

## ICMA CSDR-SD Working Group & ISLA

Meeting/Call on SFTs and mandatory buy-ins  
February 4, 2020

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### Meeting notes

#### 1) Proposed ESMA Q&A on exemption for open-SFTs

- The Group was asked to provide feedback and potential enhancements for the proposed redrafted ESMA Q&A requesting clarification that open, and open-like, SFTs are out of scope. The argument, which follows a survey of ICMA and ISLA members on their accounting treatment of such trades, is that SFTs should be viewed from the perspective of the earliest contractual termination date. This is consistent with regulatory treatments for liquidity measurements.
  - One suggestion was to emphasize the fact that not explicitly exempting open-SFTs would result in a change of market behaviour as to how open trades are booked; i.e. moving to short-dated term trades (potentially with calls). This would simply create inefficiencies, without bringing more transactions into scope.
  - It was noted that the ISLA WG had not had chance to review the document (as it had not been circulated until the evening before).
  - Members were asked to come back to ICMA by Friday February 7 with any additional comments or edits.
- ❖ Barring any fatal flaws comments, ICMA will submit the open-SFT Q&A by Monday February 10 latest. This would be accompanied by the survey results, which should support the regulatory based arguments.

#### 2) Other potential SFT exemption requests

- The Group was reminded that ICMA had broached the issue of basket trades with ESMA some time ago, and the possibility of Level 3 clarification of an exemption. This was on the grounds that buying-in a substitutable basket of securities was at best impractical and at worst pointless.
- It was recognized that the likelihood of a triparty trade failing for the entirety of the relevant extension period (7 business days in the case of bonds), was close to zero; and

in the rare event of a fail, firms would most likely apply their contractual remedies. However, it was felt that it was still important to establish clarification on scope, even if largely an academic consideration.

- It was suggested that it would be helpful in any Q&A submission to distinguish between triparty trades, where the collateral is allocated and managed by a third-party agent, and bilateral basket trades (where a buy-in might be appropriate).
- The question was raised as to whether this was a priority issue, and if it was something that could be submitted to ESMA at a later stage.
- ❖ It was agreed that a Q&A submission for an exemption for basket trades (triparty and DBV) would be deprioritized for now.
- AFME informed the Group that the previously drafted Q&A submission related to an exemption for margin and collateral movements (part of a broader submission on 'ineffective buy-in processes') would be redrafted as a standalone submission.
- It was agreed that members of the ICMA or ISLA WGs could direct comments via ICMA and ISLA.
- Securing an exemption for margin and collateral movements was considered a priority of the Group, given the potential contractual repapering exercise that would be otherwise be required.
- The case of evergreens also came up, which are used to manage LCR metrics and usually have a rolling term of 35 calendar days (which is under the 30-business day cut-off applied by CSDR buy-in scope). ICMA explained that based on the proposed Q&A submission, these would also be deemed out of scope, since the earliest contractual termination date would always be less than 30 business days.
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### 3) Legal update

- ICMA Legal Counsel updated the Group that it had produced, in cooperation with Clifford Chance, a draft CSDR Settlement Annex for the GMRA (and in parallel with ISLA, for the GMSLA). It was made clear that the scope of the current draft Annex was to assist users in addressing the requirements of the Article 25 of the RTS, working to a deadline set by the respective association Legal Working Groups, and not encompassing any complementary commercial considerations.
- The Group were informed that during the drafting process a number of commercial questions had been raised, which required the input of trading, risk management, and compliance teams. The Legal WG members had been requested to consult with their respective firm CSDR-SD WG members on such questions so in order to facilitate this internal dialogue it was proposed that the draft Annex and relevant questions be circulated to the CSDR-SD WG members, alongside a request for substantive feedback ASAP.
- It was asked whether the Annex intended to incorporate the ability to settle the buy-in and cash compensation symmetrically, with respect to the original transaction and buy-in/cash compensation reference prices. The Group was informed that this was currently beyond the anticipated scope of the Annex, particularly given that the industry was still waiting on official Level 3 guidance to confirm that this was possible.

- The question was raised as to whether it made sense to push back the deadline for finalizing the Annex in order to incorporate a contractual solution to the asymmetry, assuming that Level 3 guidance to that effect was expected by the end of March. It was further noted that it was now widely expected that the implementation date was about to be moved from mid-September 2020 to start-February 2021.
- Legal Counsel explained that the current timeline for the Annex, set by the respective ICMA and ISLA WGs, did not take account of anticipated Level 3 guidance, such as solving for the asymmetry, nor the anticipated postponement of the implementation date.
- The question was raised as to whether the GMRA/GMSLA Annex would be a protocol or a stand-alone bilateral annex. Legal Counsel explained that it could be either or both. In the case of the former, it may be easier to apply from the perspective of future changes to incorporate eventual Level 3 guidance with respect to important commercial considerations such as symmetrical buy-in/cash compensation differential payments and pass-ons.
- A number of participants suggested that protocol solutions tended to work well in other markets, in particular derivatives. ICMA noted that, to date, protocols with respect to the GMRA had not garnered much traction; however, they had not been based on regulatory imperatives, so could not necessarily be used as a precedent in this instance.
- There was a strong view from the Group that the Annex, or any other legal framework, should go beyond the regulatory compliance requirement and should, as much as possible, incorporate commercial considerations and seek to address the flaws and limitations the regulation. It was suggested that a contractual arrangement that did not encompass commercial considerations was essentially useless.
- The question of extraterritorial extension of the regulation through the GMRA (or other contractual arrangements was raised). This is particularly pertinent with respect to the requirements of Article 25 of the RTS. The initial view was that the Annex would only apply in the case of in-scope transactions, which inherently would involve a transaction between the two parties intended to settle on an EU (I)CSD.
- ❖ It was agreed that ICMA would circulate the draft GMRA CSDR-SD Annex, along with the related market practice / commercial questions, encouraging CSDR-SD members to coordinate internally with their respective trading, risk, compliance, and legal experts to provide swift answers to help inform the finalization of the Annex (noting the relatively tight timeline imposed on the contractual work).
- ❖ ISLA would undertake the same process with their members in parallel in relation to the draft GMSLA CSDR-SD Annex.

#### **4) Best practice for executing a buy-in against a repo**

- The Group was asked to provide feedback on the most recent draft best practice guidelines for executing a mandatory buy-in against an in-scope repo.
- It was noted that in previous ICMA/ISLA WG discussions, the general view had been that market best practice should be that in the case of failing SFTs, the relevant contractual remedies (i.e. the mini close-out provisions) should be expected to be executed before

the end of the relevant extension period, thereby making the regulatory buy-in obligation redundant.

- It had also previously been discussed, and agreed, that in the event of a failing SFT going to the point of a CSDR buy-in, where this related to the start-leg, the buy-in would effectively be against the entire SFT: thereby replacing both legs of the transaction with an outright purchase. While this was probably not the intention of the regulation, the view was that this more practicable (and also reinforced the best practice recommendation of exercising the contractual mini close-out provisions before reaching the point of mandatory buy-ins).
  - This point was challenged, however, suggesting that it may be viable for a CSDR buy-in to be executed against a start-leg of an SFT, resulting in the cancellation of the relevant delivery trade instruction, but keeping the end-leg open. (It was also noted that the Level 1 text seems to view SFTs as two separate, but 'linked', transactions, which would be consistent with this interpretation, if not with the legal construct of the underlying transaction).
  - There was not much appetite for this particular interpretation, but it was noted that this is one of the questions related to the development of the GMRA/GMSLA Annex. It was pointed out that this interpretation of applying the buy-in obligation to the start-leg of an SFT is further complicated in the case that the buy-in goes to cash compensation.
  - It was asked whether the so called 'mini close-out provision' in the GMRA only applied to the end-leg of an SFT. It was noted that the term 'mini close-out' does not appear in the GMRA but is often used to refer to paragraphs 10(h) and 10(i) and is applicable to both legs, but the application takes different forms.
  - The fact that there is not any contractual interoperability between the GMRA/GMSLA close-out provisions and a cash market buy-in (say, under the ICMA SMR&R Buy-in Rules) was highlighted. It was noted that this has been a long-standing risk-management challenge, particularly given the direct connectivity between SFTs and outright cash transactions, but the lack of related contractual interoperability in the event of settlement fails. Members expected this to become an even bigger issue under CSDR, and likely to be to the detriment of securities lending.
- ❖ It was agreed that further work was needed to establish industry consensus on whether a buy-in against a start-leg of an SFT only related to the on-leg or the entire transaction, and whether this would be contingent on the successful outcome of the buy-in, as opposed to going to cash compensation.

*[There was little expectation that the regulators would be able to provide helpful guidance on such a fundamental issue, given the drafting mess that is the Level 1 text.]*

## 5) Identifying in/out-of-scope SFTs [transaction and settlement level flags]

- The question was raised as to whether there was a requirement to include flags or identifiers in trade confirmations and/or settlement instructions to indicate whether a transaction is in scope or not of the mandatory buy-in obligation.
  - There were mixed views on what was required, if anything.
  - Some felt that there was no need to flag trades at the confirmation level, and that it was the responsibility of firms to know whether transactions were in or out of scope based on the legal provisions. Others argued that it could be useful for firms to agree on scope before reaching the point of buy-in, although it was suggested that this may only be important in the case of bespoke SFTs where it was not necessarily obvious.
  - It was also not clear whether this was required at the settlement level. It was noted that SWIFT already has a field to indicate SFTs as distinct from outright cash transactions, although this was not mandatory (and often not used). Accordingly, it was not obvious to CSDs whether a trade was an SFT. Furthermore, in the case that they did see that a trade was an SFT, they would not be able to distinguish between start and end legs, or able to determine the term of the SFT (which would be required to determine scope).
  - It was also pointed out that there is no regulatory requirement for CSDs to 'police' the buy-in regime: they merely had a reporting obligation based on aggregated fails and buy-in data.
- ❖ It was suggested and agreed that the case for an SFT and/or CSDR buy-in scope identifier, whether at confirmation or settlement level, should be considered by the ERCC Operations WG, possibly in coordination with the respective ISLA and AFME post trade groups.

## 6) Other priority areas for SFT related ESMA Q&As and market best practice

- It was suggested that going forward SFT specific issues should be covered in the general CSDR-SD WG meetings, rather than being discussed in separate fora, given that the implementation challenges for settlement discipline applied equally to cash transactions and SFTs.