



EU's Central Securities Depository Regulation (CSDR) and Impact on CCP Clearing

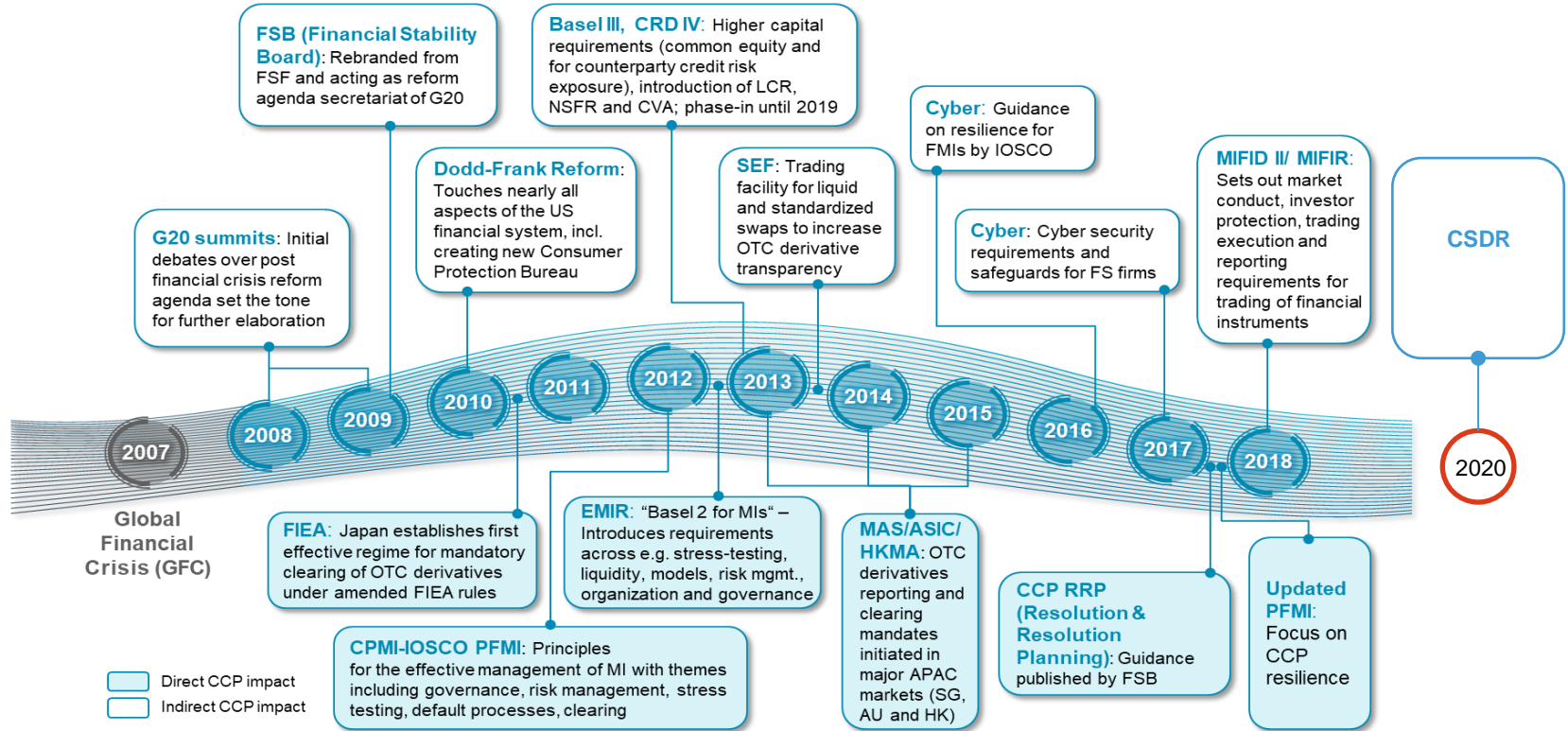
swissSPTC

Storm, March 26, 2019

The Roll-Out of a Global Financial Market Reform Agenda

- In the wake of the financial crisis, the G20 countries' leaders agreed in 2009 Pittsburgh, to reform financial markets;
 1. Enhance resiliency and supervision of banks
 2. End To Big To Fail (TBTF)
 3. Promote central clearing and mandate it for certain asset classes
 4. Regulate non-bank financial sector
- To drive a shift to CCP clearing it was decided to;
 - **mandate clearing** for standard OTC-derivatives,
 - require **CCP-like collateralisation of bilaterally cleared** derivatives and
 - give a **risk capital set-aside rebate for exposures towards CCPs** ("2% rule")
- All in all it led to a string of new regulations - all based on internationally agreed principles: CRR/CRD IV, BRRD MiFID II/MiFIR, EMIR, MAD, UCITS V, AIFD, and now CSDR

Overview of Main Post-Crisis Regulatory Reforms Impacting CCP Clearing and Stakeholders



Source: World Federation of Exchanges

Next on Financial Market Transformation Time-Line

Next for CCPs & CSDs;

- **CSDR** (Sept 15, 2020)
 - **EU EMIR Refit and 2.2** (YE 2019);
 - Exemptions for SMEs and in aggregation calculations of groups exposures vs. thresholds
 - CCP Supervision;
 - Tiering of CCPs in terms of systemic importance (Tier 1: important, Tier 2: substantially important)
 - Colleges also for 3rd country CCPs, engaged also in any changes to CCP activities
 - Engagement of CBIs and ESMA in colleges with veto rights and coordination responsibilities alongside NCAs
 - More extensive reporting
 - Possible EU domiciliation requirements
 - Calibration of previous reforms (e.g. **CPMI's Guidelines for CCP Resiliency 2017**)
 - Best-practice **guidelines for CCP auctions** (FSB/CPMI, mid 2020)
 - **EU CCP Recovery & Resolution Directive (end 2019)+ International Guidelines on Resiliency, financing and handling of equity for CCPs in resolution (FSB, End 2020);**
 - Use of VMGH, tear-ups and other resources
 - Compensation (such as through equity) for top-up contribution and such
 - Administrators' rights to write down equity and issue new equity
- + Shareholders' Rights Directive (SRD), Securities Financing Transactions Regulation (SFTR), Interest Benchmark Reform, etc.

CSDR Background (EU/909/2014)

- CSDR - the **Central Securities Depository Regulation complements the asset management, banking, CCP, trade repository, and exchange regulations** (UCITV V, AIFD, CRR/CRD IV, BRRD, EMIR, MiFID II/MiFIR)
- **Enforcement date is 15.09.2020** (two months ahead of the Nov SWIFT standards release)
- The **aim is overall greater securities issuance and settlement efficiency** through;
 - Enforced **rights of issuers and investors to chose any CSD within the Union** (or a CSD recognized by the Union) (L1, Art 49)
 - Enforced **competition among CSDs**, under stricter prudential regulations, by;
 - Open and fair access rights
 - Separate (new) licenses and prudential and supervisory rules for CSDs and, in particular, for CSDs' ancillary banking services (such as deposits and credits)
 - A levelling of the CSD playing field (e.g. by harmonizing settlement processes, identical finality points, harmonized messaging and matching standards)
 - More CSD & SI-transparency and disclosures (fees, membership criteria, etc.)
 - Strict governance, prudential and business rules
 - Obligation to offer segregation of house, and client positions and collateral (individually or omnibus accounts)
 - **Strict settlement discipline for all parties;**
 - Standard settlement fails procedures and penalties
 - Mandatory buy-ins (also partials coupled with cash compensation)
 - Obligations for CSDs to provide auto-partialling, cancellations, hold-and-release functionality, and more.
 - Suspension of any systematically failing entities
 - Strict dissuasive penalty scheme based on value

Key Aspects of CSDR (1)

- It affects: issuers, asset managers, investment firms, credit institutions (including their separately licensed Systemic Internaliser (SI) activities, and to be separated Settlement Agent activities) , trade venues, CCPs , and CSDs
- Encompasses all instruments settled in an EU Securities Settlement System (as operated by a CSD) and traded on an EU trade venue, including transferable securities, money-market instruments and UCITS (incl ETFs)
- Separates CSD-activities into ;
 1. Cores services (notary, maintenance and settlements)
 2. Non-banking ancillary services (sec-lending, matching, collateral management, corporate actions, issuer services, ISIN assignments and changes, fee collections, etc.)
 3. Ancillary banking services (cash accounts and transfers, credit facilities, corporate actions pre-financing, FX and related payment services, treasury activities)
- Requires CSDs to apply for new operating licenses (Art 17, L1) + a separate Credit Institution license for any ancillary banking services (Art 54, 55&56, L1) + separate approvals for any outsourcings (including any sourcing of ancillary banking services) + for any CSD-links (Art 48, L1) + for a settlement finality designation (Art 39, L1)
- Requires 3rd country CSDs to apply for legal equivalence, settlement finality designations and ESMA-recognition, alongside with establishment of Supervisory Authority cooperation agreements

Key Aspects of CSDR (2)

- All securities to be presented in book-entry form, i.e. to be dematerialized (Art 3, L1)
- Reporting obligations for CSDs and Systemic Internalisers (SIs) on settlements, and on settlement discipline (Art 9, L1)
- CSDs must establishment formal User Committees (Art 28, L1)
- CSDs must offer fair, open and transparent access rights and procedures (Art 33, L1)
- CSDs must provide transparent and fair pricing (Art 34, L1)
- CSDs and others must use international standard messaging and connectivity (Art 35, L1)
- Settlement agents , must operate such activities under separate authorization
- CSDs must apply for settlement finality designation (and apply the law of the designating authority) + + clearly define irrevocability point, which is synchronized with any linked-CSDs + apply DVP in central bank money (only as a 2nd option commercial bank money) (L1, Art 39&40)
- CSDs must have an approved Recovery Plan in place and set aside capital for wind-down (min. 6 months), credit, liquidity, operating and business risks, and additional for any ancillary services (+added surcharge for any authorized ancillary banking services)
- CSD-links are regulated and must be authorized (L1, Art 50 – 53)
- CCPs and Trade Venues must offer CSDs fair and open access (L1, Art 33)
- CCPs are appointed penalty collectors and buy-in agents for their cleared transactions (L1, Art 7(10)(a))
- All parties along the settlement chain will have to update their agreements (L2, Preamble 28)

Key Aspects of CSDR (3)

- CSDs should offer users real-time information on status of settlement instructions (L2, Preamble 9)
- CSDs should offer real-time gross and several times a day, batch process possibilities
- CSDs should send monthly settlement fails reports to authorities, including on systematically failing entities, as per prescribed standard format
- Penalties collected should not be booked or construed as revenue by the CSD, but should flow through separate accounts (L2, Preamble 19)
- Any manual interventions in the settlement process must be separately reported (L2, Art 4)
- The settlement tools (auto-partialling, hold-release, recycling, cancellations) do not need to be applied if the fails are less than 0.5% pa (value/volume) and less than EUR 2.5 bn in aggregate
- Systematic failing entities are assessed as those with 15% lower efficiency individually than the system as a whole over last 12 months

Key Settlement Disciplinary Aspects of CSDR

A **detailed trading-clearing-settlement-buy-in time-line** (Art 5 and 7, L1) => see separate overview

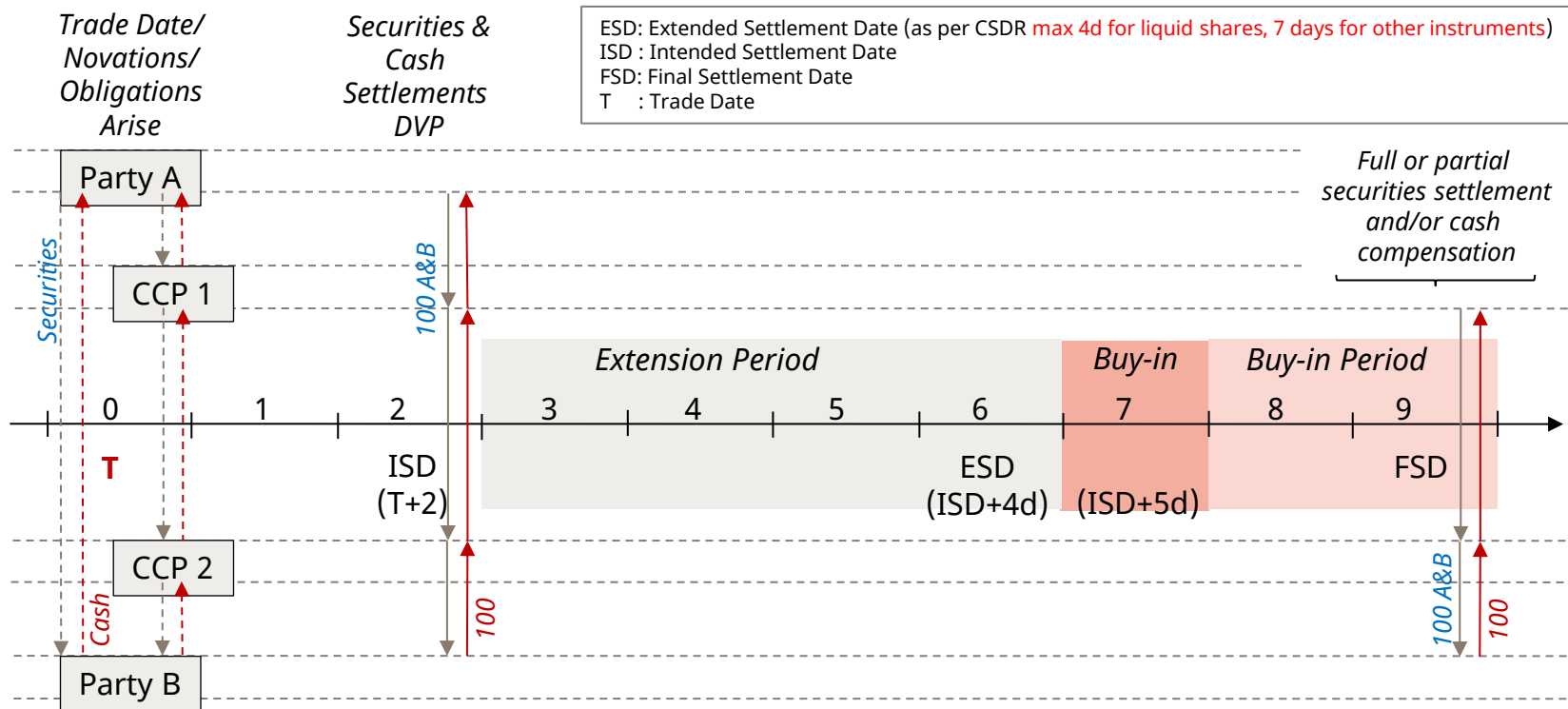
- T+2d for liquid instruments = Intended Settlement Date (ISD)
- T+7d for illiquid
- T+15d for SME Growth markets
- Buy-ins are mandatory (partial if not in full), after any possible extension period

Mandatory **Settlement Discipline (SD) and Efficiency measures** covering:

- CSDs to apply harmonized matching rules (Art 5 & 6, L2)
- CSDs to offer Cancellation (Art 7, L2)
- CSDs to offer hold-and-release functionality , to be offered by the CSD (Art 8, L2)
- CSDs to offer settlement recycling (Art9, L2)
- All participants to apply and CSDs to offer auto-partialling (splitting of settlements) (L2, Art 10)
- CSDs to offer Real-time (within 1 hour) on settlement status (Art 11, L2)
- CSDs to report settlement fails monitoring and reporting (Art 13&14, L2), including any systematic failing entities
- CSDs must offer segregated participant/house accounts, alongside with segregated client accounts and omnibus client accounts and make transparent associated risks (Art 38, L1)
- Mandatory buy-ins apply (by the CCP if it is a cleared trade) – including partial buy-ins with separate cash compensation, on trade date + 5 (for liquid instruments)
- A strict penalty scheme for any settlement fails (Art 7, L1 and Art 16, L2)

Strict Trading Time Lines

(example of liquid cash equities)



CSDR Penalties

- To be calculated daily by the CSD, for each settlement instruction that fails to settle on Intended Settlement Date (ISD)
- Penalties will be aggregated and netted for collection once a month (around the 10th (indicated by ECSDA))
- Where the transaction is centrally cleared, the CCP will collect the penalty fees as calculated by the respective CSD
- Penalties will be calculated based on the end-of-business-day status and prices
- Cash penalties shall be deposited to dedicated penalties accounts and redistributed to the non-failing parties (and not constitute a CSD-revenue source) (L2, Art 19)
- Penalty will be due for the “last participant who has entered or modified the relevant settlement instruction” in the securities settlement system
- CCPs are exempt from any settlement penalties (L1, Art 8(11) + L2, Preamble (22))

=> Late in the day settlement instructions, and instructions changed close to cut-off times, are more likely to be incurred penalties

Applicable Fail Penalties(L2, + Annex)

	Type of fail	Applicable Rate
1	Lack of shares, that have a liquid market and excluding those under#3	1.00 bp
2	Lack of shares, but which do not have a liquid market	0.50 bp
3	Lack of instruments traded on SME growth markets, excluding debt instruments under #6	0.25 bp
4	Lack of debt instruments, issued by sovereigns, authorities, central banks, or multinational intergovernmental bodies	0.10 bp
5	Lack of debt instruments, other than those under #4 and 6	0.20 bp
6	Lack of debt instruments on SME growth markets	0.15 bp
7	Lack of instruments, other than those listed under 1 to 6	0.50 bp
8	Lack of cash	Official over-night interest rate for central bank with a floor of zero

- The penalties to be calculated daily, by the CSD, based on the End-Of-Day (EOD) price for the instrument in question, on its most “liquid” market (the Reference Price).
- Cash penalties calculated daily, by the CSD, based on the official over-night credit charge & rate at the central bank of issuance for the currency in question.

Mandatory Buy-Ins (A)

- For centrally cleared transactions, the CCP shall execute the buy-in (L1, Art 7 (10)(a))
- Where the buy-in fails, or is impossible, the receiving party can choose to be paid in cash or defer the execution for the Deferral period. Thereafter a cash compensation will be paid. (Art 7(7),L1)
- Where the full amount cannot be bought in, a partial buy-in will be executed with any remainder or the full compensated for in cash (and collected from the failing participant)
- The CCP will as a rule execute the buy-in on ISD+1, and only in case of less liquid instruments and markets on ISD+5 (for generally liquid instruments) and in if the non-failing party has explicitly agreed not to accept a cash compensation and to extend the period for attempting settlement
- For trades not centrally cleared, the buy-in should be done by the parties that originated the trade
- Any buy-in agent used, should apply best-execution principles (L2, Preamble 33), Art 24
- A failing party has the right to deliver instruments up to the point of announcement that a buy-in has been initiated (e.g. a buy-in agent appointed) (L2, Preamble 34)
- Once the buy-in is initiated, the original trade should be put on hold and subsequently cancelled once the original trade is finally settled or compensation paid (monitored by all parties, and with penalties calculated by the CSD) (L2, Preamble 39&40)

=> Asset Managers, Investment Firms and Credit Institutions must consider how to allocate (a) penalties, (b) partial buy-ins, and (c) any residual cash compensation

Mandatory Buy-Ins (B)

Where the price of the buy-in is lower than the original trade price, the failing party shall compensate the non-failing party for the value loss (L2, Preamble 41)

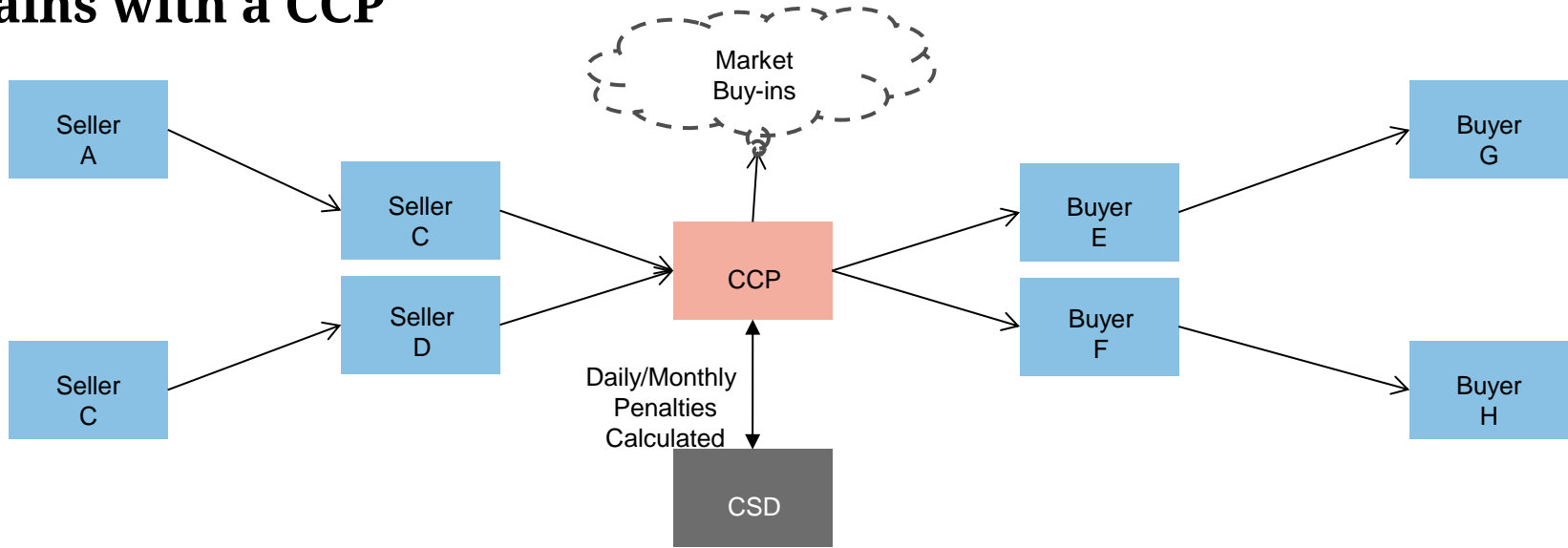
The cost of the buy-in, and the overall buy-in arrangement, should be separately charged to the failing member (L2, Art 34)

The CCP will;

1. Verify if a buy-in is possible, on ISD+End of extension period, and either
 - a) Calculate cash compensation, collect this from the failing participant and pay the non-failing party (within 2 days)
 - b) Initiate the buy-in process/appoint a buy-in agent, and proceed to settle
 - i. The trade in full, or
 - ii. In part, with the rest undergoing a cash compensation collection and forwarding
2. Notify failing and non-failing members (and CSD) of status, and then again upon completion of the buy-in process

=> Non-failing parties, granting extension periods, impose daily penalty fees onto their counterparties and expose the latter to cash compensation and price difference risks

Handling of Buy-ins and Penalties in Settlement Chains with a CCP



- ⇒ Last entity in the settlement chain and instructions changed close to cut-off times, are the ones primarily incurred penalties, but in case of chains of fails, this should be identified by the CSD
- ⇒ Sequence of trades and settlement instructions important, and in omnibus account models with Continuous Net Settlements (instead of batch) will impact the allocation of penalties and buy-ins
- ⇒ Allocation principles (for partial buy-ins, cash compensations and penalties) and mechanisms will need to be established higher up in the chain, and will change the P&L

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Supporting Material



FinfraV/-G (CH)

958.1 von 19.06.2015 & 01.01.2019

- Covers Exchanges, MTFs, CCPs, CSDs, TRs and Payment Systems (and FIs and NFCs)
- Authorization as FMI
 - Incl. approvals of material changes
 - Approvals of non-Swiss activities and entities
- Organization, board and management
- Ancillary services
- Outsourcing
- Minimum Capital
- Business Continuity
- Data protection and privacy
- Market abuse
- Fair and open access
- Record keeping
- Conflicts of interest
- Disclosures
- Systemic important FMIs
 - SyIm Processes
 - Business continuity
 - Recovery plans

- CCPs
 - Collateral (Margin, Default Fund)
 - Default Funds
 - Settlements
 - Capital
 - Liquidity
 - Default Management
 - Segregation and porting
 - Interoperability
 - Fair and open access
 - Approvals
 - Disclosures
 - Pricing
 - Segregation benefits, risks and costs
 - 3rd country CCP recognition
- Oversight
- Resolution
- Clearing obligations (FIs, NFC)

+ SNB and FINMA Guideances

Clearing Obligations in Stages (EMIR example)

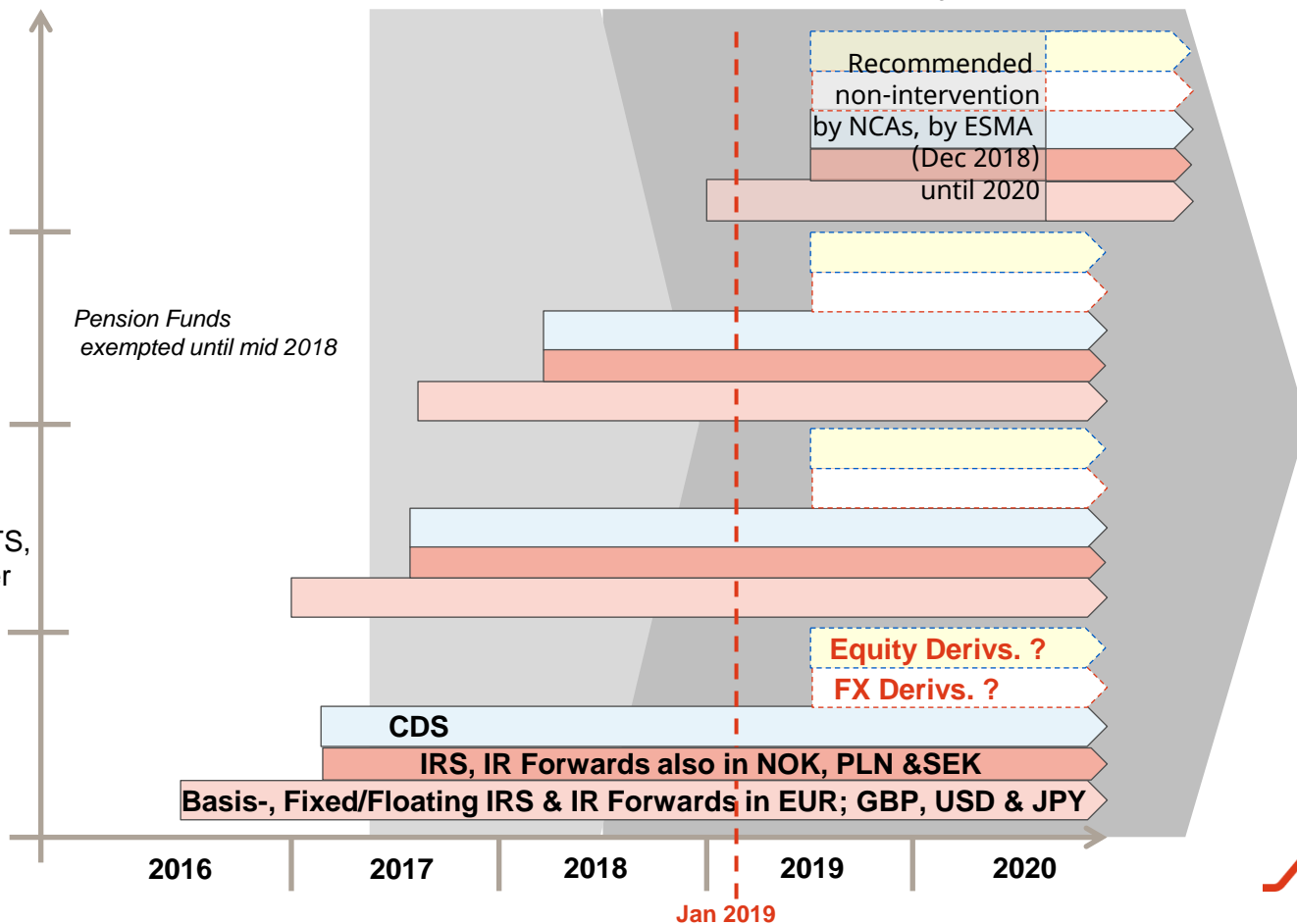
VM required for bilaterals => IM required for bilateral trading (with step-down thresholds)

Cat. 4. Non-Financial Counterparties (“NFCs”; exceeding thresholds)

Cat. 3. Other FCs and AIF Counterparties (“FC3s”; exceeding thresholds)

Cat. 2. Other Financial Counterparties (“FC2s”; banks, insurers, asset managers, AIFs, UCITS, EUR <8 bn outstanding, over 3 months)

Cat. 1. CCP Member Financial Counterparties (“FC1s”)



Swiss CCP Clearing Obligations from 2019

- Analogue to the G20 countries (EU, US, etc.), Switzerland now mandates CCP clearing for certain OTC derivatives from 2019, as per decree from FINMA (the Swiss financial market oversight authority)
- The ordinance came into force 01.09.2018, and foresees an implementation in stages (2019) and is conditioned on there being a sufficient number of CCPs offering access, and/or GCM's offering clearing services
- The Swiss clearing obligation covers (for now, and as per Annex 1 of the FMIO and FINMA decree);
 - Interest swaps in EUR, GBP, JPY and USD (basis, fixed-floating, FRAs, index swaps)
 - Credit Default Swaps (CDSs)
 - That are not traded on an exchange or multilateral trading venue (which is different from EU law, which requires both exchange trading and clearing)
 - Between 'large' Financial Counterparties (FC+s) and between FCs and 'large' Non-Financial Counterparties (NFC+s)
 - Over a certain aggregate notional value threshold (CHF 8 bn over a 30 day period)
 - With 'large' defined analogue to EMIR rules - determined per aggregate notional outstanding per asset class: (i) CHF 1.1 bn for CDS & Equity Derivatives and (ii) CHF 3.3 bn for interest swaps, FX & commodities derivatives
- CHF denominated instruments are excluded (for now)
- Until now there is no Swiss CCP offering clearing of such instruments
- Bilateral Margining rules apply for trades not centrally cleared

<https://www.finma.ch/de/news/2017/12/20171218---mm---rs---finfrav/>