The ICMA Buy-in Rules

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The ICMA Buy-in Rules

Introduction to the ICMA Buy-in Rules by Lee Goss, ICMA Legal Counsel

- ICMA provides a highly cost-efficient and effective framework to resolve settlement fails quickly.
- It does this through giving buyers the right to self-help – ie to cover the failed delivery by buying the securities elsewhere in the market and settling any market price difference with the seller (symmetrically).
- This applies to trades between members automatically, unless disapplied.
- Parties are expected to follow the ICMA Rules as these form part of the “terms of trade”; ie they are enforceable contract terms in court or arbitration – should that become necessary.

Agenda

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2) Buy-ins
3) The buy-in notice
4) Delivery during the buy-in notice period
5) Buy-in execution
6) Confirmation of the buy-in execution
7) Pass-ons
8) Settling the buy-in
9) Exemptions from buy-ins
10) Potential disputes arising from a buy-in
11) Sell-outs
12) Summary of the buy-in process
13) EU CSDR Mandatory buy-ins

1) Context: the ICMA SMR&Rs

What are the ICMA Secondary Market Rules & Recommendations?

- The ICMA Secondary Market Rules & Recommendations ("the Rules") apply to all transactions conducted by members as buyer or seller, in either a principal or agency capacity in international securities.
- The Rules cover a range of secondary market practices, including calculating coupon accruals, trading defaulted securities, interest claims for settlement fails, and, perhaps most famously, the process for issuing and executing buy-ins.
- With the Rules automatically applying between ICMA members, it is one of the benefits of membership. Non-member firms can also elect to apply the Rules with their counterparts individually ad hoc or by incorporation through reference in their general terms of business.
- The Secondary Market Practices Committee (SMPC) is tasked with reviewing the Rules in light of new regulation, evolving market structure, and market best practice.
- The latest version of the Rules was published in 2023 and includes the recently approved best practice recommendations to support settlement efficiency, which provides guidelines for shaping bond transactions into maximum lot sizes, partialing trades, and using CSD auto-borrow and lending programmes. It also incorporates the 2017 revisions to the Buy-in and Sell-out Rules.

1) Context: the ICMA SMR&Rs

ICMA International Capital Market Association

What is the scope of the ICMA Rules?

Rule 2 Scope and application of rules

2.1 The Association's rules and recommendations shall apply to all transactions concluded by members as buyer or seller, in either a principal or agency capacity, in international securities as defined below but unless otherwise stated shall not apply to the syndication and allotment process or to repurchase and to other transactions entered into under the Global Master Repurchase Agreement or similar master agreements.

Where a transaction is subject to the rules of an exchange, its rules shall apply. In all other cases, the Association's rules shall apply.

Nothing contained in the Association's rules and recommendations shall be construed as discharging the member from complying with the applicable local laws and regulations when concluding a transaction.

- Automatically apply to all members transacting in secondary markets in international securities (except for repo), unless disapplied.

1) Context: the ICMA SMR&Rs

What is an international security?

2.2 For the purposes of the Association's rules and recommendations, an international security is a security intended to be traded on an international, cross-border basis (i.e. between parties in different countries), and capable of settlement through an international central securities depository or equivalent.

- Generally taken to mean ‘bonds’ that can be traded cross-border.

1) Context: the ICMA SMR&Rs

Enforceability

2.6 In any transaction in international securities between members, the rules which stipulate terms of trade shall apply as direct and enforceable obligations between members.

2) Buy-ins

ICMA International Capital Market Association

What is a buy-in?

- Buy-ins are used to manage counterparty risk arising from a settlement fail by enforcing settlement.
- In the event of a settlement fail, a buy-in mechanism provides the disappointed buyer of securities with the option to purchase the failing securities from a third party. This will replace the delivery obligation of the failing seller.
- Buy-ins are usually **a contractual right** of the non-failing party, and not an obligation.
- Any difference in the cash value between the buy-in (replacement) transaction and the original (failing) transaction is settled between the original counterparties, along with any reasonable direct costs incurred by the disappointed party in executing the buy-in. This is to ensure that the disappointed party is returned to the same economic position they would have been in had the original transaction settled as intended.
- **The payment between the parties can go in either direction**, depending on whether the buy-in value is higher or lower than the value of the original transaction.
- While the failing party will usually incur a cost from being bought in, **buy-ins are not intended to be a penalty or compensation mechanism.** From the perspective of the disappointed party, buy-ins are economically neutral.

2) Buy-ins

Other key features of a buy-in mechanism

- Buy-ins are usually executed for “**guaranteed delivery**”. This is to ensure successful settlement of the buy-in, and to minimize risks to both the disappointed and failing party.
- It is usual for the disappointed party to provide the failing party with notification of their intention to execute a buy-in and a specified buy-in date. This will usually allow enough time for the failing party to attempt to source and settle the securities before the buy-in is actioned. This is in the form of a **buy-in notice**.
- Buy-in mechanisms usually have a “**pass-on**” provision that allows for a buy-in to passed along a failing settlement chain. This provides for a single buy-in to remedy multiple, dependent fails.

2) Buy-ins

Who initiates and executes a buy-in?

- Initiating a buy-in is a commercial decision since it could result in a cost (sometimes substantial) for the failing party.
- Buy-ins are also a risk management decision, since fails can result in counterparty credit risk for the disappointed party.
- Buy-ins are regulated market transactions.
- Buy-ins create market risk for the failing party.
- Buy-ins require timely communications between the affected traders of both parties, as well as the relevant operations teams.
- It is important that parties adhere to the contractual provisions of the buy-in process.

❖ **While the buy-in process is generally managed by the relevant trading desk, it will usually also involve risk managers, legal, and operations teams.**

2) Buy-ins

ICMA Buy-ins

- The process for buy-ins under the Rules is outlined in **Section 450** of the Rules

3) The buy-in notice

Issuing the buy-in notice

- Must be in writing (eg email)
- Must be issued before **10am** London time
- Pass-on notices must be issued **immediately** on receipt of buy-in/ pass-on notice
- *When issuing a buy-in notice or pass-on, it is advisable to request acknowledgement of receipt*
- *On receiving a buy-in or pass-on notice, it is important to notify the relevant trading desk immediately*

Rule 451 Buy-in notice

451.1 451.1.1 If a delivery is not made on the value date, the buyer shall have the right to issue the seller a buy-in notice in writing.

451.1.2 Where a delivery has been refused through the fault of the buyer or its clearing agent, the buyer shall have the right to issue the seller a buy-in notice in writing on the business day following the date on which instructions are corrected or re-submitted as per rule 404.

451.1.3 The buyer shall not lose its right to issue a buy-in notice after the expiration of the timing prescribed in this rule.

451.1.4 A pass-on situation exists where the seller is in turn a buyer of all or part of a corresponding amount of securities from a third party and passes on a buy-in notice in respect of those securities to that third party.

451.2 A buy-in notice shall be issued before 10.00 a.m. London time on the relevant date. Where a pass-on situation exists, a buy-in notice shall be issued immediately upon receipt of the previous buy-in notice.

3) The buy-in notice

Selecting the buy-in date

- The issuing party must select and communicate the buy-in date
- The execution of the buy-in transaction should commence on this day
- The buy-in date can be a **minimum of 4 business days** from the notice date and a **maximum of 10 business days**
- **The buy-in date cannot be changed** once communicated in the buy-in notice
- **The specified buy-in date will remain the same in any subsequent pass-on notices**

451.3 A buy-in notice shall state:

451.3.1 the buyer's intention to close out the contract by means of a buy-in;

451.3.2 the date, as determined by the buyer, when the buy-in will be executed, which shall be at least four but not more than ten business days following the date of such notice; and

451.3.3 full details of the contract and the principal amount of the bonds to be bought in.

3) The buy-in notice

Information in the buy-in notice

- Intention to buy-in
- Buy-in execution date
- Details of transaction being bought in

  Incl. trade date, settlement date, nominal., security description/identifier, price, value, delivery/settlement details
- Whether a pass-on situation

451.4 A buy-in notice shall be in the following format:

To the international securities settlements manager

We hereby give you notice of our intention to close out the contract between us, of which details are given below, by means of a buy-in in application of the Association's buy-in rules. Unless delivery is made on or before [date – in accordance with sub paragraph 451.3.2], the date of execution of the buy-in shall be that date.

The details of the contract between us are as follows:

trade date:

settlement date:

nominal amount:

security description:

price:

net amount:

delivery details:

Please inform us immediately if you have any disagreement.

451.5 Where a pass-on situation exists, the following wording shall be added to the buy-in notice as given in paragraph 451.4:

This is a pass-on situation.

4) Delivery during buy-in notice period

Partial delivery

- Following the buy-in notice, the failing party can continue to attempt to settle part or all of the failing trade
- The disappointed party should receive any partial settlement and reduce the amount of securities to be bought in accordingly
- Partials should be accepted on the condition that the residual buy-in amount is a tradeable amount
- Any attempt to settle on or after the buy-in date **should be notified in writing the day before**, and accepted by the disappointed party
- ***It is advisable that both parties put their settlement instructions on hold from the buy-in date***

Rule 456 Partial delivery

456.1 While a buy-in notice is in force, or an incomplete buy-in is in force, a partial settlement of the trade subject to the buy-in shall only be effected to the extent of any outstanding portion of the securities, provided that the seller must advise the buyer, in writing, 24 hours in advance of any partial delivery intended to be made on any execution date of the buy-in.

456.2 Such securities received shall be deducted from the principal amount of securities stated in the buy-in notice or from the balance of securities still to be bought in.

456.3 Settlement as prescribed in this rule will take place against payment of the pro rata countervalue depending on the terms of the original contract.

456.4 Partial deliveries shall not render the balance of securities still to be bought in an untradeable amount.

5) Buy-in execution

Rule 454 Buy-in execution

454.1 On failure of the seller to effect delivery on or before the business day preceding the date of the buy-in, the buyer shall, acting in good faith, purchase on the buy-in day, in the best available market for guaranteed delivery on the normal value date, all or any part of the securities. In executing the buy-in, the buyer shall take into account such factors as price, cost and size of the trade and the liquidity of the market.

454.2 The buyer initiating the buy-in may not effect the buy-in using securities held for its own account or that of an affiliate, either directly or through an intermediary.

"Affiliate" shall mean an entity directly or indirectly controlling, being controlled by, or under common control with the buyer (e.g., parent, subsidiary, branch, main office).

454.3 The seller shall be liable for reasonable direct costs strictly related to the buy-in execution.

454.4 In the event that a buy-in cannot be completed on the buy-in date specified in the buy-in notice, the buyer may complete the buy-in of the securities on any subsequent business day until completed or until such time as the parties agree to a settlement of the trade subject to the buy-in. Such settlement may be in the form of cash, alternative securities or in any other form as agreed by the parties.

5) Buy-in execution

Best execution

- The executing party should, acting in good faith, attempt to execute in the best available market, for normal value date, for part or all of the buy-in amount, taking into account factors such as price, cost, size, and liquidity. This is intended to protect the failing party.

Conflicts of interest

- The disappointed party initiating the buy-in cannot use any of their own inventory, or that of an affiliate, to settle the buy-in, whether directly or through an intermediary.

Guaranteed delivery

- The buy-in should be executed for **guaranteed delivery**. This allows for the buy-in to be completed (in part or full) at the moment of execution, and not be dependent on successful settlement, thereby ensuring certainty of outcome for both parties.
- It is likely that the party selling into the buy-in will require an additional premium to the current market price as compensation for guaranteeing delivery.

Notification of execution

- **The failing party should be informed Immediately** following the successful execution of part or all of the buy-in, ideally **at the trading level**. This minimizes the market risk of the failing party and allows them to hedge or trade out of their resulting change in position before any movement in the market.

5) Buy-in execution

Reasonable direct costs

- Any reasonable direct costs incurred by the disappointed party arising from the buy-in execution (eg brokerage fees, buy-in agent spread or fees, trading venue costs, etc.) should be included in the final buy-in value when settling the difference between the buy-in and the original transaction value.

Unsuccessful completion

- If part or all of the buy-in cannot successfully be executed on the specified buy-in date, the disappointed party may elect to continue working the buy-in on subsequent days until the buy-in is fully executed.
- It is advisable for the disappointed party to communicate to the failing party, at the end of each day, their intention to continue working the buy-in on the subsequent day.
- The disappointed party may elect to discontinue working the buy-in at any stage. In this case they should inform the failing party. Should they subsequently choose to continue the buy-in they will be required to begin the buy-in process again and issue a new buy-in notice with a new buy-in date.

Alternative settlement

- If the buy-in cannot be completed successfully, both parties may elect to **negotiate an alternative remedy**, such as cash settlement.

6) Confirmation of the buy-in execution

Notifying the failing party

- **Immediately** following successful execution of part or all of the buy-in, the disappointed party should notify the failing party of relevant details (**quantity and price**)

- This should be in writing (eg email or electronic messaging

- *It is advisable to communicate this at **the trading level**, and possibly also to do so by phone*

- This should also apply in the case of a pass-on situation

- The disappointed party should also provide the failing party with a confirmation note (ideally same day). This should be passed along any pass-on chain.

Rule 457 Confirmation of buy-in execution

The buyer shall immediately on execution of the buy-in notify the seller, in writ-ing, of the quantity purchased and the price contracted, and shall promptly issue a contract note or confirmation note. In the event of multiple executions, the above shall apply in respect of each individual execution.

Where a pass-on situation exists, a copy of the buy-in execution confirmation must be passed on through the entire chain to the final defaulting member as evidence of close-out proceedings. The price at which the buy-in is executed will apply equally to all transactions closed-out.

One execution will satisfy the total chain.

7) Pass-ons

Pass-on notice

- A pass-on situation can arise where a party is failing to settle a sale as a result of a failing purchase, and where both transactions are subject to the Rules.

- A party that finds themselves in a pass-on situation, on receipt of a buy-in or pass-on notice should **immediately** pass this on to their failing counterparty, including in the notice that this is a pass-on situation.

- The buy-in date specified in the original buy-in notice cannot be changed. **The same buy-in date will apply for each pass-on notice**.

- Where a pass-on chain is particularly long, or crosses multiple time-zones, it is possible that by the time the notice reaches the final failing party in the chain the buy-in date may be less than the minimum 4 days specified in the original notice.

- *It is advisable that from the buy-in date, parties in a pass-on situation **put their settlement instructions on hold** and only accept partial or full delivery subject to their other counterparty also accepting delivery in accordance with the conditions outlined in the Rules.*

7) Pass-ons

Pass-on execution

- On receiving notification of the execution of part or all of the buy-in, a party in a pass-on situation should notify their failing counterparty **immediately**.

- Again, any communication should be in writing and ideally at the trading level. Additional communication by phone is also advisable.

- The buy-in confirmation note, which includes the details of the buy-in execution, including price and size, should be passed along the buy-in chain promptly. (Note that this price will be used to settle the pass-on payments between respective counterparties.)

8) Settling the buy-in

Buy-in settlement

- The cash differential between the value of the buy-in (including accrued interest and any direct costs) and the original transaction is settled between the failing and disappointed parties.
- The payment can go in either direction, depending on whether the value of the buy-in (including costs) is higher or lower than the value of the original transaction.
- The differential should be settled as soon as possible after the buy-in execution.
- In a pass-on situation, the difference between the buy-in value (including costs) and the original transaction value should be settled between parties in the chain and their respective counterparties.

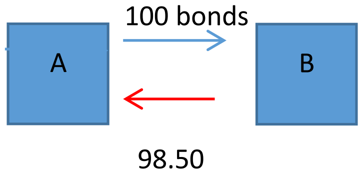
Rule 458 Buy-in settlement

The money difference(s) between the original contract(s) and the close-out contract, taking into consideration possible costs as per rule 454.3 and interest coupon due dates, shall be settled in each case between the seller and the buyer without any delay.

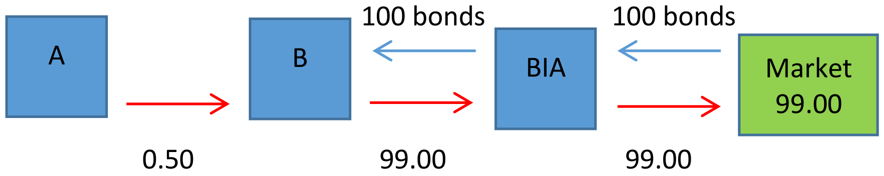
8) Settling the buy-in

Examples

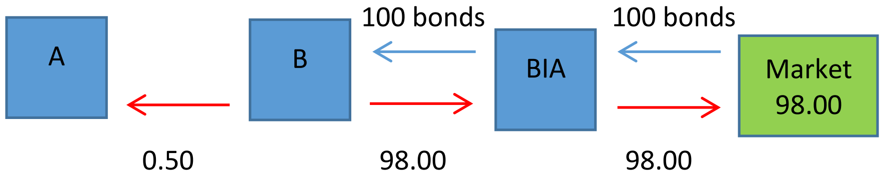
Original trade



Buy-in at a higher price



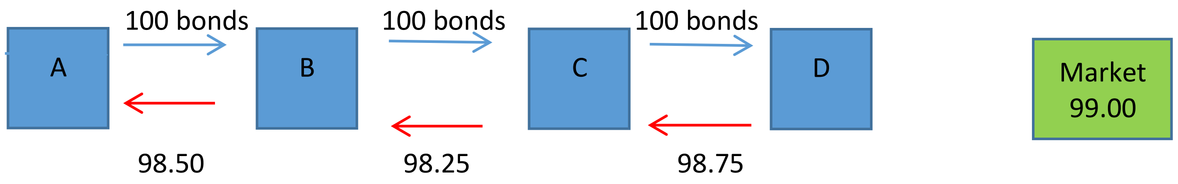
Buy-in at a lower price



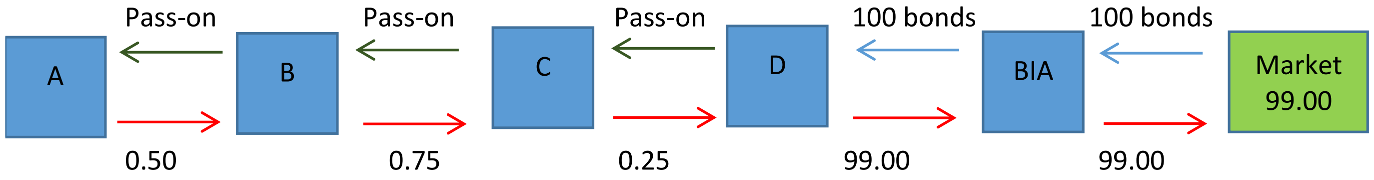
8) Settling the buy-in

Examples: pass-on situation

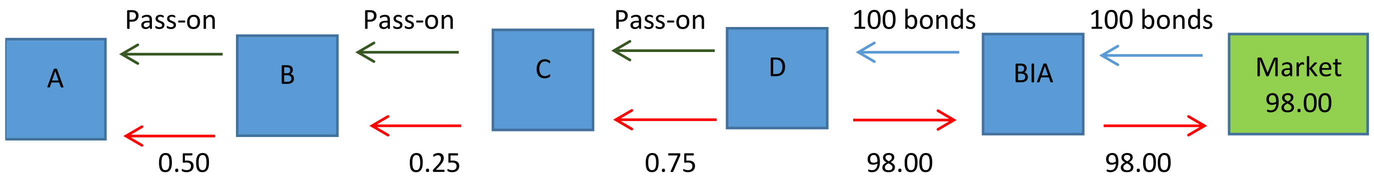
Original trade



Buy-in at a higher price



Buy-in at a lower price



8) Exemptions from buy-ins

- Securities that have been redeemed in their entirety cannot be bought in.

- Transactions not subject to the Rules also cannot be bought in. These include primary market transactions, documented securities financing transactions (eg repurchase agreements), and transactions subject to the rules of an exchange.

- Transactions not executed under the Rules, or where the Buy-in Rules have been specifically disapplied, are not subject to the ICMA Buy-in Rules.

Rule 459 Securities exempt from buy-in

The provisions of the buy-in procedure as set forth in this section shall not apply to contracts for any issue of securities which has been entirely called for redemption.

10) Potential disputes arising from a buy-in

Non-adherence to the Rules

- Where the disappointed party has not adhered to the relevant Rules specified in the Rules, including those pertaining to the buy-in notice, the failing party may reject the buy-in.

The buy-in price

- In some cases, the buy-in price may be significantly higher than the understood market price. This could be the result of any premium for guaranteed delivery as well as poor market liquidity. The executing party should be able to evidence that they executed the buy-in, to the best of their ability, in compliance with Rule 454.1.

Conflict of interests

- The disappointed party should be able to evidence that they have not used their own inventory, or that of an affiliate, to settle the buy-in.

Arbitration

- While buy-in disputes sometimes occur, It is extremely rare that firms seek recourse in litigation or alternative dispute resolution. ICMA's experience is that most disputes can be resolved successfully by negotiation between the affected parties, particularly at a senior, commercial level.

11) Sell-outs

- While much rarer, the Rules also provide for sell-outs in the case of a failing buyer.

- In a sell-out, the disappointed seller has the right to sell the securities to a third party, and for any difference between the value of the sell-out and the original transaction to be settled between the seller and the original buyer.

- The Sell-out Rules mirror the Buy-in Rules, including with respect to the sell-out notice, partial settlement, execution, and settling the sell-out.

- The sell-out provisions can be found in **Section 480** of the Rules

Rule 481 Sell-out notice

481.1	481.1.1	Where a delivery against payment has been refused through the fault of the buyer or its clearing agent and if no instruction has been corrected or re-submitted as per rule 404 by the close of the business day following the day of the refusal, the seller shall have the right to issue to the buyer a sell-out notice in writing.
	481.1.2	If a payment due on the value date of a transaction or a payment requested by a written advice of delivery has not been received on the value date or advice of delivery date, the seller may issue to the buyer a sell-out notice in writing.
	481.1.3	The seller shall not lose its right to issue a sell-out notice after the expiration of the timing prescribed in this rule.

12) Summary of the buy-in process

- Issue buy-in notice by 10am London time. Must specify buy-in date (from 4 to 10 business days following the notice date)
- Pass-ons to be forwarded immediately (noting that buy-in date cannot be changed)
- Partial or full delivery while the buy-in notice is in force to be accepted provided the seller advises the buyer in writing at least 24 hours in advance of any such delivery intended to be made on the execution date of the buy-in (advisable for parties to put settlement instructions on hold from the buy-in execution date)
- Buy-in execution to be communicated to failing party (and along any pass-on chain) immediately (ideally at the trading level), including any partial executions
- Buy-in confirmation note to be issued to failing party (and along any pass-on chain) promptly
- Buy-in differential to be settled between the parties (including those in a pass-on chain) without delay following successful execution of part or all of the buy-in.

13) EU CSDR Mandatory buy-ins

While never implemented, the EU passed into law a controversial mandatory buy-in (MBI) regime as part of CSD-Regulation in 2014. The regime was intended to make buy-ins a legal requirement rather than a contractual right and would be applied at the EU (I)CSDR participant level, rather than at the regulated entity level.

The implementation of the MBI regime was delayed several times, ostensibly due to timing issues, but ultimately the result of recognized design challenges, a lack of market preparedness, as well as concerns about the impact on market liquidity.

In 2022, as part of a targeted CSDR Review, the European Commission proposed a “two-step approach” to MBIs, which would only be applied in specific markets where settlement efficiency rates were of concern or threatened to undermine market stability. During the 2023 trilogue process, the European Council and Parliament added even more stringent requirements before applying MBIs.

It is not expected that MBIs will ever be implemented in the EU. There are still a number of design challenges that potentially render them inoperable, as well implementation challenges relating to the contractual arrangements required to make them enforceable.

In the meantime, contractual buy-ins, such as the **ICMA Buy-in Rules**, continue to play an important role in managing counterparty credit risk in the event of fails as well as supporting settlement efficiency; not only in the EU, but across international bond markets more widely.

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