

ICMA Secondary Market Rules & Recommendations Working Group

Meeting note from November 27 2018

Participating firms: BAML, Banque Cantonale Vaudoise, BlackRock, Citadel, Clearstream, Deutsche Bank, Goldman Sachs, SocGen

1) Buy-in pass-ons

The SMR&Rs require that a buy-in (pass-on) notice shall be issued *immediately* upon receipt of the previous buy-in notice (Rule 451.2). Members were asked whether there was a case for guidance on what is expected by *immediately* and possible clarity on the right to reject a pass-on in the event of a delay in receiving the pass-on.

The group suggested that there seemed to be some confusion among market participants as to whether the pass-on required a minimum of four business days notification, the same as buy-ins. It was confirmed that while the original buy-in required a minimum four business days' notification (and a maximum ten days'), the time between the pass-on being sent and the established buy-in execution date might be less than four business days. This could be for reasons such as a long transaction chain or parties operating in different time zones.

It was further explained that a minimum of four business days' notice was required for the original buy-in since this was intended to provide for enough time for it to be passed along a transaction chain, ideally leaving at least two-days' notice for the final party in the chain. In other words, it had been envisaged in the design of the buy-in framework that there would be scenarios where pass-ons provided a shorter notification period than the original buy-in.

A suggestion was made for a possible minimum two-days' notice for a pass-on. This would rest on the possibility of extending the entire buy-in process where a pass-on is received within two days of the buy-in execution date. However, it was agreed that this would be logistically challenging, since agreement to do this would be required from the buy-in originator, who may be several parties along the transaction chain from the final pass-on.

Another suggestion was that where initiating parties suspect that there may be a long settlement chain, they opt for a longer buy-in notification period than four days. A further consideration raised was for pass-ons to be numbered sequentially, which would at least provide the final pass-on recipient with information on the length of the chain (although it was noted that other parties in the chain would not have this information unless it is also passed back along the chain).

The ICMA secretariat felt that many of the problems stemmed from an erroneous view that the minimum four days' notification period also applied to pass-ons. It was further recognized that the real risk to timely pass-ons stemmed from firms 'sitting' on buy-ins or pass-ons, and that the threat of their eventual pass-on being rejected should provide enough incentive for firms to tighten their buy-in management process. It was also discussed that it was reasonable for firms receiving pass-ons to request evidence from the originating firm of when they received the buy-in or pass-on (noting that this is not specifically required under the Rules).

It was discussed whether the Rules should be more prescriptive with respect to pass-ons as well as outlining what constitutes 'immediately'. The secretariat felt that it would be impossible to cover every pass-on scenario or every reason for a legitimate delay, and that the risk of this was potentially more pass-ons being rejected, which would undermine the efficiency of the process. It was further noted that the instances of pass-on timing issues being raised with the ICMA Legal Helpdesk were relatively seldom.

The group agreed that some FAQs on the pass-on process would be helpful. In particular ICMA should consider guidance on:

- (i) the possibility that pass-ons, for good reason, may be served with less than four business days' notice based on the original buy-in notification period;
- (ii) consideration of the potential length of transaction chains be given by the initiating party when determining the by-in notification period (bearing in mind that they may not have sight of this); and
- (iii) good practice for pass-ons (including timing and information sharing)

It was also agreed that as CSDR Settlement Discipline loomed near (September 2020), tightening-up buy-in best practice would be helpful from an industry perspective.

❖ **Action point: ICMA to draft FAQs on buy-in/pass-on process**

2) Rule 407

Following numerous discussions on Rule 407 ('interest claims against the failing seller'), it was agreed that there was no further requirement to amend or update the SMR&Rs with respect to this Rule.

3) Special situations

It had been discussed by the group previously that while Section 180 of the SMR&Rs provides for special situations with respect to a number of settlement scenarios, including the exercise of rights attached to securities or public offers (Rule 183), called/drawn securities (Rule 184), and the treatment of accrued interest in the case of bonds in default (Rule 185), there were still a number of scenarios not covered relating to where bonds unexpectedly cease to exist, either in their current form or altogether, between the transaction being agreed and the intended (or delayed) settlement date.

At a very broad level, three scenarios had been identified where the SMR&Rs might be helpful:

- (i) Where a bond unexpectedly changes its form into another deliverable security (another bond, equity, certificate of entitlement, 'proceeds', etc.).
- (ii) Where a bond unexpectedly changes its form into something other than a deliverable security – such as a bail-in scenario where it ceases to exist or effectively becomes a 'claim' (or potential claim).
- (iii) Where there is an option to change the form of the bond into another security or proceeds

While the group appreciated that it would be difficult to provide prescriptive Rules for every possible scenario (given that each is likely to be unique), it was felt that a general Recommendation would at least help in establishing market guidance or best practice.

The ICMA secretariat suggested that member firms provide case studies of situations where bonds have unexpectedly changed form (or ceased to exist) after trade date, but before the trade could be settled, along with details of how the trade/issue was eventually settled/resolved. Such case studies could then help to widen the discussion among members as the basis for potential additions to the Rules and Recommendations.

- ❖ ***Action point: ICMA to solicit case studies from members relating to transactions where the bonds unexpectedly changed form (or ceased to exist) before settlement.***

4) Interest accruals for new overnight indices

The group was asked whether it felt ICMA should look to update Section 250 ('Calculation of accrued interest') to take account of accrual practices for new issues with coupons referenced to new overnight risk-free rates (RFRs), such as SONIA and SOFR.

The group felt that issuance referencing new indices was still at an early stage and that it was too early to discern consistent practice by issuers for the various RFRs.

5) Buy-ins post CSDR

The ICMA secretariat updated the group that it was still in contact with ESMA with a view to updating the ICMA Buy-in Rules to align with the CSDR buy-in requirements from September 2020. The updated Rules are intended to support implementation of the CSDR requirements, provide for market best practice, as well as addressing the potential asymmetry in the buy-in/cash compensation differential payments.

It would also seem likely that there will be more than one version (or application) of the ICMA Buy-in Rules, covering scenarios where:

- (i) a buy-in is executed under the CSDR requirements;
- (ii) a buy-in is executed before the end of the CSDR extension period; and
- (iii) a buy-in is executed against an out-of-scope transaction.

ICMA hopes that ESMA would provide official guidance (as part of its Level 3 Q&As) on the ability to address the potential asymmetry in the buy-in/cash compensation differential payments by means of a

contractual agreement in early 2019. However, it was explained that ICMA would still need to seek legal counsel with respect to the enforceability of the ICMA Buy-in Rules under CSDR.

ICMA, through its CSDR-SD Working Group, is also seeking clarity from ESMA on a number of other issues, including a proposal for a pass-on mechanism and the possibility that a buy-in agent cannot be found. Once there is a more complete understanding of what is or is not possible under the CSDR buy-in process, ICMA will launch a consultation with members, and the broader industry, with a view to updating the Rules to align with CSDR-SD implementation.

- ❖ ***Action point: ICMA to keep the group and members informed of ongoing discussions with ESMA with respect to the CSDR buy-in mechanism.***

Ends

Prepared by Andy Hill, January 2019