

FIA and ISDA response to the European Commission's request for feedback on its CSDR Review proposal

The Futures Industry Association (**FIA**) and the International Swaps and Derivatives Association (**ISDA**) (together the **Associations**) welcome the opportunity to comment on the European Commission's (EC) proposal to review the Central Securities Depositories Regulation (CSDR), in particular with respect to reforms of the mandatory buy-in regime (MBI) under Article 7 CSDR.

The primary concern of the Associations' members remains the application of the MBI regime to margin transfers and the physical settlement of derivatives transactions which would lead to significant uncertainties and unintended adverse consequences, as well as the disruption of existing contractual default provisions in ways parties did not contemplate when they entered into the agreement, all as described in previous publications, consultation responses and case-studies of the Associations.¹

Executive Summary

- The EC's suggested two step approach allows for a more targeted application of MBI. Technical changes to the SDR are also welcomed by the Associations.
- The application of MBI provisions to margin transfers would have a negative effect on the settlement practices of margin transfers and undermine the objectives of CSDR and EMIR.
- With respect to physically settled derivatives, MBI provisions would be disproportionate and implementation efforts outweigh any potential benefits.
- The review of CSDR should provide legal clarity that derivatives transactions and collateral relating to derivatives transaction are not in scope of the MBI provisions.

Margin transfers

FIA and ISDA have consistently argued that the application of the MBI provisions in the CSDR and the Commission Delegated Regulation with regard to regulatory technical standards on settlement discipline² to margin transfers has negative effects on the receiving party, as it would increase that party's exposure to the failing / posting counterparty. Therefore, the effect is directly contrary to the intentions of the MBI regime. The purpose of margin transfers is the mitigation of credit risk arising from an exposure created by an underlying trade and is not meant to satisfy the settlement of a financial instrument as part of

¹ FIA and ISDA Position paper on the CSDR Settlement discipline regime, dated 1 July 2020:

<https://www.isda.org/a/0pbTE/Joint-ISDA-and-FIA-advocacy-letter-on-CSDR-settlement-discipline-regime.pdf>

FIA, FIA EPTA and ISDA joint response to the EC's targeted consultation on the CSDR Review, dated 1 February 2021: <https://www.isda.org/a/4jCTE/ISDA-FIA-and-FIA-EPTA-joint-response-to-Commission-Consultation-on-CSDR-Review.pdf>

FIA and ISDA response to the EC's consultation on the CSDR Inception Impact Assessment:

<https://www.isda.org/a/0EFTE/ISDA-and-FIA-response-to-the-European-Commissions-consultation-on-the-CSDR-inception-impact-assessment.pdf>

ISDA and FIA submitted practical examples to the EC for cleared and non-cleared transactions, demonstrating the use of ISDA and FIA documentation in the context of derivatives settlement

² Commission Delegated Regulation (EU) 2018/1229

a commercial transaction. Margin and clearing as risk mitigation techniques are regulated in the EU under the European Market Infrastructure Regulation (EMIR). The application of MBI to margin transfers would increase risks arising from posting/failing counterparties whilst increasing derivatives market participants' costs due to the need to conduct wide-scale repapering exercises. This would seriously undermine the objectives of EMIR and would be contrary to the CSDR objectives to promote safe and efficient settlement of financial instruments in the Union.

Physically settled derivatives

The Associations also remain of the view that the application of the MBI regime to physically settled derivatives contracts is not appropriate. The scale of the implementation required, including the need for extensive client outreach and repapering, would be wholly disproportionate to any benefit. Currently, industry standard derivatives trading and clearing documentation (such as ISDA and FIA documentation) already include provisions setting out the parties' rights and remedies in case of settlement failures. Whilst the industry provisions, including buy-in rules of CCPs, allow market participants to address concerns resulting from settlement fails, grace periods under ISDA/FIA documentation are notably more efficient and shorter than regulatory buy-in measures, so it is questionable whether the MBI, as envisaged under CSDR, would ever apply in practice in the context of derivatives transactions. However, a large-scale repapering exercise would still be required to incorporate the operational mechanisms necessary to give contractual effect to the MBI requirements. We have provided the EC with practical examples of existing grace periods and close-out mechanisms for cleared and non-cleared derivatives transactions (and margin transfers relating to those transactions) in this context.

Legal clarity

ISDA and FIA remain of the view that the current settlement discipline provisions under CSDR have not been drafted with derivatives transactions in mind. However, given the uncertainty regarding the involvement of in-scope underlying financial instruments, the references to the term 'transaction' and whether CSDR shall only apply '*without prejudice to provisions of Union law concerning specific financial instruments*' (in this case EMIR), market participants remain concerned about the lack of legal clarity with respect to the scope of the MBI regime, from a derivatives perspective. **The Associations believe that the CSDR Review gives an ideal opportunity to clarify in Level 1 that margin transfers and physically settled derivatives transactions are out of scope of the MBI regime.**

Whilst the Associations understand that the EC has proposed to further define the suggested carve-outs from the settlement discipline regime under Articles 7(2) and 7(4) CSDR, in particular with respect to '*transactions that do not involve two trading parties*', as part of Level 2 legislation, we believe that it should be further clarified in Level 1 that this exemption includes the posting of margin. Alternatively, the co-legislators should consider adding an additional paragraph to the MBI carve-out provisions, clarifying that transactions "*for the purpose of collateral management operation settlements or any settlement of obligations under physically settled derivatives transactions, including intragroup transactions*" are not in scope of the MBI regime, with a view to enhancing legal clarity in

this respect. In terms of legal drafting, such carve-out should also be reflected in the EC's suggested Recital 4.

In addition, the Associations agree that – in principle- *'settlement fails that occurred for reasons not attributable to the participants'* should not be in scope of the MBI provisions. However, it would be helpful to further clarify the meaning of *'not attributable'*.

The EC's "Two-Step" approach

In addition to the need to expressively carve out derivatives transactions from the scope of the mandatory buy-in regime, the Associations are aware of the current lack of clarity with respect to which 'transactions' are in scope of the Settlement Discipline Regime (SDR) and several cases, in addition to margin transfers and physically settled derivatives, where MBI provisions would be counterproductive to the objective of safe and efficient settlements. It should also not be underestimated that an unintended application of the MBI regime to certain transactions would likely lead to a very costly contractual repapering exercise, requiring extensive outreach to clients, without any added benefit to clients or the wider financial system.

Therefore, we generally support the EC's suggested "Two-Step" approach, based on an ESMA Impact Assessment and, if needed, the option to define the scope and procedure of the MBI for certain types of transactions via the use of an Implementing Act, as it would significantly enhance legal clarity and reduce adverse economic impacts resulting from the MBI provisions. The EC's approach allows for a more targeted approach to the MBI regime, based on evidence with respect to settlement failures. However, we believe the EC and the co-legislator should provide further clarity to market participants (and regulators) on how any determination of settlement efficiency having reached 'appropriate levels' will be conducted. Similarly, the meaning of the proposed Article 7(2a)(b) with respect to *'appropriate levels considering the situation in third-country capital markets...'* remains unclear and should be clarified. Furthermore, in the event the EC decides to bring in scope certain financial instruments/transactions, the EC should always allow market participants a sufficient implementation period to conduct client outreach and contractual repapering.

Technical changes to the settlement discipline regime

The Associations generally support the technical changes in relation to the asymmetry of payments and the introduction of a pass-on mechanism.

ISDA & FIA recommendations

- ISDA and FIA believe it is crucial to clarify that margin transfers and physically settled derivatives are not in scope of the MBI regime as its application would have a detrimental effect on derivatives markets.
- ISDA and FIA recommend targeted amendments with respect to the Level 1 carve-outs from the MBI regime, with a view to enhancing legal clarity and avoiding unnecessary costs for market participants.
- ISDA and FIA support the EC's suggested 'Two-Step' Approach, subject to further specification of measures with respect to 'appropriate levels' of settlement efficiency.



About FIA

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers.

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 principal members of derivatives clearinghouses worldwide, FIA's clearing firm members play a critical role in the reduction of systemic risk in global financial markets.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 960 member institutions from 78 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, LinkedIn, Facebook and YouTube.