ICMA CSDR-SD Working Group
Workstream on Best Practice for Cash Compensation

Call: February 13, 2020

Meeting notes

- The Group discussed the difference between a buy-in auction and a 'dealer poll' to set a price for cash compensation. It was re-affirmed that the latter would need to be an open reverse auction requiring he submission of firm, actionable offers. In many respects it would be similar to a buy-in auction, with the subtle difference being that the buy-in auction would require 'guaranteed delivery' (with the consideration that any trades would be cancelable in the event of a settlement fail), while the cash compensation auction would not be for guaranteed delivery (and therefore any offers lifted would be subject to CSDR-SD provisions in the event it failed).

- The question was raised as to the need to define 'guaranteed delivery'. There were no views on this.

- The point was made that an auction-based buy-in process could be limiting in the case of illiquid bonds. Holders (usually end-investors) would be reluctant to sell out of their positions without knowing that they can substitute with a similar security. This made bilateral switch negotiations (with the buy-in agent acting more in the capacity of a traditional broker-dealer) possibly more effective than an auction process. This would also likely help to ensure better offers, and so more likely comply with any best execution requirements.

- It was questioned whether a cash compensation auction process would offer any value if the buy-in process had failed to solicit any offers. Also, to the extent that it did, the failed-to party would almost certainly want to lift offers, rather than going to cash compensation. In which case, the cash comp process is not really any different to the original intention of the deferral period.

- There was a view that as part of the buy-in waterfall logic, there was the need for a stage between the buy-in attempt and going to the RTS provisions for the use of a screen price to establish cash compensation. However, it was not clear what that intermediate step should be.

- The discussion turned to the likelihood of ultimately having to rely on a reference price that did not necessarily relate to a firm offer or an actual recent trade. While there was general agreement that the responsibility for deriving this price should be given to an independent third party (the buy-in agent), there were no clear ideas on a robust process for establishing a fair value price that would be acceptable to both parties.

- It was pointed out that firms will have their own internal valuations for the position, but it was not clear whether the two parties to the failing trade would necessarily have the same valuation on their books. [Furthermore, the failing selling party could be flat, and not marking any position.]

- The GMRA was cited as having an existing contractual provision that is applied in the case of default valuation scenarios to assign a value to securities as part of a close-out process. While this was not necessarily directly relevant in the case of cash settlement of an outright transaction, it may at least provide some ideas. [See Annex 1.]

- The CDS determinations auction process was cited as another possible model. [However, this could be quite cumbersome, and impractical, given that multiple buy-ins and cash compensation processes would be occurring on a continuous basis.] Again, this is seldomly relied upon.

- The suggestion of using a CCP methodology of a percentage limit of the original transaction value was thrown out as a discussion point. This was quickly dismissed as it does not solve for the inherent problem of the market price moving, and that of establishing what the market price should be (in other words, it only serves as an additional penalty, but does not mitigate the market exposure of either party – in fact it would only increase it).

- It was also noted that any 'pre-agreed' methodology for establishing cash compensation that went beyond the provisions outlined in the RTS would require relevant NCA approval.

- It was suggested that Workstream members consider some of the questions raised in the discussion ahead of the next meeting, likely to be in the subsequent two weeks.

Questions for consideration

- If a buy-in is not possible, is there any value in a cash compensation auction process that requires actionable prices?

- Should it necessarily be the role of an independent third-party (the buy-in agent) to establish the cash compensation reference price?

- Could firms' own internal valuations (book values) play a role in establishing a cash compensation reference price?

- If a firm was asked to establish the fair value of a security that seldomly trades, what methodology, variables, or parameters would they likely consider?

- What should be the extent of best practice with respect to the cash compensation process, and what should be left purely to commercial considerations?

Prepared by Andy Hill, February 2020

Annex 1

GMRA 2011

Default valuation mechanism extract

10.

(e) For the purposes of this Agreement, the "Default Market Value" of any Equivalent Securities or Equivalent Margin Securities shall be determined by the non-Defaulting Party on or as soon as reasonably practicable after the Early Termination Date in accordance with sub-paragraph (f) below, and for this purpose –

(i) the "Appropriate Market" means, in relation to Securities of any description, the market which is the most appropriate market for Securities of that description, as determined by the non-Defaulting Party;

(ii) "Deliverable Securities" means Equivalent Securities or Equivalent Margin Securities to be delivered by the Defaulting Party;

(iii) "Net Value" means at any time, in relation to any Deliverable Securities or Receivable Securities, the amount which, in the reasonable opinion of the non-Defaulting Party, represents their fair market value, having regard to such pricing sources (including trading prices) and methods (which may include, without limitation, available prices for Securities with similar maturities, terms and credit characteristics as the relevant Equivalent Securities or Equivalent Margin Securities) as the non-Defaulting Party considers appropriate, less, in the case of Receivable Securities, or plus, in the case of Deliverable Securities, all Transaction Costs which would be incurred or reasonably anticipated in connection with the purchase or sale of such Securities;

(iv) "Receivable Securities" means Equivalent Securities or Equivalent Margin Securities to be delivered to the Defaulting Party; and

(iv) "Transaction Costs" in relation to any transaction contemplated in paragraph

10(e) or (f) means the reasonable costs, commissions, fees and expenses (including any mark-up or mark-down or premium paid for guaranteed delivery) incurred or reasonably anticipated in connection with the purchase of Deliverable Securities or sale of Receivable Securities, calculated on the assumption that the aggregate thereof is the least that could reasonably be expected to be paid in order to carry out the transaction.

(f) If -

(i) on or about the Early Termination Date the non-Defaulting Party has sold, in the case of Receivable Securities, or purchased, in the case of Deliverable Securities, Securities which form part of the same issue and are of an identical type and description as those Equivalent Securities or Equivalent Margin Securities (regardless as to whether or not such sales or purchases have settled), the non-Defaulting Party may elect to treat as the Default Market Value