

IMPACT OF CSDR SETTLEMENT DISCIPLINE FOR THE BUY-SIDE

Buy-side firms, wherever established, which trade in-scope securities that settle on EEA central securities depositories (CSDs) should start preparing for the impact of new EU settlement discipline rules that will apply from 1 February 2022 (the Rules). The Rules have extra-territorial impact and will require amendments to a wide range of contractual arrangements and operational processes. This briefing highlights the impact of the mandatory buy-in and penalties regime on buy-side firms introduced by the Regulation on Central Securities Depositories (CSDR).

Background

CSDR is a major limb of post-crisis reform of financial market infrastructure aiming to harmonise certain aspects of securities settlement given the fragmented nature of the EU settlement markets and the additional risks and costs associated with cross-border settlement. CSDR has introduced harmonised rules on the timing of settlement and an authorisation process for EEA CSDs. The next major phase of implementation relates to the settlement discipline regime, with measures being introduced to prevent and address settlement fails, including mandatory buy-in and cash penalties.

What are the new settlement discipline rules?

Buy-in

Buy-in is a tool used to remedy a transaction that fails to settle and involves securing delivery of the relevant securities from a third party where the original counterparty is unable to deliver those securities.

Under CSDR, if a settlement failure continues for a specified period of time after the intended settlement date, a buy-in process must be initiated to effect the settlement unless the transaction is bi-laterally cancelled. Ultimately, if the buy-in process is unsuccessful, cash compensation must be paid.

Penalties

In order to deter settlement failures, EEA CSDs are required to impose cash penalties on CSD participants that cause a settlement failure. Cash penalties will apply daily for every day that a transaction fails to settle after the intended settlement date.

In practice, settlement failures are not often caused by CSD participants themselves so they may seek to pass the penalties up the settlement chain to the trading parties responsible for the settlement failures - this may include a buy-side firm or their underlying client.

Written allocations

There will be a direct obligation on EEA MiFID investment firms to take measures to prevent settlement failures which includes arrangements with professional

clients to communicate securities allocations and transaction confirmations.

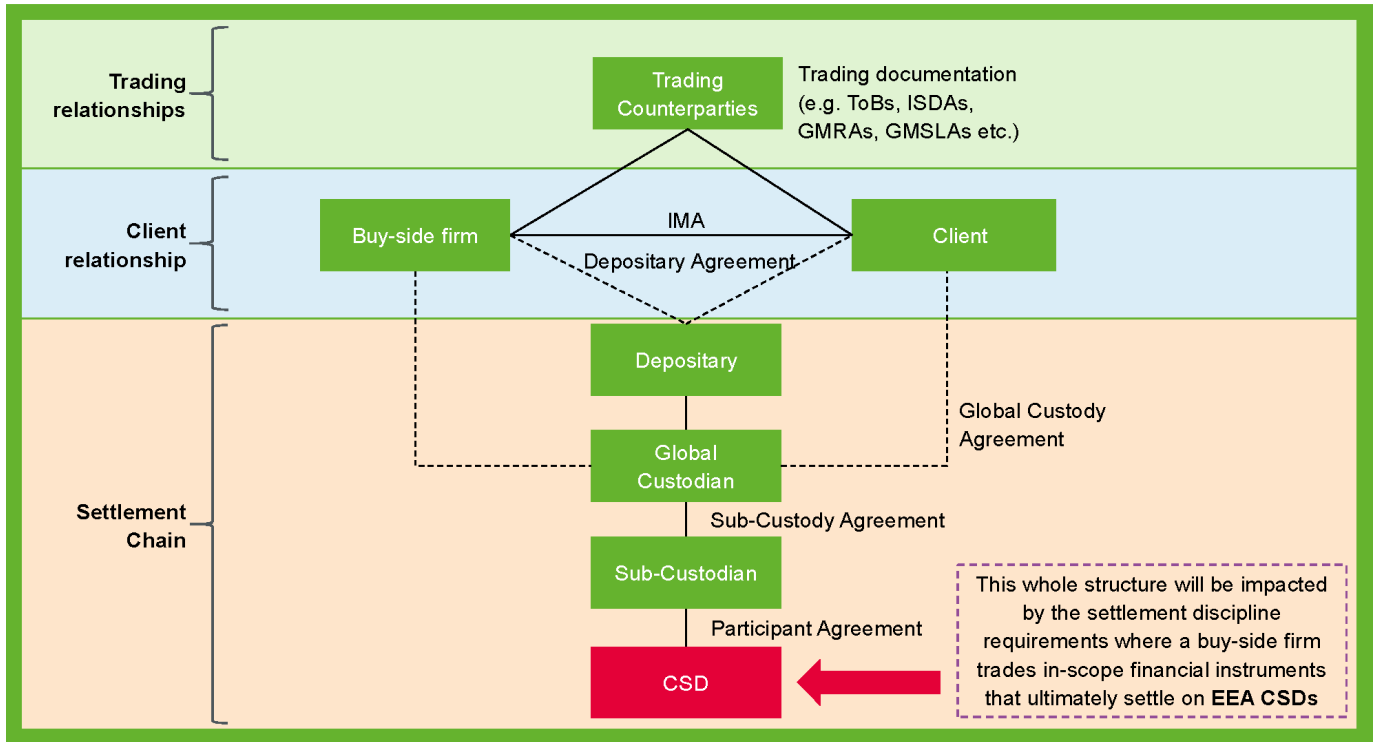
When do the new Rules apply?

The Rules, as currently drafted, are expected to come into force from 1 February 2022. The European Commission is considering making changes to the Rules as part of its broader review of CSDR, but details of these are not expected until Q4 2021.

Why is the buy-side impacted?

Many buy-side firms (European and non-European) will be buying and selling EEA financial instruments on a frequent basis as part of their trading or investment strategies. The new Rules will apply to certain types of financial instruments (e.g., shares, bonds, units in funds) that are settled through an EEA CSD. To be in-scope for the buy-in and penalties rules, those financial instruments must be (i) admitted to trading on an EEA trading venue (including when these instruments are traded OTC), or (ii) cleared by an EEA central counterparty.

Settlement Chain



What is the settlement chain?

In order to facilitate the settlement of transactions, buy-side firms engage custodians (and/or depositories) to safeguard and maintain their securities (and cash) accounts who, in turn often appoint local custodians who are participants in the relevant CSD where the securities will be settled.

The Rules will impact buy-side firms because the relevant obligations will be pushed up the settlement chain. The CSDR Level 2 regulation expressly envisages this, requiring “each party in the settlement chain” to agree contractual provisions that incorporate the mandatory buy-in process and procedures.

What is the impact on UK firms or trading in UK securities?

The UK has not onshored the Rules into UK CSDR so trading securities that are ultimately settled in CREST will not be impacted by the Rules. However, UK buy-side firms that trade in securities that settle through an EEA CSD will be impacted by the buy-in and cash penalties requirements. Further, UK buy-side firms that use EEA brokers will be impacted by the written allocations and confirmations requirements.

What should the buy-side do next?

Buy-side firms should:

- determine whether they trade in-scope financial instruments and where these are settled;

- consider the practical impacts of the new Rules on the relationships with custodians, clients and counterparties;
- assess whether existing client, trading and custodial documentation needs to be amended or re-papered; and
- implement new processes to manage the procedures around buy-in, cash penalties and written allocations and confirmations.

Sell-side firms are currently working on various initiatives, for example, efforts to find common buy-in language to repaper agreements ahead of 1 February 2022 deadline. Some firms are already starting to reach out to clients to repaper their agreements. Buy-side firms will need to consider their strategy for responding.

How is the buy-side impacted?

Issue	Impact on buy-side
Mandatory buy-in requirements pushed up the settlement chain to the trading parties	Custody / depository agreements
	Buy-side firms should expect their custodians / depositories to seek to amend custody / depository agreements to require the buy-side firm to comply with the mandatory buy-in requirements
	Trading agreements
	Amend their trading documentation to ensure trading parties will comply with the mandatory buy-in requirements in the case of a settlement fail
	Client agreements
	Address whether the asset manager is appointed by the underlying client to act as its buy-in agent or contractually require the underlying client to comply with the mandatory buy-in requirements
	Address the allocation of losses arising from the buy-in process
Establish procedures to execute a buy-in	Buy-in policy and procedures
	Arrangements to execute the buy-in, pay cash compensation, the price difference and the buy-in costs
	Buy-in agent arrangements
	Establish arrangements with buy-in agents before it becomes necessary to execute a buy-in
	Transactional impact
	When buying-in the counterparty to the original transaction, buy-side firms may receive cash instead of securities (if buy-in cannot be achieved), which could breach their own investment restrictions or require them to unwind contingent positions
Cash penalties are likely to be pushed up the settlement chain to the trading parties	Custody / depository agreements
	Custodians / depositories may seek to pass on cash penalties relating to settlement fails caused by the buy-side firm, either under existing contractual provisions or by amending relevant agreements
	Check whether custodians / depositories also intend to pass on the benefit of any cash penalties received in relation to the buy-side firm's settlement activity
	Client agreements
	Client documentation may need to be amended to address how the burden of cash penalties is allocated between the asset manager and its underlying client (which may depend, for example, on whether the settlement failure was caused by the asset manager or the underlying client)
Written allocations and confirmations	Trading agreements
	When trading with EEA MiFID investments firms, may need to agree to revised terms of business which incorporate the requirements on written allocations and confirmations
	Ensure that operational procedures are in place to meet these new requirements
	Client agreements
	Update client agreements to ensure that they have access to the information they need to comply with sell-side firms' new requirements for allocations and confirmations

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