CANADIAN FIXED INCOME FORUM | CIMPA

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Best Practices for the Settlement of Government of Canada Securities

I. BACKGROUND

- On January 11, 2024, the Government of Canada Market Functioning Steering Group (GMF) published the final framework on a fee for failing to settle Government of Canada (GoC) bond and bill transactions.[1] This framework had been endorsed by the Canadian Fixed Income Forum (CFIF) and benefited from a public consultation as well as targeted industry outreach.[2]
- With the GMF's mandate fulfilled, CFIF tasked the Collateral Infrastructure and Market Practices Advisory Group (CIMPA) with steering the implementation of the fail fee infrastructure, conducting the fail fee trial phase, refining the fail fee framework's governance and develop a set of best practices for the settlement of GoC securities.
- These best practices are not legally mandated and should be considered non-binding guidelines outside of regulatory frameworks. Nevertheless, CIMPA strongly encourages their broad adoption by all types of financial market participants that are active in GoC cash-, repo- and securities lending markets, including dealers, banks, prime brokers, buy-side firms, custodians, and others. Certain elements of the best practices are contingent on the actual exchange of fail fee payments, yet most practices would apply even if the fail fee exchange remains inactive.
- This document should not be viewed as exhaustive and is meant to serve as a living document that will be maintained to ensure relevance and appropriateness.

II. RECOMMENDATIONS

1. Market participants should avoid behaviours that create or exacerbate settlement fails.
   - To promote efficient market clearing and reduce settlement fails, market participants should avoid holding back deliveries or payment until immediately before any cut-off time.
   - All market participants should be diligent in addressing persistent settlement fails.
   - Market participants should avoid imprudently on-selling securities where significant doubts exist as to being able to make delivery (e.g., if security is on special and cannot be sourced via securities lenders, or an incoming trade has failed multiple days in a row).[3]

[1] Available at https://www.bankofcanada.ca/wp-content/uploads/2024/01/gmf-framework.pdf

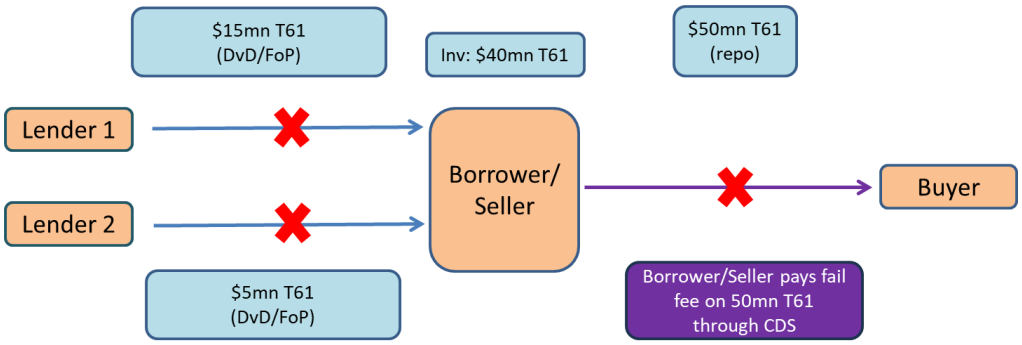
[2] All available at https://www.bankofcanada.ca/2024/01/gmf-publishes-final-framework-fee-for-failing-settle-goc/

[3] A security is "on special" when it is in high demand in cash and repo markets, making it difficult to source. The security will therefore trade at repo rates well below those for general collateral.

- A trade should not be deleted or DK'd for the sole purpose of avoiding a fail fee.[4]

2. Robust internal controls to protect against fails should be in place.
   - Market participants should establish internal operational processes to generate automated alerts to flag trades that have not settled by a specific time (e.g., ARROW or CDS Broadcast Message Process can be used to facilitate automated notifications).
   - Market participants should maintain up-to-date contact details for all their counterparties across all relevant front-, middle-, and back-office functions. This allows for efficient communication between counterparties to assist in resolving unsettled trades before a settlement fail occurs.

3. Partial settlements should be prioritized whenever feasible. Notwithstanding the primary applicability of the fail fee to delivery-vs-payment (DvP) transactions, fails associated with ***non-DvP*** transactions should also be subject to bilateral fail fee claims between the failed-to and failing counterparties to ensure a level playing field.
   - For ***DvP*** transactions, fail fees will be centrally administered and charged by the Canadian Depository for Securities (CDS), which will directly invoice its members for failed trades. This creates an issue of potentially uneven pass-through of the fail fee, e.g., if an incoming fail of a non-DvP transaction contributed to the DvP fail. Non-DvP transactions settle via pledges or free-of-payment transfers and include securities loans and margin transfers.
   - The example below illustrates this situation with a repo seller failing on $50mn of a bond (CA135087T610, "T61") despite having $40mn of the security in inventory.[5] This is because two incoming deliveries (non-DvP) of T61 from different securities lenders also fail. CDS will charge the seller a fail fee on the full $50mn for the failed repo.



   - Until technical solutions are available for automatic partial settlements, market participants should do the following, when feasible:
     - Borrowers/sellers should make sound judgement on the likelihood of incoming deliveries settling and look to source the remainder elsewhere (i.e., in the

[4] Normally, a confirming party will set the trade status to DK ("don't know") if there are issues with the trade details. The trade will then be sent back to the submitter, who can amend or delete it. A "DK" status does not incur a fail fee.

[5] This example would also be applicable if the seller had sold the security in the cash market.

example, the seller should source $10mn elsewhere to cover the delivery of the full $50mn in the repo).
    - If it is infeasible to source the remainder elsewhere, the borrower/seller should attempt a partial delivery, if the counterparty agrees (e.g., deliver the $40mn the borrower/seller has in inventory in the example). Market participants should communicate with their counterparties as early as possible when requesting a partial settlement. Custodians should facilitate partial settlements when requested and communicate promptly with their clients on a best-efforts basis.
    - Partial settlements should be attempted irrespective of the size of the trade, i.e., including for trade amounts less than a $50mn split in the settlement system. If a trade is partially settled, i.e., split into a settled part (the "partial") and an unsettled remainder), the original trade should be deleted or DK'd promptly, so that only the unsettled remainder incurs a fail fee if it remains unsettled by the deadline.
- While the fail fee will only be charged automatically by CDS for DvP transactions, to avoid an uneven playing field, market participants should apply the fail fee broadly to non-DvP transactions as well via a bilateral claims process.
    - In the example above, being able to claim both securities lending fails eliminates any uncertainty regarding how much and from which lender the borrower/seller should claim a fail fee payment, and whether any proof of the fail would need to be furnished. Even though the fail fee charged by CDS will only be on the $50mn repo fail, the borrower/seller should be able to claim the fail fees associated with both the $15mn and the $5mn fail securities lending fail; to the extent that Lenders 1 and 2 also experienced incoming fails, they would also be able to claim them from their counterparts.
    - Existing documentation in the form of GMSLAs contains language allowing a failed-to party to claim interest, overdraft and similar costs from a party failing to return a borrowed security. For enhanced clarity, counterparties wishing to enable bilateral fails claims under both an MSLA and a GMSLA are encouraged to add the appropriate provisions in annexes to their agreements. CIMPA will also provide a template for market participant intending to use the bilateral claims process.[6]
    - In case there are disputes regarding bilateral claims, CIMPA expects that market participants will handle claim disputes bilaterally and in good faith.

4. No minimum transfer amount (MTA) should be in place for bilateral claims, but claims should be aggregated on a monthly basis to ensure even pass-through between DvP- and non-DvP transactions.

[6] The template will be similar to that provided by the US TMPG in Annex A of the Fails Charge Trading Practice.

- As in the case of DvP fails, and to facilitate an even playing field, no minimum transfer amount should be applied to bilateral fail fee claims. Market participants may want to aggregate their claims vs. any given counterparty on a monthly basis and use the same monthly invoice and payment schedule applied by CDS to DvP fails. This would ensure that both the CDS and bilateral fail fee payments are on the same schedule and ensure an even pass-through of any fail fee payments.