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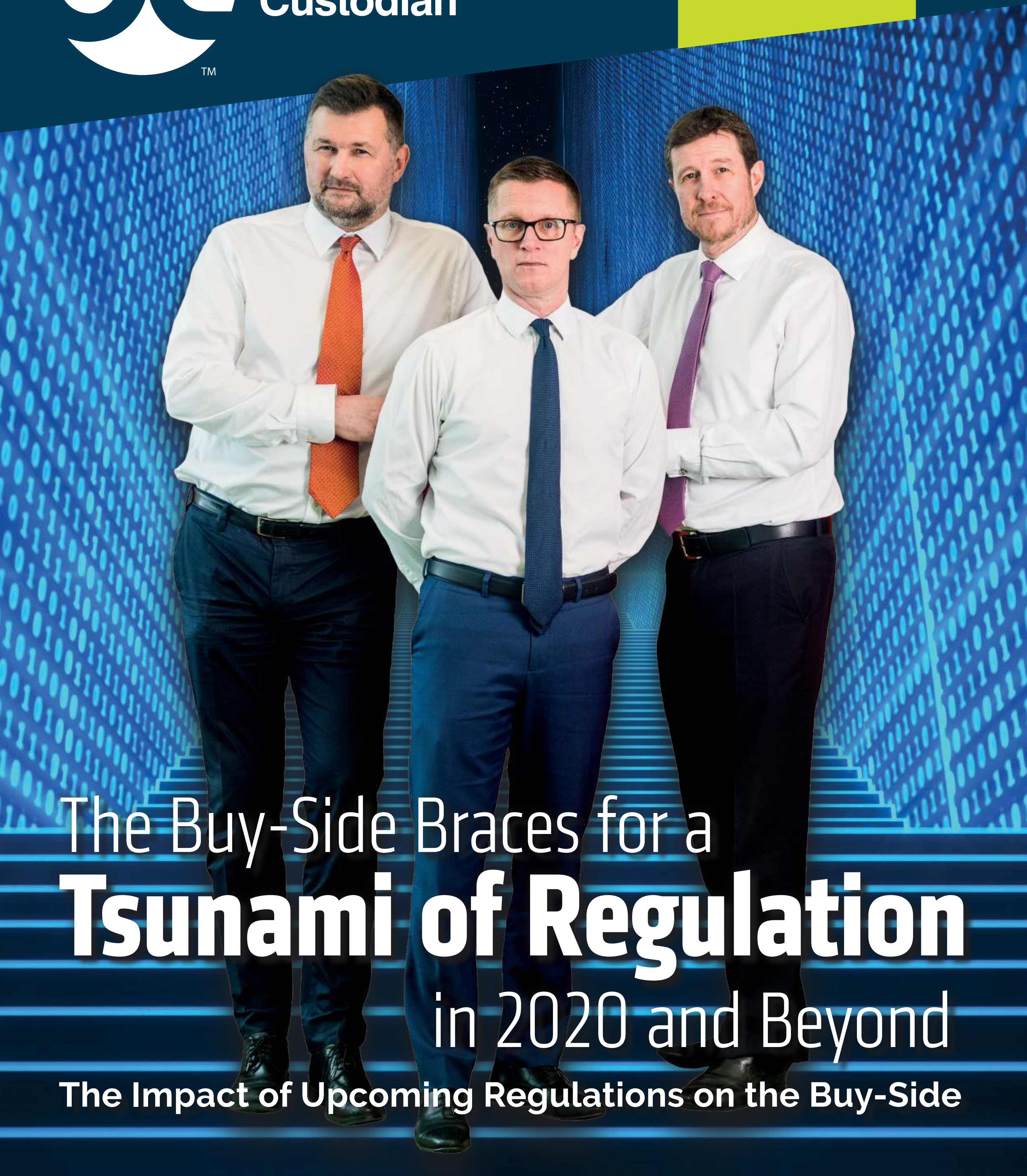

The Buy-Side Braces for a **Tsunami of Regulation** in 2020 and Beyond

The Impact of Upcoming Regulations on the Buy-Side

PREPARING FOR THE PIPELINE

INTRODUCTION

Buy-side firms face an unprecedented wave of financial and operational challenges in 2020 and beyond as they prepare for the perfect storm: the go-live of multiple new regulations. Over the next 18 months Uncleared Margin Rules (UMR) along with key provisions of the Securities Financing Transactions Regulation (SFTR) and Central Securities Depositories Regulation (CSDR) will take effect. For the buy-side, this regulatory tsunami is straining traditional operating models and introducing new costs and regulatory reporting requirements.

UMR's phases 5 and 6 offer one example of the compounding impact of these multiple regulations and the law of unintended consequences. These phases will predominantly impact funds and institutional investors, requiring buy-side firms to perform functions they have never before undertaken. Many firms are expected to make securities lending a key element of their liquidity management strategies to offset UMR's operational and funding costs. In turn, this reliance on securities lending will increase firms' SFTR reporting obligations and cause other adverse effects as firms look to mitigate settlement risk under CSDR.

Relevant authorities recently postponed the implementation dates of SFTR phase-one and UMR, with the delay of CSDR's settlement disciple regime (SDR)* expected by the industry, which will help firms maintain their focus on managing daily operations during the coronavirus pandemic. While this temporary relief allows firms to postpone allocating resources to the technology and operational upgrades needed to meet demands of these regulations, it does not eliminate the enormous pressure the mandates put on asset managers, hedge funds and other market participants.

Timeline of Buy-Side Regulatory Compliance Dates

11 October 2020: SFTR phase-three reporting obligations for buy-side firms

1 February 2021*: CSDR's settlement discipline regime (SDR)

1 September 2021: UMR phase 5, threshold aggregated average notional amount (AANA) > EUR/USD 50 billion

1 September 2022: UMR phase 6, threshold AANA > EUR/USD 8 billion

"A period of substantial regulatory change lies ahead for the financial sector," says Matt Johnson, Associate Director, Institutional Trade Processing (ITP) Product Management at DTCC. "It should prompt a holistic assessment of the impacts on firms' operations and how firms can prepare for successful implementation." Johnson cites CSDR as an example: this mandate is expected to increase the volume of stock loans and borrows as participants look to cover short positions. Repos may be also be used to cover shorts to enable settlement and avoid buy-ins and penalties under CSDR. However, Johnson points out, "all of those repos and stock borrows and loans will need to be reported under SFTR when the first phase of SFTR goes live this year."

Duncan Scott, Margin Transit Utility (MTU) Product Management Consultant at DTCC, says clients preparing for UMR will face similar considerations. "Some firms may need to transform securities into cash to post collateral or meet margin calls under the new rules, which is uncharted territory for them," he says. "Their approach may be to start trading repo, and that brings them into scope for SFTR and CSDR."

"A firm with limited resources should examine all the regulations to identify overlaps and synergies in its compliance strategies," says Mark Steadman, Executive Director, Repository & Derivatives Services (RDS) Product Development at DTCC. "A central project management office function could perform this work. For example, today a firm might choose to forego settling on time in order to have more time to source its data. But, because all these regulations emphasise timeliness, if the firm moved from manual to automated sourcing, it could also achieve timely settlement and reporting."

"Firms that internally discuss how they will interpret and address the rules will benefit," says Johnson. "Teams should share their information and collaborate as much as possible."

In that spirit, we sat down with these DTCC executives to discuss key client priorities and available solutions as firms prepare to manage the regulations coming through the pipeline in the months ahead.

UMR AT A GLANCE with Duncan Scott, MTU Product Management Consultant, DTCC

The first four phases of UMR have come into force in stages since 2016 and have affected banks. Many more firms, most on the buy-side, will come into scope with phases 5 and 6, which are now delayed 12 months to September 2021 and September 2022, respectively. Regulatory initial margin (IM) in the over-the-counter (OTC) derivatives space will be a new operational burden for many of these firms. Phase 5 firms with an aggregated average notional amount (AANA) of more than EUR/USD 50 billion will need to exchange IM with their counterparties for swaps that are not centrally cleared as of September 1, 2021. The AANA threshold will drop to EUR/USD 8 billion for Phase 6 firms from 1 September, 2022.

How do UMR phases 5 and 6 affect the buy-side?

UMR's requirements for posting initial and variation margin and mandatory central clearing of OTC derivatives are raising margin call volume and the amount of collateral required substantially. Furthermore, UMR mandates that IM be posted by both counterparties to each other and this two-way margining be held in segregated account structures.

Phases 1 to 4 covered banks but phases 5 and 6 will predominantly impact funds and institutional investors. When these phases take effect they will put stress on buy-side operating models and introduce new costs and regulatory reporting requirements for these firms.

What firms will be impacted?

The size of a firm's AANA of derivatives is the determining factor. Firms can perform a relatively quick, two-step check to see when they'll come into scope.
For phase 5, in-scope firms will have an AANA of non-cleared derivatives of EUR/USD 50 billion or more - but they need to start posting initial margin only where their IM calculation versus a particular counterparty exceeds EUR/USD 50 million. Then, the AANA threshold will drop to EUR/USD 8 billion for Phase 6 firms beginning 1 September, 2022.

What are some key challenges of UMR implementation?

First is the in-scope assessment process. Second is calculating the requisite initial margin, a risk-based calculation. Models are available to do it and firms need to decide whether to outsource this piece of work. Firms should also establish a process for agreeing to the amount with their counterparty. In phase 5, a lot of

DUNCAN SCOTT, MTU Product Management Consultant, DTCC

firms will be very new to these activities and may not have the resources to carry them out internally.

Then, having calculated the amount, firms must find a way to pay it, bearing in mind the need to use segregated accounts.

Can you offer guidance for how to evaluate whether to outsource or handle in-house?

I recommend doing a gap analysis of your firm's skillset. If you're already posting margin, calculation of IM may be the only new thing you need to master. And that's the piece I would focus on - getting help with the calculations, using the existing models that are out there.

Other aspects of meeting the regulations, such as connecting to tri-party providers or a third-party custodian, are within the realm of a lot of operations departments.

UMR requires that the model used to calculate IM is subject to back-testing and the responsibility to do this testing remains with each firm. Use of a common industry model will allow you to meet the UMR requirements and minimise your compliance risk.

Also, talk to your settlements department about their existing repo, tri-party and securities lending facilities, then piggyback off them where possible. Account opening is proving quite a problem for some firms. Some of those hurdles are removed if you have an existing relationship.

In terms of upskilling, maybe you lean on your specialist settlement staff to determine what the firm as a whole can do, rather than worry you've never done a particular thing before in your area.

Besides the operational challenges and resource constraints, what other aspects of UMR will be difficult for the buy-side?

Keep in mind that as well as posting IM to a segregated account to secure a counterparty, buy-side firms also have to onboard wherever their counterparty chooses to secure them. This represents both a documentary and operational challenge.

How can DTCC help?

DTCC helps firms simplify and streamline compliance with emerging regulations. We saw an opportunity to do this for UMR and developed our solution: the Margin Transit Utility (MTU).

MTU automates the margining process from point of agreement through to settlement. It applies automation to the validation, enrichment, settlement, reporting and monitoring of matched collateral calls globally. MTU incorporates a feed from AcadiaSoft, which provides matching for 70% to 80% of the industry's margin calls. We're connected to the SWIFT network so, very simply, we get a message from AcadiaSoft that says party A and party B have agreed to move collateral in the following form from one to the other. To get collateral settlement instructions, MTU leverages DTCC's Alert® standing settlement instructions (SSI) database, which is the industry standard for settlement instructions, then SWIFT messages are generated to the custodians and, tri-party agents and/or paying agents.

What about the credit and liquidity risk firms incur from UMR?

MTU also helps firms manage credit and liquidity risk by accelerating the distribution of settlement data. Because MTU acts for both parties, upon receipt of the collateral both payer and payee can share the status update. This transparency allows firms to work with real-time settlement rather than assumed settlement, which is quite important for credit and risk managers as well as treasurers in financial institutions. With assumed settlement, by contrast, firms book what they assume was paid or received but the next day may learn there was a break or a fail and have to unwind or make adjustments.

Why is margin call automation important?

Technology upgrades have accelerated trading and post-trade processing across many asset classes, yet much of the activity around margin calls and collateral movement remains untouched by automation. The result: margin calls today still rely in part on faxes, emails and manual processes – which slows processing, impedes transparency and increases error rates.

MTU delivers the automated workflows firms absolutely require in order to meet the rigorous operational demands of rules like UMR and avoid the financial penalties for noncompliance.

CSDR AT A GLANCE with Matt Johnson, Associate Director, ITP Product Management, DTCC

CSDR aims to harmonise the authorisation and supervision of central securities depositories (CSDs) across the EU and improve settlement discipline in the securities settlement systems they operate. Its settlement discipline regime (SDR), anticipated to go live 1 February, 2021, introduces penalty fees for failed transactions and forced mandatory buy-ins where a failing participant does not deliver the financial instruments to the receiving participant within four, seven or 15 days after the intended settlement date depending on the asset class of the transaction.

What's most important for buy-side firms to know about CSDR?

CSDR's provisions are very broad but a key aspect of this mandate is its settlement discipline regime. We expect the SDR will come into force in February 2021 and will have a huge impact on every single post-trade market participant – to the point that firms, including on the buy-side, will have to change the way they conduct business.

If we look at the Markets in Financial Instruments Directive (MiFID II), probably the biggest piece of financial

MATT JOHNSON, Associate Director, ITP Product Management, DTCC

regulation to date in the UK and Europe, it changed best-execution rules that were referenced in the first iteration of MiFID. Best-execution rules for the buy-side now require firms to take into account things like settlement cost and settlement likelihood when placing business with an investment bank or broker-dealer. These mandates are relevant to CSDR's discipline regime because they're all about increasing settlement performance across European markets. In preparation for CSDR buy-side firms should start looking at their brokers' post-trade performance.

All markets have failed trades. Is it utopian to try eliminating failed trades?

Failed trades are inevitable, but certain strategies can minimise their incidence. CSDR imposes penalties to ensure you are not the party responsible for a fail.

We're telling our clients to take a critical look at their trade processing, from execution through to settlement and including the way trades are being captured after execution and how they're being confirmed.

The key is prevention, prevention, prevention. If you don't fail any transactions, you have nothing to worry about regarding the SDR.

How can firms improve confirmation and settlement to reduce trade fails?

We encourage electronic or automated confirmation. If you're trading with a broker that requires an email allocation or email confirmation, you may want to look at moving confirmation onto an automated platform.

We also advise automating the various steps in the settlement process. Now that Europe works on a T+2 settlement cycle, you only have 48 hours after execution to capture the trade, book the trade, confirm it, affirm it, instruct it, fund it, pre-match, then settle. At the same time, you need to make sure the reference data you're using - i.e., settlement instructions - are correct.

What tools are available to the buy-side?

DTCC's ITP no-touch workflow offers multiple tools to facilitate confirmation and settlement and minimise inaccurate or incomplete standing settlement instructions (SSIs), which are one of the biggest reasons for trade failure.

Confirmation ensures you understand what's been bought or sold, what needs to be delivered or received. Ideally it should also verify the place of settlement and location of the relevant accounts. If both parties provide that information and both parties have agreed, you've locked in your economic risk and your settlement risk. Using the no-touch workflow eliminates your need to pre-match prior to settlement because it's been done straight after execution as part of confirmation.

Our central trade matching platform (CTM™) enables same-day confirmation and matching of trades globally. CTM in tandem with our ALERT database can reduce SSI-related trade fails by enriching trades with golden-source account and standing settlement instructions. Additionally our ALERT Key Auto Select (AKAS) feature determines the preferred place of settlement and location of accounts.

We encourage clients to populate their outbound SWIFT messages to their settlement agent or custodian with this locked-in data. That way, they're distributing the same data they've agreed with their broker-dealer all the way through the post-trade lifecycle.

For buy-side firms we offer the Global Custodian Direct workflow. This tool allows global custodians to manage SSI maintenance and ownership within

DTCC's **Margin Transit Utility (MTU)** automates the margin settlement process for OTC derivatives transactions and other marginable products on behalf of buy-side firms, their administrators and custodians and dealer counterparties. MTU leverages the ALERT® database to obtain collateral instructions to minimise trade fails.

MTU Features & Benefits

• Accommodates bilateral, third-party and tri-party workflow

• Eliminates the need for direct, multiple builds to individual counterparties and custodians

• Validates formatting of pledge-accepted margin calls

• Integrates with ALERT® to enable real-time enrichment of collateral standing settlement instructions

• Automates outbound settlement instructions

• Eliminates the need for authenticated release faxes where counterparties use a segregated account at a third-party custodian

• Delivers consolidated end-of-day reporting

• Offers scalability and capacity to handle rising collateral demands

ALERT on behalf of their buy-side clients by automating the exchange of SSIs between a custodian's central repository and the ALERT database.

In cases where trade failures and exceptions do happen, DTCC Exception Manager will allow counterparties to view exceptions when they occur so they can be addressed or fixed prior to settlement. If trades do fail, the exceptions can be highlighted, and the dataset can be shared among the relevant parties to that transaction. Fixing exceptions prior to trade failure, or quickly after, allows firms to mitigate their exposure to regulator-imposed penalties and buy-ins.

Can CSDR preparations be outsourced?

Buy-side compliance cannot be outsourced to a custodian or a broker. Therefore, firms must look for gaps in their current trade processes and post-trade lifecycles in terms of what the CSDR discipline regime will impose, then run an analysis to judge whether they can plug those gaps internally or need to seek out a vendor or third-party system.

Our clients can do this gap analysis using a DTCC best-practice scorecard that breaks the post-trade lifestyle into four components: SSI and general reference data; confirmation and the automation of confirmations; notification out for settlement; and exception management capture and trade analytics.

The scorecard can identify gaps in data sources or processing. Where there are gaps, we can help clients plug them - by identifying the DTCC services they can use or, for those who want to keep some work in-house, recommending capabilities they should build in order to mitigate their settlement risk.

Some clients may achieve top marks across all four areas of the scorecard yet still have trades fail. In that case, the scorecard says you're likely not at fault because your processes are designed to make sure the trade is settled with finality on its settlement date.

One thing that I emphasise to my clients is: make sure you're using your systems, in-house or outsourced, the way they're intended. If you use a service, utilise all of its features - it doesn't cost you extra and you'll get additional benefit when CSDR's discipline regime takes effect.

SFTR AT A GLANCE with Mark Steadman, Executive Director, RDS Product Development, DTCC

SFTR phase-one, with a three-month delay, is now scheduled to go live simultaneously with phase-two on 13 July, 2020. Buy-side firms will be primarily captured in phase-three, scheduled to take effect on October 11, 2020, followed by non-financial counterparties (NFCs) in January 2021. The regulation aims to reduce perceived shadow banking risks in the securities financing markets by imposing conditions on the reuse of financial instruments provided as collateral and requiring that managers of UCITS and alternative investment funds (AIFs) make detailed disclosures to their investors regarding their use of securities financing transactions (SFTs) and total return swaps. To provide transparency to regulators SFTR also requires both parties to a trade to report new, modified or terminated SFTs and the associated collateral to an ESMA registered or recognised trade repository (TR) on a T+1 basis.

What are the biggest challenges SFTR poses to buy-side firms?
I don't think anyone would disagree that SFTR is the most complex trade reporting regime to date. SFTR requires the reporting of the underlying collateral, not just its netted value, therefore collateral reuse reporting may be difficult to delegate, and then there is the pain of sourcing the data to populate 155 fields, including a unique transaction identifier (UTI) which needs to be paired and shared. Additionally, the formatting requirements for SFTR reports submitted to TRs are strict - they must be in ISO 20022 - so any firm not well versed in reporting in XML will face a challenge. If that isn't enough, repo, stock lending and margin lending are very different products with very different workflows, and each has its own industry representative body. So there's a lot to get your arms around.

Tell us more about the difficulty of collateral reuse reporting for the buy-side and its implications?
Collateral reuse needs to be reported at an aggregated level for each entity that reuses its collateral. As its not at a trade or counterparty-to-counterparty level as with all other trade reporting, and requires some sensitive information to be provided, this means delegating this to another party is going to be very difficult to do. Certain restrictions are already in place for reuse but, given the nature of reuse reporting under SFTR, this regulation may make it too onerous to bother with reuse.

DTCC Tools to Minimise Trade Fails

CTM™ enables same-day trade confirmation and matching by automating the processing of equities, fixed income and repo trades from trade execution to instruction.

CTM used in conjunction with **ALERT®** reduces the likelihood of SSI-related trade fails by automatically enriching trades with account and standing settlement instructions.

CTM used along with **ALERT Key Auto Select (AKAS)** populates preferred place of settlement and preferred depository.

DTCC Exception Manager supports timely settlement by accelerating the resolution of trade exceptions.

DTCC best-practice scorecard helps firms conduct gap analyses of their post-trade processing.

MARK STEADMAN, Executive Director, RDS Product Development, DTCC

Presumably some buy-side firms have not yet started preparing for SFTR. Do you have advice for these firms?
Many of these firms may be unfamiliar with SFTR and the regulatory expectations around it, so first they should undertake an audit. What security finance products do you trade? What products are you in scope for? Who do you trade with today? Start talking to those firms, especially if you are seeking to delegate your reporting.

Second, they can gather lots of useful information through industry bodies like the International Capital Markets Association (ICMA) and International Securities Lending Association (ISLA). Each have issued SFT reporting best practice guides.

When it comes to reporting, DTCC is enabling clients to meet their SFTR reporting obligations through our Global Trade Repository (GTR) service. GTR is the world's largest trade repository

DTCC's SFTR Solution: GTR + DTCC Report Hub™ Service

The Global Trade Repository service **(GTR)** in combination with the **DTCC Report Hub** service simplifies the trade reporting process.

DTCC Report Hub's customisable suite of quality assurance and reconciliation tools manage trade data on the front and back ends of submission.

The service's **pre-reporting capabilities** include, among others, data normalisation, data enrichment, pre-validation and exception management.

Once the data has been vetted and formatted, clients submit it to a DTCC licensed/registered trade repository.

Post-submission, clients can use the DTCC Report Hub's **post-reporting capabilities** to reconcile GTR end-of-day reports with the data submitted from their internal books and records.

for OTC derivatives reporting and it is entering the securities financing market as a registered TR.

With our years of experience in jurisdictions around the world, we understand clients' top pain points around reporting and can advise on best reporting practices. We're also committed to minimising the client build-out effort for SFTR. To that end, we have rolled out the DTCC Report Hub™ service, a suite of tools clients can use in combination with GTR to manage their pre- and post-reporting tasks.

Be more specific about these pre- and post-reporting tasks and how the DTCC Report Hub works.

SFTR requires extensive effort to transform and enrich trade data so that it meets stringent eligibility, completeness, accuracy and timeliness standards before it is submitted to a TR in the mandated ISO 20022 XML format and, on the back end, to reconcile reported data with firms' internal records. Yet most firms lack efficient, rationalised in-house systems and procedures to perform this work.

We built the DTCC Report Hub to serve this unmet need, which will only keep growing as reporting mandates are extended to more jurisdictions and get more complex. In fact, we plan to adapt the service to function across products and regulatory jurisdictions.

The DTCC Report Hub leverages automation technology to translate transaction data into formats required by regulators, enrich the data using reference data sources, and find and fix errors and/or missing data before firms submit to a TR. The service also lets users compare their trading books to transactions to ensure the trade reports match.

Because users choose the features they want, the DTCC Report Hub service is a flexible toolbox for buy-side and dealer firms, small or large. It is also an efficient way for firms to allocate resources by alleviating the stress on in-house technology and staff.

At the start of this conversation, we discussed the extent to which clients can benefit from overlaps and synergies in preparing for UMR, CSDR and SFTR. Is DTCC looking at new ways to connect the dots between services to offer greater value?

Absolutely yes. We're continuously looking for ways to join our services together into a more seamless offering that helps our clients. Now that we've incorporated MTU into our ITP service suite alongside CTM, ALERT, DTCC Exception Manager and other post-trade capabilities, we offer clients a fairly comprehensive solution for UMR and CSDR compliance. And GTR is now working with our CTM team to develop straight-through processing from CTM into GTR, which will further streamline SFTR trade reporting.

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