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CSDR- new ways to fail

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On 8 May 2020 the EC adopted a Delegated Regulation, delaying the entry into force of the controversial third phase of the CSDR. Rules imposing a new settlement regime were expected to operate from 13 September 2020, the amendment postpones the start date until 1 February 2021. Earlier phases of the CSDR had limited commercial impact; by contrast, the new settlement regime envisages a system of fines and mandatory buy-ins. Impacting CSDs and all their clients, compliance will require systems redesign and extensive repapering.

CSDR Background

Although perhaps less remarked than its stablemates EMIR and MiFID 2, CSDR is a major plank in European post 2008 crisis reforms. The Regulation aims to create a harmonised set of prudential, organisational and conduct of business standards for all European CSDs. The CSDR is implemented in three key stages:

Phase 1 – Omnibus/Segregated Accounts

Article 38 obliges CSDs and their direct participants to offer clients the choice between differentially segregated accounts and to inform them of associated risks and costs. In force.

Phase 2 – Internalised Settlement Reporting

Article 9 mandates quarterly reporting by volume and value of all transactions that take place outside the securities settlement system. Application 12 July 2019.

Phase 3

Articles 6 and 7 aim to support the objectives of the Target2Securities system imposing a penalty mechanism for settlement fails and a mandatory buy-in process following failure to deliver after the settlement date. Current (delayed) application 1 February 2021. The requirement applies to the following transactions via a CSD: transferable securities, money-market instruments, UCITS and emission allowances. By virtue of volume, the burden of change will fall on the Repo markets.

Controversy

The third phase of the CSDR introduces a new settlement discipline, imposing automatic daily penalties on counterparties that fail to settle on T+2[1].If the failure remains unresolved for a total of four or seven days (for liquid and illiquid securities respectively), the securities will be delivered to the

[1] The exact quantum of the applicable penalty depends on the nature of the securities- Government Bonds, Corporates, Equities

purchaser by a mandatory third party buy-in charged to the failing party. Penalties act as a deterrent to settlement failure, buy-in is its consequence. Reasonable on paper, not so simple in practice.
If settling via a European CSD/ICSD, in the event of settlement failure the CSD will impose a cash penalty on the failing party which will then be credited to the other side. The Regulation only extends to CSDs and its direct participants, it does not address settlement failure due to indirect client inaction/insolvency. Equally, if a penalty is in an indirect client's favour to what extent does this involve Client Money regulations?

Mandatory buy-ins will apply either four or seven days following settlement failure depending on a binary liquid/illiquid categorisation of the applicable securities. As implied, liquidity is fluid and inimical to metrics. The Regulation avoids the MiFID 2 rabbit hole, accordingly containing no guidance as to liquidity schema. Buy-ins will be direct legal obligations between counterparties, without the involvement of CSDs, the Regulation fails to address the current market procedure of partial settlement. Consequently, concerns abound that the requirement will negatively impact overall market liquidity, potentially causing a single settlement failure to cascade through a repo'd collateral chain. Even when clear guidance is issued or a market standard emerges as to liquidity categorisation, valuation and notification, significant changes will be required to systems and documentation.

Penalties in brief

CSDs will be required to extract cash penalties from settlement failing participants. Participants are directly responsible to the CSD irrespective of underlying client failure to settle. Cash penalties are calculated from failure until either actual settlement or application of the buy in regime. Penalty rates are set out by a Delegated Regulation according ('ish) to the class and liquidity of the underlying security.

"Buy-in" in brief

Buy-in is the *requirement for a receiving party* to purchase securities subject to failed settlement from the market[2]. It is unclear which of the receiving parties should initiate the buy-in. The rules currently contemplate bilateral transactions rather than a chain of receiving parties as well as envisaging an OTC "principal" designation with no on-venue equivalent. In potential practice, the receiving party appoints a "buy-in agent" who delivers the failed settlement bonds on a best execution basis. The original transaction is cancelled and any cost difference is payable by the failing party. The process must be completed within 4 or 7 days dependent on the undefined liquidity categorisation of the securities.

[2] Such action is subject to counterparty insolvency proceedings and certain exclusion e.g. 30 day settlement periods for securities financing trades

Impact on Documentation

In the event of a settlement failure CSDs are mandated to apply one-way penalties and then buy-in, depending on the duration of failure. While penalties are levied by the CSD and passed on to the receiving party, the entity responsible for buy-in execution depends on the venue of the transaction:

- Buy-in for transaction via a CCP
  In the event of settlement failure by a CCP member, the CCP will determine the possibility of buy-in. If possible it must complete by auction or appointment of an agent. If buy-in is not deemed possible, cash compensation will be levied on the failing party.
- Buy-in for transaction on non-CCP trading venue
  Receiving party determines buy-in possibility. It will appoint a buy-in agent. It must put the settlement fail notification on hold and accept transfer of the securities from the agent. On transfer, any difference will be paid as cash by the failing party. If buy-in is not possible, cash will be paid in full by the failing party.
- Buy-in for OTC transaction
  As above for non-CCP. The receiving party determines possibility, appoints agent and requests cash transfer if applicable.

Evidently, existing documentation-most particularly GMSLA/GMRAs, will require extensive amendment to reflect new penalty and buy-in provisions.

Next Steps

Despite the remaining lack of clarity, aside from operational issues, CSDR Phase 3 clearly presents a repapering challenge. It is unlikely that existing contracts will anticipate the new penalty and buy-in requirements and defined timings. Industry working groups are in the final stages of drafting template amendment clauses. Pending their arrival:

1. Do not assume or rely upon further postponement
2. Review contracts to assess the degree of repapering required
3. Assess existing resources in light of “competing” workstreams eg. IM and Benchmark Transition
4. In the likely event that in-house resources are strained- engage cost-effective documentation specialists

It’s fair to say that Phase 3 of the CSDR is having a difficult birth. The 8 May delay confirmation of phase 3 delay until February 2021 was consequent upon the late delivery of the ECB’s Target 2 mechanism for penalising late settlement. Even with the five month delay, it would be a challenge to divine Regulatory intention in the absence of detail, and then amend systems, processes and contracts. In these increasingly precedented times, firms also face the hurricane force headwinds of Covid-19 disruption. The re-phasing of relatively uncontroversial SFTR and IM regulations would argue for a similar approach to CSDR. However, a 16 April 2020 reply to industry advocacy by ESMA chair Steven Maijoor tersely reconfirmed the February deadline. In the UK, the Brexit fog inevitably adds obscurity. Phases 1 and 2 of the CSDR will be grandfathered, the status of

Phase 3 is theoretically open to negotiation- if any were progressing. Given the centrality of the CSDR in the European framework and the importance for the UK of equivalence decisions, it is highly likely that the CSDR will be replicated in full. Given the likely resource strain from coincident workstreams, market participants should start planning for CSDR now.

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