International
Capital
Market
Association

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

**Inaugural meeting/call**
**January 29th, 2020**

## Meeting notes

### 1) Identifying the problem

- The provisions for establishing the reference price to determine the cash compensation reference price are outlined in Article 32 of the RTS. In particular para 3(b) provides as follows:

*3. The market value referred to in paragraph 1 shall be determined as follows:*

*(b) for financial instruments admitted to trading on a trading venue within the Union other than those referred to in point (a), the value determined on the basis of the closing price of the trading venue within the Union with the highest turnover;*

- This seems to be designed with exchange traded equity markets in mind. In the case of bonds, while some MTFs to provide actual transaction data or firm executable prices, there is a risk that for less actively traded bonds a price taken from an MTF (or other post-trade data source) could be stale, based on a transaction that was executed days or weeks earlier, or could be an indicative quote (i.e. not an actionable price); any of which could be far from fair value.
- Given that cash compensation will apply in the case of securities where a buy-in could not be executed, this increases the likelihood that any screen derived reference price will be stale or indicative, and therefore an unrealistic representation of fair market value.
- An off-market reference price would create risks for both parties to the trade. In the case of the purchasing party, they would not only be forced out of a trade against their wish (with the additional consequences of unwinding contingent trades and potential mandate implications) but could also suffer a market loss where the reference price is too low. In the case of the selling party, if the reference price is too high, they will incur losses; the unpredictably of this is a deterrent to market-making.
- Where cash compensation reference prices are based on a non-executable trade price, they can easily be 'gamed'.

- Essentially, in the case of bonds, the cash compensation reference price established by application of the RTS would, in most cases, result in an artificial valuation.

## 2) Scope and deliverables of the workstream

- It was agreed that the group should aim to establish a standardized approach to establishing a reliable reference price in the case of cash compensation.
- It was questioned whether this could apply to all asset classes, with the view that it might be advisable to start from the perspective of bond markets, where the problem was more readily identifiable.
- Ideally the proposed approach should be shared with ESMA with a view to obtaining Level 3 'approval'.
- The approach should be codified into market best practice, and ideally included in the ICMA Secondary Market Rules & Recommendations (and could also be included in other contractual arrangements). It was to be determined how prescriptive this should be, and what elements should be 'recommendations' as distinct from 'rules'

## 3) Potential framework for a solution

- The regulation is silent on who should determine the reference price. There was a strong view that, similar to the buy-in, this should be the responsibility of an independent third party. This potentially should be one of the responsibilities of any buy-in agent.
- It was proposed that to ensure that reference price reflects real market prices, a form of dealer-poll would be required. This would need to be based on firm, executable prices.
- Such a dealer-poll would probably need to be in the form of an open auction, to ensure the widest possible participation and full transparency.
- It was further suggested that this should be part of the established buy-in process, leveraging the regulatory provisions for a deferral period. Essentially this would facilitate a two-step approach to the buy-in:
    - Step 1: The buy-in agent attempts to source the bonds for guaranteed delivery to settle the buy-in.
    - Step-2: If the buy-in is not possible (for all or part of the amount), then the deferral period would be used to run a dealer poll.
- In the case of the dealer poll, offers would need to be firm (executable), but not necessarily for guaranteed delivery.
- The purchasing (failed-to party) would have the choice of purchasing the securities tendered in the poll, or of accepting the weighted average price (up to the bid amount) as the reference price for cash compensation.

- While the view is that the failure of a buy-in to settle would be viewed as an 'unsuccessful buy-in' (with the buy-in being canceled), offers put into the dealer-poll would probably need to be in-scope of the CSDR buy-in requirements in the event that they are lifted.
- In the case that the dealer poll does not produce any offers, it was suggested that the fallback would have to be the regulatory provisions (i.e. Article 32(3)b). However, it may be possible to agree on a market standard price source, or composite.
- In the case that the dealer poll provides enough offers to cover the bid size, it was suggested that the cash compensation reference price could be determined partially based on the dealer poll offers and partially using Article 32 fallback.
- It was pointed out that while the proposed model looked to utilize the deferral period to establish the  cash compensation reference price, the application of the deferral period was at the discretion of the purchasing (failed-to) party, which may also need to be addressed in any market practice guidelines.

## Other related considerations

- It was proposed that the success of this model is likely to depend on the willingness for large, established market participants, with strong credentials and client networks in the European and global bond markets, to take on the role of buy-in agent. This would also require an economically viable business model, which may have to be different to the historical function of market-makers acting as buy-in agents to provide an ancillary pro bono market service.
- Running buy-in auctions and dealer-polls would likely work best if held on pre-set days (say two or three times a week). This would not only serve to concentrate liquidity but could group together multiple buy-ins in the same securities, reducing the risk of market instability. It may also help in identifying, and collapsing,  fails chains, potentially reducing the number of buy-ins (even more important in the event of a limited application of a pass-on mechanism).
- It was further suggested that while the current challenge was the potential scarcity of buy-in agents, particularly from the perspective of less liquid bond markets, having too many buy-in agents could be inefficient, in that it could split limited liquidity and even result in competing buy-ins.
- While guaranteed delivery is not specified in the regulation (although it was pointed out that this could be inferred from the regulation), this should probably be specified in market best practice. This raised the question of whether 'guaranteed delivery' should be defined (noting that it is not defined in the ICMA Rules), or whether it is broadly understood.
- It was pointed out that one of the firms marketing themselves as a buy-in agent post-CSDR has indicated that they will execute buy-ins on a T+0 basis. While this essentially amounts to guaranteed delivery, it was also discussed that this may restrict the ability of holders of securities to offer securities against a buy-in, since many firms would struggle to instruct in such a tight settlement window. So long as firms held the securities in their box (i.e. they had not been loaned out, were not contingent on an inward delivery, and could be segregated in the case of an omnibus account), then standard (T+2) delivery should be fine.

Furthermore, in many cases firms would want to replace their sale with a purchase of substitute securities (rather than holding cash), so may require an even longer settlement period).

- It was agreed that the design for any functional buy-in and cash compensation process would need to be based on the possibility to solve for the payment asymmetry in the regulation, and that payments could be made between buyers and sellers in either direction, depending on whether the buy-in or cash compensation reference price is higher or lower than the original transaction price.

## 4) Next steps

- ICMA agreed to circulate a note of the meeting. Following further feedback, ICMA would then paper a draft outline proposal, identifying key questions and considerations, to form the basis of the discussion of the next meeting/call.
- ICMA would aim to hold the next workstream meeting/call in two weeks' time, with regular follow-up meetings/calls.

Prepared by Andy Hill, January 2020