settlement in an EEA CSD, then it won't be in scope of the CSDR settlement discipline regime.

This could be because the financial instruments are settled in a non-EEA CSD or because settlement is "internalised" by a custodian or settlement agent, such that there is no movement of securities between accounts at a CSD (e.g. where the buyer and seller use a tri-party agent or otherwise have the same custodian and so settlement is effected by the custodian updating their books and records).

8. Are dual-listed securities in scope?

Yes, dual-listed securities are in scope of the CSDR settlement discipline regime, with the exception of dual-listed shares for which the principal venue for trading is outside the EEA. This determination is made by the European Securities and Markets Authority (ESMA) under the EU Short Selling Regulation[3].

3. *ESMA maintains a register of exempted shares for which the principal trading venue is in a third country, at: https://registers.esma.europa.eu/publication/searchRegister?core=esma_registers_mifid_shsexs*

9. How does the mandatory buy-in regime apply to securities lending and borrowing transactions?

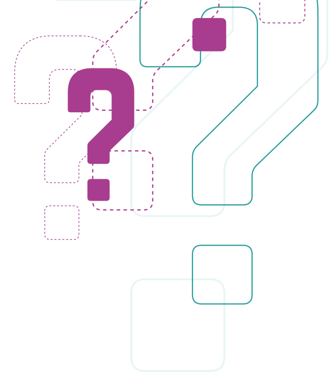
In general, the mandatory buy-in regime will apply in relation to all transfers of in-scope financial instruments that occur in connection with a securities lending or borrowing transaction, unless a carve-out applies.

There is a specific carve-out from the mandatory buy-in regime in respect of the securities being lent or borrowed under a securities lending or borrowing transaction, where the intended settlement date (ISD) of the return leg is set within 30 business days of the outward leg of the transaction. The rationale for this is that this timeframe is short enough to mean a buy-in would be ineffective in this scenario.

The carve-out applies irrespective of whether the settlement fail occurs on the outward or the return leg of the securities lending or borrowing transaction. The carve-out also applies to other types of securities financing transactions such as repos. However, it does not apply to cleared transactions relating to shares.

This carve out is drafted so that it refers specifically to the securities being lent or borrowed under the relevant transaction. It does not expressly refer to transfers of collateral connected with securities financing transactions. However, guidance has been sought from ESMA about whether collateral transfers may also benefit from the carve out from the buy-in requirements, as well as whether certain types of transactions (such as 'open' or 'evergreen' trades) may benefit from this carve out.

Note to members: We are aware that firms may take different views on these points and that including a definitive statement in these FAQs may risk undermining ongoing advocacy efforts seeking guidance from ESMA.



10. What is a 'settlement fail'?

A 'settlement fail' as defined in CSDR occurs where:

- settlement instructions have been entered into a CSD; but
- the relevant transaction (or transfer order) fails to settle on the intended settlement date.

Therefore, the concept of a 'settlement fail' does not include situations where parties have not attempted to deliver securities or cash (as relevant) and so they have not entered settlement instructions in a CSD.

In general, a settlement fail may occur due to a lack of securities or a lack of cash. However, the mandatory buy-in regime will only apply where there has been a failure to deliver securities – i.e. the settlement fail occurs on the securities side.

General - Mandatory Buy-in Regime

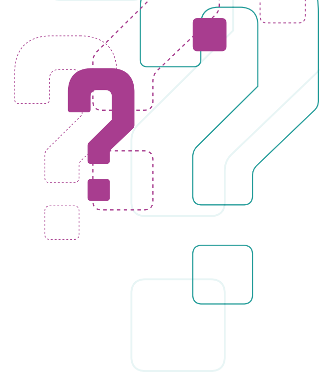
11. When will the buy-in process be triggered?

The mandatory buy-in process will be triggered if there is a failure to deliver in-scope financial instruments that is not remedied within a set number of days after the intended settlement date, referred to as the "extension period".

The extension period is:

- 4 business days for liquid equities;
- 15 business days for instruments traded on SME growth markets; and
- 7 business days of the intended settlement date for all other in-scope instruments.

The mandatory buy-in process is then triggered automatically on the business day following expiry of the extension period. The SD RTS set out the detail of the mandatory buy-in process, timing and related notification requirements.



12. Who is responsible for carrying out the buy-in process?

The responsibility for carrying out the buy-in process depends on whether the relevant transaction is cleared by an EEA CCP and/or executed on an EEA trading venue.

For securities lending transactions that are neither cleared nor executed on a trading venue, the 'trading parties' (i.e. the counterparties to the transaction) are responsible for carrying out the buy-in process. Provided that a buy-in is considered possible, the 'receiving' trading party is required to appoint a buy-in agent to execute the buy-in transaction.

Note that for transactions cleared by an EEA CCP, the CCP is responsible for carrying out the buy-in process by launching an auction or appointing a buy-in agent, and for uncleared transactions that are executed on an EEA trading venue, the receiving trading venue member is required to appoint a buy-in agent. However, these FAQs focus on uncleared, off-venue transactions (such as securities lending transactions) where the receiving trading party is responsible for appointing the buy-in agent.

13. Are there any circumstances when the buy-in won't be triggered at the end of the extension period?

Yes, CSDR and the SD RTS set out specific circumstances where the buy-in procedure will not be triggered at the end of the extension period, as follows.

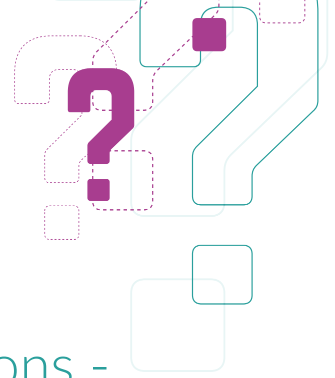
(a) A buy-in will be considered 'impossible' where:

- the relevant financial instruments no longer exist; or
- the failing trading venue member (for uncleared, on venue transactions) or the failing trading party (for uncleared, OTC transactions) is subject to insolvency proceedings.

In these situations, the buy-in procedure will not be triggered but cash compensation will be payable instead.

(b) The mandatory buy-in requirements will not apply at all (meaning that no cash compensation will be payable either) if:

- insolvency proceedings have been opened against the failing CSD participant; or
- the settlement fail relates to "operations composed of several transactions" where "the timeframe of those operations is sufficiently short and renders the buy-in process ineffective". The SD RTS provide that this carve-out applies to securities financing transactions where the ISD of the return leg is set within 30 business days of the outward leg (also see question 8). However, it does not apply in relation to transactions in shares that are cleared by a CCP.



Buy-in Process for Uncleared, OTC Transactions - Mandatory Buy-in Regime

14. What happens if the failing counterparty tries to deliver the securities after the buy-in process has started?

The SD RTS state that once the failing counterparty receives notice that a buy-in has been initiated, the failing counterparty must ensure that the settlement instructions relating to the settlement fail are put on hold. The failing counterparty will only be permitted to deliver the securities if the buy-in agent gives its consent.

Note to members: in terms of the contractual implications under the GMSLA, the working group is still considering its preferred approach on the impact of an Event of Default during a buy-in.

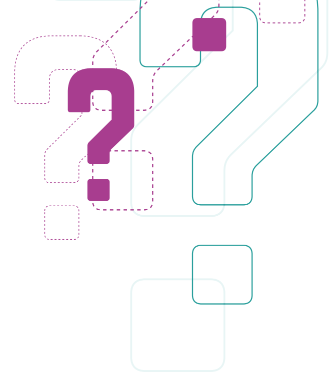
15. What happens if the buy-in fails?

If the buy-in has not been successfully executed at the end of the initial buy-in period specified in the rules, the receiving counterparty has the option to defer the buy-in, in which case it must notify the failing counterparty of this on the last day of the initial buy-in period.

If the buy-in has still not been successfully executed at the end of the deferral period (or if the receiving counterparty decides not to defer the buy-in), the receiving counterparty must notify the failing counterparty that the buy-in has failed. The deferral period is 4 business days for shares that have a liquid market (but are not traded on SME growth markets), or 7 business days for all other in-scope financial instruments.

In this case, the failing counterparty will be required to pay cash compensation to the receiving counterparty. The SD RTS specify how cash compensation is to be calculated, based on the change in the market value of the relevant securities.

At this point, the buy-in process is complete and the counterparties must ensure that the original settlement instructions are cancelled.



16. What happens if the buy-in is successful?

If the buy-in is successful, the buy-in agent will deliver the bought-in securities to the receiving counterparty. The receiving counterparty is required to accept and pay for the securities at the bought-in price and notify the failing counterparty of the successful execution of the buy-in.

The failing counterparty is required to pay the buy-in costs and an amount corresponding to the difference between the price paid for the bought-in securities and the price agreed at the time of the trade.

The price difference only needs to be paid where the buy-in price was higher than the original transaction price.

Contractual Requirements - Mandatory Buy-in Regime

17. What is the purpose of the CSDR Annex?

Article 25 of the SD RTS requires all parties in the settlement chain up to and including trading parties establish "contractual arrangements…that incorporate the buy-in process requirements". Article 25 of the SD RTS also requires these contractual arrangements to be "enforceable in all relevant jurisdictions".

The CSDR Annex is intended as a means by which counterparties to a GMSLA may satisfy these requirements (but is not the only means by which compliance with Article 25 of the SD RTS may be achieved).

The CSDR Annex also seeks to ensure that the CSDR buy-in process operates in a manner that is predictable and meets the expectations of counterparties to the GMSLA. For example, the CSDR Annex sets out how the CSDR mandatory buy-in process interacts with other relevant provisions of the GMSLA, such as provisions relating to failure to deliver and termination rights.

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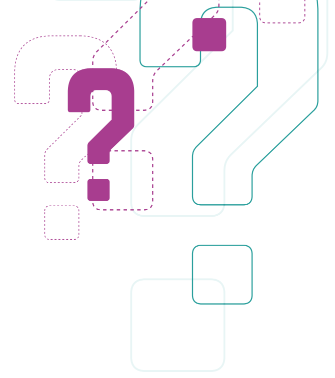
Note to members: other key features of the Annex may be highlighted here, once agreed – e.g. symmetric payment obligations.



18. How does this apply to non-EEA firms?

The contractual requirements of Article 25 of the SD RTS also mean that the CSDR buy-in regime has an extraterritorial impact, as it will create a chain of contractual obligations on parties in the settlement chain (including non-EEA entities) to give effect to the mandatory buy-in regime under CSDR.

In this context, the "settlement chain" refers to the trading counterparties, their settlement agents (or global custodians) and any sub-custodians, all the way down to the local custodian that is the direct participant in the relevant EEA CSD. EEA CSDs are also required to amend their rulebooks to include provisions giving effect to the mandatory buy-in regime, which will apply directly to the CSD participants and start the chain of contractual obligations envisaged under Article 25 of the SD RTS.

Therefore, non-EEA counterparties trading in in-scope securities (see question 5 for which securities are in scope) are expected to be under a contractual obligation to give effect to the CSDR buy-in requirements, even if they are not regulated in the EEA.

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Cash Penalties Regime

19. What are the CSDR cash penalties requirements?

In addition to the mandatory buy-in regime, CSDR introduces a cash penalties regime which is intended to serve as a deterrent to settlement fails.

The cash penalties requirements provide that EEA CSDs must include rules in their rulebooks imposing cash penalties on their participants that cause settlement fails. Cash penalties are to be charged for each business day on which a settlement fail in in-scope financial instruments has occurred and remains outstanding. CSDs must distribute the cash penalties collected to the 'receiving' CSD participant.

Note that if the CSD participant is a CCP, the CSD will not impose cash penalties on the CCP. Instead, the CCP is required collect and distribute cash penalties as between its clearing members, in respect of settlement fails relating to cleared transactions at that CCP.

20. Who do the cash penalties requirements apply to?

The cash penalties requirements under CSDR apply directly to the EEA CSDs and CCPs, who must include rules for the collection and distribution of cash penalties between their participants or members in their rulebooks.

Therefore, the CSDR cash penalties requirements will not generally apply directly to parties entering into securities lending and borrowing transactions under a GMSLA. However, there may be indirect commercial impacts on these parties through their contractual relationships with their custodians or settlement agents (who may be CSD participants).

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