ISDA Safe, Efficient Markets

FIA

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FIA and ISDA position paper on the CSDR settlement discipline regime

The Futures Industry Association (**FIA**) and the International Swaps and Derivatives Association (**ISDA**) (together, the **Associations**) have been working with members to assess the potential impact of the settlement discipline regime under Regulation (EU) No 909/2014 (**CSDR**) on derivatives transactions and would like to take this opportunity to highlight a number of potential unintended consequences arising from the application of the regime to settlement fails arising in the context of derivatives transactions.

We support the aim of the CSDR settlement discipline regime to reduce the number of settlement fails that occur across the EEA and acknowledge that the CSDR settlement discipline requirements were finalised some time ago. However, a number of new practical considerations and concerns have come to light in recent months as market participants have turned to consider the detailed practical implications of the regime for derivatives transactions, in preparation for the application of the regime (currently expected to be 1 February 2021).

In particular, the CSDR settlement discipline regime does not appear to have been devised with derivatives transactions in mind. Accordingly, applying the cash penalties and mandatory buy-in regimes to settlement fails arising in the context of derivatives transactions is likely to lead to unintended adverse consequences and distort the economic agreement of the parties in relation to impacted transactions. We set out these concerns below and request that the Commission and ESMA consider making changes or clarifications to the regime in order to address these concerns.

Whilst this letter focuses on the impact of the CSDR settlement discipline regime on derivatives transactions, we are aware of broader concerns about the negative impacts that the mandatory buy-in regime could have on financial markets more generally, particularly in times of market stress and reduced liquidity. We echo these concerns and support recent industry requests made for urgent action to mitigate some of the more problematic aspects of the mandatory buy-in regime – including to address the derivatives-specific issues raised in this letter.

Executive summary and aims of this position paper

Focus of CSDR and overlap with EMIR: Overall, we are concerned that the CSDR settlement discipline regime was not drafted with derivatives transactions in mind and that applying these requirements to derivatives would overlap with – and undermine the risk-mitigating purpose of – derivatives-specific requirements such as margin rules under EMIR, contrary to Article 1(3) CSDR.

Contradictory outcomes for EMIR purposes: Whilst the types of financial instruments in scope of the CSDR settlement discipline regime (as identified in Article 5(1) CSDR) do not include derivatives, derivatives transactions may nevertheless involve settlements of in-scope financial instruments, for example when transferring margin and/or when physically settling a

derivative contract where the underlying is an in-scope financial instrument. However, mandating a buy-in (or imposing cash penalties) where a transfer of such financial instruments as margin fails to settle would likely increase the receiving party's exposure to the posting/failing counterparty. This would have exactly the opposite effect to the risk-mitigating purpose of regulatory margin requirements. The timing of daily margining requirements would also render a buy-in ineffective in this situation.

Exemption for short-dated operations: Article 7(4)(b) CSDR provides an exemption from the buy-in process for "operations composed of several transactions including securities repurchase or lending transactions" where "the timeframe of those operations is sufficiently short and renders the buy-in process ineffective". This leads to an exclusion of such transactions with a tenor of up to 30 business days. By way of comparison, margin requirements under EMIR generally require daily determinations, with a maximum timeframe of 10 business days for refreshing initial margin calculations. We believe that the same logic should apply to such margin transfers, which should therefore be excluded from the buy-in process.

Robust existing framework for settlement failures under derivatives transactions: Further, failures to deliver financial instruments or cash in the context of derivatives transactions (including as a result of a settlement fail in the context of margin transfers or physical settlement) are already dealt with effectively in industry standard documentation for cleared and uncleared derivatives transactions. These contractual provisions are well understood by the market and reflect the commercial agreement between the parties. Applying mandatory buy-in requirements on top of these existing contractual mechanisms would add an additional layer of complexity to the documentation and risks distorting the commercial agreement between the parties, particularly for existing master agreements and transactions.

Clarifications respectfully requested: We therefore request express clarification that the cash penalties and mandatory buy-in requirements of Article 7(2)-(10) CSDR shall not apply to settlement fails arising in the context of derivatives transactions. In particular, we request that:

- amendments are made to Delegated Regulation (EU) 2018/1229 (the **RTS on Settlement Discipline**) to confirm expressly that margin transfers are exempt from the mandatory buy-in regime under Article 7(4)(b) CSDR and/or that ESMA publishes Q&A confirming that that mandatory buy-ins do not apply to margin transfers (noting that ESMA is already considering a draft Q&A on this point)[1];
- ESMA provides Level 3 interpretation via Q&A clarifying that the mandatory buy-in regime will not apply to settlement fails arising in the context of physical settlement of physically settled derivatives; and

[1] We note that the UK government announced (on 23 June) that it would not be implementing the settlement discipline regime in onshored CSDR, and will instead further deliberate on how and if to implement an enhanced settlement discipline framework. Please see https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2020-06-23/HCWS309/

- ESMA provides Level 3 interpretation via Q&A clarifying that cash penalties should not apply to settlement fails arising in the context of derivatives transactions.

We ask that clarity is provided quickly on these issues in order to give firms time to understand the impact of the CSDR settlement discipline regime on their activities as a whole. Otherwise, and in the absence of clarity that settlement fails arising in the context of derivatives transactions are out of scope, meeting the 1 February 2021 application deadline for these requirements in respect of derivatives transactions would present a very significant implementation challenge for firms. In this case, we would request that ESMA and the Commission consider granting a further delay to the application date of the CSDR settlement discipline regime via changes to the RTS on Settlement Discipline, particularly in light of the COVID-19 pandemic. Such a delay would also allow time to consider how the cash penalties and buy-in requirements might impact market stability in times of market stress similar to those experienced over recent weeks and whether further elements of flexibility or other changes should be built into the regime as a result.

Issues arising from application of the CSDR settlement discipline regime to derivatives

For the reasons set out below, we consider that application of the CSDR settlement discipline regime to settlement fails occurring in the context of derivatives transactions is not necessary and may lead to unintended adverse consequences. We do not believe that the CSDR settlement discipline regime was drafted with derivatives transactions in mind, perhaps due to the fact that the types of financial instruments that are in scope of the cash penalties and mandatory buy-in regimes do not expressly include derivatives.

Under Article 7(10) CSDR, the cash penalties and mandatory buy-in regimes apply to settlement fails that occur in EEA securities settlement systems relating to transactions in the financial instruments listed at Article 5(1) CSDR (i.e. transferable securities, money-market instruments, units in collective investment undertakings and emission allowances) that are traded or admitted to trading on a trading venue or cleared via a CCP. Therefore, trades in ETDs and other derivative contracts are not themselves caught by the CSDR settlement discipline regime. However, derivatives transactions will involve transfers of in-scope financial instruments that are required to be settled in EEA CSDs in two main scenarios. The first is where in-scope financial instruments are posted as margin for a derivatives transaction or portfolio of transactions. The second relates to physical settlement of a physically settled derivatives transaction where the underlying is an in-scope financial instrument.

However, the commercial context of these types of transfers of financial instruments is very different from a typical cash trade in the same financial instruments, as discussed below. Therefore, applying cash penalties and mandatory buy-ins to settlement fails arising in these situations would give rise to adverse unintended consequences that will often be inconsistent with the commercial agreement and intentions of the parties to the derivatives transaction.

Whilst it may be possible to mitigate some of these consequences through contractual provisions, this would require extensive repapering of existing agreements with little or no practical benefit and with uncertain implications for the legal and regulatory characterisation

of transactions governed by these agreements (e.g. in terms of clearing or margin requirements, (re)pricing and/or close-out netting). We therefore request clarification that the settlement discipline regime should not apply to these types of transfers.

(a) Margin transfers

Exchange of margin is an important risk-mitigation tool for both cleared and uncleared derivatives. Under EMIR and the related EMIR Margin RTS[2], counterparties to uncleared OTC derivatives are required to collect variation margin and initial margin from their counterparties (subject to various thresholds). Under Article 9 EMIR Margin RTS, counterparties must calculate variation margin at least on a daily basis and must calculate initial margin at least every 10 business days (and more frequently where a trigger event occurs such as entry into a new transaction). For cleared derivatives, CCPs will typically call for (or return) margin on at least a daily basis (including intra-day where relevant) and clearing members will themselves collect margin from their clients on a similar basis in the case of client clearing.

We do not consider that margin transfers were intended to be captured by the mandatory buy-in regime. There are three main reasons for this. Firstly, the purpose of margining; secondly, the timing aspects of margining; and thirdly, the overlap with existing EU regulations.

(i) Purpose of margining

In general, there seems to be an implicit assumption behind the mandatory buy-in regime that the receiving party has contracted to receive specific financial instruments and that it is important from a commercial perspective that they actually receive them (i.e. that delivery of cash or of different financial instruments will not suffice). However, this assumption does not hold true in the case of margin transfers, the purpose of which is to mitigate credit risk arising from an exposure created by an underlying trade rather than to receive specific financial instruments.

Mandating a buy-in in this situation would be counterproductive as it would likely increase the receiving party's exposure to the posting/failing counterparty, quite apart from the buy-in extension period during which the margin taking party would be uncollateralised, and would undermine the risk-mitigating purpose of regulatory margin requirements. Therefore, we consider that there should be an explicit carve-out from buy-in requirements for settlement fails arising in the context of margin transfers.

(ii) Timeframe of margin transfers

Article 7(4)(b) CSDR provides an exemption from the buy-in process for "operations composed of several transactions including securities repurchase or lending transactions" where "the timeframe of those operations is sufficiently short and renders the buy-in process ineffective". Article 22 of the RTS on Settlement Discipline indicates that this exemption will apply in relation to securities financing transactions where the settlement

[2] Commission Delegated Regulation (EU) 2016/2251

date of the second leg of the transaction is set within 30 business days of the intended settlement date first leg.

However, there is nothing in Article 7(4)(b) CSDR that would prevent Article 22 of the RTS on Settlement Discipline from being expanded to expressly exempt margin transfers. The scope of the Article 7(4)(b) CSDR exemption "includes" (but is not limited to) securities repurchases or lending transactions and so this exemption from the mandatory buy-in requirements could also apply to other types of transactions which are sufficiently short and could render the buy-in process ineffective.

Indeed, we consider that the exemption in Article 7(4)(b) CSDR should apply to all margin transfers relating to derivatives transactions. This is on the basis that margin calls are usually made on a daily basis and even initial margin requirements must be recalculated every 10 business days at most (i.e. significantly shorter than the 30 business day timeframe referred to in Article 22 RTS on Settlement Discipline). Therefore, keeping a derivatives transaction or netting set margined throughout its lifetime involves operations composed of several transfers or "transactions" that occur within a timeframe that is short enough to render the buy-in process ineffective. We request that this is expressly clarified either through an amendment to Article 22 of the RTS on Settlement Discipline or via Level 3 guidance.

(iii)Overlap with existing EU regulation

Article 1(3) CSDR states that the requirements of CSDR shall be "*without prejudice to provisions of Union law concerning specific financial instruments*". This includes the risk mitigation provisions of EMIR in relation to derivatives transactions, including margin requirements. However, if the buy-in procedure were to apply to margin transfers this would undermine (and so prejudice) the risk-mitigating effect of the margin rules under EMIR in that it would increase the failed to party's claim against the failing party. Again, this supports the position that the CSDR buy-in rules should not apply to margin transfers.

However, if this point is not clarified, we are concerned that parties may need to agree complex operational and contractual mechanisms to ensure that a buy-in would never be triggered in practice and so mitigate the adverse impacts of applying a buy-in to margin transfers. These contractual arrangements would need to be negotiated in parallel with ongoing repapering exercises required under the margin rules and other regulatory requirements applicable to derivatives, thus increasing the repapering burden in the market. They would also require a further sub-set of counterparty classifications to identify clients who may or would be impacted by these requirements.

Further, applying cash penalties where a margin transfer fails to settle may worsen the posting/failing counterparty's financial position and increase the counterparty default risk in respect of the derivatives transaction, contrary to the purpose of the risk mitigation requirements of EMIR. Again, we request that there is an express carve out from cash penalties requirements for settlement fails arising from margin transfers, on the basis that Article 1(3)

CSDR indicates that its requirements should not prejudice the provisions of EMIR in relation to derivatives transactions.

(b) Application to physically settled derivatives

The CSDR settlement discipline regime may also impact the delivery of in-scope financial instruments to settle obligations under physically-settled derivative contracts where the underlying is an in-scope financial instrument, such as a physically settled equity option.

ISDA and FIA documentation already includes extensive provisions setting out the parties' rights and remedies in case of a default such as failure to deliver financial instruments in physical settlement of the derivatives transaction. In many cases, this may involve moving to cash settlement instead of physical settlement and/or allowing for termination and close out of relevant transactions, potentially after an appropriate grace period. These default and other provisions are well understood by the market and reflect the commercial agreement between the parties.

Application of the mandatory buy-in regime to a settlement fail in the context of physical settlement of a derivatives transaction will likely distort this commercial agreement between the parties. In particular, the mandatory buy-in regime will likely disrupt and interact with the existing contractual default provisions (including grace periods) in ways that the parties did not contemplate when they entered into the agreement. For example, it may be unclear whether and how the buy-in requirements interact with netting arrangements amongst other things (e.g. if the parties have not expressly agreed whether buy-in costs, cash compensation and other amounts relating to a buy-in should be included in close out netting calculations). In addition, the provisions at Article 32 RTS on Settlement Discipline specifying how the price difference and cash compensation are to be calculated will not generally take into account the economics of derivatives transactions.

These issues would be particularly acute for existing contracts entered into before the CSDR settlement discipline regime starts to apply but which would only move to settlement after the regime starts to apply. However, we consider that these legacy transactions should not require amendment to incorporate the buy-in procedure, even in the absence of the full carve out requested in this letter (which remains our preferred solution). Indeed, Article 25 RTS on Settlement Discipline does not indicate that amendment of legacy transactions is required. In light of this and the unintended effects that applying mandatory buy-ins would likely have on the commercially agreed terms of such legacy transactions, we should be grateful for confirmation that mandatory buy-ins should not apply in this situation.

Even for new contracts entered into after the regime starts to apply, application of the mandatory buy-in regime would add an additional layer of complexity into transactions the terms of which are already often complex – but generally well understood by the market and finely tuned over many years of incremental development. Indeed, preliminary work undertaken so far indicates that lengthy contractual provisions would need to be agreed with counterparties to reflect the mandatory buy-in requirements in ISDA and FIA documentation

in a way that seeks to ensure they interact with existing default and other contractual provisions in a sensible and predicable manner.

The repapering process itself will also create an additional burden for firms, particularly when viewed in the context of other new regulatory requirements due to apply over the next couple of years that also require amendments to contractual documentation. In particular, -IBOR transition and compliance with Article 28(2) Benchmarks Regulation, contractual stays requirements under BRRD2, EMIR Refit reporting changes and EMIR initial margin requirements for Phases 5 and 6 counterparties may all require members to agree contractual changes to their derivatives documentation over the next couple of years. However, all of these new requirements start to apply at different times, meaning that it is not possible to streamline client outreach effectively. This leads to concerns that multiple rounds of client engagement and related amendment processes can themselves lead to amendment fatigue and lower levels of counterparty engagement.

Whilst ISDA is considering whether the development of a protocol might be necessary to aid with agreement and adoption, the very broad agreement and counterparty scope of the CSDR settlement discipline regime, coupled with the substantive impact that a buy-in would have on the substantive terms of transactions, means that a protocol may be difficult to achieve in this context. Indeed, no current solution exists and the development and widespread adoption of a protocol to meet the requirements of Article 25 RTS on Settlement Discipline in respect of derivatives transactions would be a complex exercise, requiring amendment of multiple documents including master agreements and terms of business, clearing addenda, collateral documentation and related custody documentation. The broad extraterritorial reach of the CSDR settlement discipline requirements to any trading parties settling transactions in in-scope financial instruments on EEA CSDs would also necessitate a global repapering exercise. Further, the lack of clarity in CSDR and the RTS on Settlement Discipline on various points of detail relating to the mandatory buy-in regime also reduces the likelihood of a protocol being effective in this context. Therefore, any potential repapering solution for derivatives would be costly and was not foreseen in the cost-benefit analysis of CSDR.

Client clearing and indirect clearing arrangements also add a further layer of complexity. We are concerned that application of mandatory-buy ins to remedy settlement failures at multiple levels of a clearing chain would be unduly burdensome. Applying multiple buy-ins in this case would be unnecessary, as a single buy-in would remedy all of the connected settlement fails. Moreover, it could create asymmetries in the clearing chain (e.g. if the buy-in period is extended at some levels of the chain but not others), undermining the principle that each transaction in the chain should be on identical commercial terms. Asymmetries in this regard could potentially affect a clearing firm's analysis of the limited recourse nature of its obligations and the associated capital treatment for these transactions, making client clearing more expensive and ultimately serving as a barrier to client clearing. Again, this could therefore undermine initiatives designed to support client clearing such as FRANDT requirements introduced under EMIR Refit. These issues are particularly concerning in the absence of clear guidance on how the mandatory buy-in rules can accommodate a workable pass-on mechanism.

Even if a pass-on were possible, it would be complex to administer in the context of client clearing chains, both from a documentation perspective and in terms of setting up communication channels along the client clearing chain and each associated settlement chain. A simpler and preferable solution would be to exempt these trades from the mandatory buy-in rules.

Therefore, we request that the CSDR mandatory buy-in regime should not apply to physical settlement of derivatives contracts or to margin transfers in the context of derivatives transactions.

Proposed clarifications

As indicated above, we request express clarification that the cash penalties and mandatory buy-in requirements of Article 7(2)-(10) CSDR shall not apply to settlement fails arising in the context of derivatives transactions, ideally through a combination of Level 2 changes and Level 3 guidance.

In particular, we request that the RTS on Settlement Discipline are amended to confirm expressly that margin transfers are exempt from the mandatory buy-in regime under Article 7(4)(b) CSDR. However, we would also support addressing this issue via ESMA Q&A setting out Level 3 guidance supporting the interpretation that margin transfers are not subject to the buy-in process mandated under Articles 7(3) to 7(8) of CSDR. We understand that ESMA is currently considering a draft Q&A on this issue.

Further, we request that ESMA provides Level 3 interpretation via Q&A clarifying that

- the mandatory buy-in regime will not apply to settlement fails arising in the context of physical settlement of physically settled derivatives; and
- cash penalties should not apply to settlement fails arising in the context of derivatives transactions.

We ask that clarity is provided quickly on these issues. This will be vital to give firms sufficient time to understand fully the scope of the impact of the CDSR settlement discipline rules on their activities as a whole (including derivatives transactions) and implement these requirements as necessary, including agreeing new contractual provisions with counterparties as well as putting in place complex operational procedures and communication channels, potentially spanning clearing chains as well as settlement chains. Indeed, if uncertainty persists around the scope of the regime, we are concerned that this could delay firms' overall implementation efforts, to the extent they remain unable to communicate clearly and effectively with clients about the scope and impact of the regime on the full range of the client's transactions and services provided.

If it is not possible to provide clarity quickly on these issues, we request that ESMA and the Commission consider granting a further delay to the application date of the CSDR settlement discipline regime via changes to the RTS on Settlement Discipline, particularly in light of practical challenges posed by the COVID-19 pandemic. Not only would this ease the

significant implementation challenge for firms (not least due to the ongoing uncertainties around scope of the settlement discipline requirements) but it would also allow time for reflection on how the cash penalties and buy-in requirements might impact market stability in times of market stress, similar to those experienced over recent months, and whether additional elements of flexibility or other changes should be built into the regime as a result.

Conclusion

In conclusion, whilst we support the aim of the CSDR settlement discipline regime to reduce the number of settlement fails that occur across the EEA, we consider that industry standard documentation for derivatives already provides for effective contractual rights and remedies in case of a settlement fail (or other failure to deliver), which are tailored to the derivatives market and are well understood by market participants. We are concerned that applying the cash penalties and mandatory buy-in requirements to settlement fails arising in the context of derivatives transactions would be unduly burdensome, lead to adverse unintended consequences and distort the economic agreement of the parties in relation to impacted transactions.

We therefore request that the RTS on Settlement Discipline are amended and/or Level 3 guidance is provided to expressly provide that the cash penalties and mandatory buy-in requirements shall not apply to settlement fails arising in the context of derivatives transactions. Otherwise, we are concerned that that cash penalties and/or mandatory buy-ins may be applied to settlement fails arising in the context of derivatives transactions, with adverse unintended consequences for individual transactions and counterparties to derivatives transactions, as well as for the market as a whole.

We request that clarity is provided quickly (or that the application date of the requirements is further delayed) in order to give firms time to understand the impact of the CSDR settlement discipline regime on their activities as a whole, engage with clients to explain the impact of the regime on them and put in place necessary documentation, operational procedures and communication channels needed to implement these requirements in practice.

Annex

About FIA

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry.

FIA's mission is to:

- support open, transparent and competitive markets,
- protect and enhance the integrity of the financial system, and
- promote high standards of professional conduct.

As the leading global trade association for the futures, options and centrally cleared derivatives markets, FIA represents all sectors of the industry, including clearing firms, exchanges, clearing houses, trading firms and commodities specialists from more than 48 countries, as well as technology vendors, lawyers and other professionals serving the industry.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 73 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter @ISDA.