

CCP Default Auctions Best Practices

Category 2 Issues:
CCP Governance, Default Management Groups, and Client
Participation

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1. INTRODUCTION

In the report “Central counterparty default management auctions – Issues for consideration,”¹ the Committee on Payments and Market Infrastructures (“CPMI”) and the Board of the International Organization of Securities Commissions (“IOSCO”), CPMI-IOSCO described issues for CCPs to consider in the design and conduct of default management auctions. The paper builds on the Principles for Financial Market Infrastructures (April 2012) (“PFMIs”) and joint CPMI-IOSCO work on CCP resilience and recovery, with the aim of enhancing auction practices and procedures. The paper reflects current practices across the industry, as well as responses to a 2019 CPMI-IOSCO discussion paper. The report and its accompanying cover note² observed three areas for further work by the industry, which are directed at the objectives of the 2019 discussion paper. These objectives are, as listed by CPMI-IOSCO:

1. promoting a common understanding of key concepts, key processes (including information needs) and operational aspects that a CCP considers when planning and conducting default management auctions;
2. highlighting key issues and challenges in auctions for those who are looking to develop or to improve upon their auction procedures; and
3. providing context for industry participants to identify opportunities to foster closer collaboration.

The three categories of work where the Policy Steering Group of CPMI-IOSCO sought industry action are:

- The first category includes several terminology and operational issues (where there is broad industry consensus to support further development and where CCPs should be well-positioned to advance these issues, bringing such work to closure.
- The second category includes areas (governance of a CCP’s default management process, use of traders in default management groups, the scope of client participation) where there may be differing views among clearing members, clients, CCPs, and other stakeholders.
- The third category includes potential nascent and emerging practices (synchronizing default management processes, identification of potential hedges between CCPs) that may require further coordination and harmonisation among the default management processes of multiple CCPs.

This paper, developed by CCP12, EACH, FIA, FIA PTG, ISDA and MFA, addresses the client participation part of the second area of work.

¹ “Central counterparty default management auctions – Issues for consideration” – June 2020: <https://www.bis.org/cpmi/publ/d192.pdf>

² “Central counterparty default management auctions – Issues for consideration” – June 2020: https://www.bis.org/cpmi/publ/d192_covernote.pdf

For auction participation, the following general points, which apply to all participants, are to be emphasized:

- A CCP should have sufficient familiarity of all the participants' capabilities in an auction.
- Furthermore, a CCP should have a sufficient number of potential bidders, which may include clients, across all asset classes it clears.
- Information leakage should be minimized, for instance through the appropriate legal practices and non-disclosure agreements (“NDAs”). Other methods, including auction format specificities may be possible to supplement these depending on the particular market, for instance utilizing a two-way bidding format for all participants.

As outlined by CPMI-IOSCO in their 2017, 2019, and 2020 papers, different CCPs can and do adopt different auction structures that are best suited to a robust and suitable default management. As such, a “one-size-fits-all” approach to the auction process is inappropriate and it is critical to recognize that differences exist, such as product types, market structures and characteristics, regulatory and legal environments in different jurisdictions, and operational requirements. It is also imperative that a CCP retains flexibility in its default auction approach to react to the facts and circumstances at the time of the event.

2. CLIENT PARTICIPATION

2.1. BENEFITS OF CCPS OFFERING CLIENT PARTICIPATION

Client participation should be an option across all asset classes and products.³ Having a diverse set of qualified participants can result in more competitive bids and increase the odds of having a successful default management auction. Often, clients are the primary liquidity suppliers in a particular asset class or product group. While it could be true for OTC markets, client participation may be especially critical in exchange-listed markets where market makers, liquidity providers, and asset class specialists, who are well-placed to price, absorb and risk manage a defaulter's portfolio, often act in the capacity of clients of clearing members. In such cases, it is expected that the clearing member of the client is supportive of such involvement. Experience with client participation in CCP default auctions has demonstrated that clients bid aggressively, reducing the overall cost of resolving the default

CCPs should always be able to consider including clients in default management auctions, subject to approval by the CCP governance body, confidentiality agreements, and approval of a clearing member who clears the client's positions. Facilitating client participation in an auction can produce more competitive bids and yield better auction results by expanding the potential risk capacity that can be absorbed and enhancing the price discovery process of the defaulter's portfolio. This benefits all market stakeholders, including clearing members, since higher quality bids, not only allows for the timelier management of the default, but it reduces the likelihood of the mutualization of losses across non-defaulting clearing members. Also, client participation can increase the probability of a successful liquidation process (hedging, independent sale, and auction execution), thus returning the CCP to a matched book.

2.2. CCPS' CONSIDERATIONS FOR CLIENT PARTICIPATION

For CCPs that clear a broad range of asset classes, they may seek participation from clients with broad market exposures, as well as more specialized clients that can bid on specific product types. There also could be circumstances where clearing members have limited proprietary activity in a given product. Ultimately, decisions on participation in an auction should focus on inviting market participants with the appropriate expertise and risk management capacity, regardless of whether they are clearing members or clients.

Pre-Approval by the CCP

When identifying suitable clients to potentially participate in an auction, the primary considerations for a CCP are:

- A clearing member's willingness for its client to participate;
- The client's willingness; and

³ For some asset classes, client participation is a general practice and is welcomed.

- The client’s ability, including operational readiness, to price and risk manage the defaulter’s exposures in a compressed timeframe, which, in part, a CCP would typically expect a client to demonstrate through participation in default management testing exercises.

CCPs consider multiple factors in determining if a potential client has the capacity to participate in an auction. Depending on the respective CCP, such factors could include, but are not limited to:

- Successful participation in previous default management testing exercises;
- Financial resources sufficient relative to the potential exposure from the defaulter’s portfolio;
- Existing positions and margin at a CCP;
- Gross monthly trading volume;
- Licensing;
- Credit worthiness; and
- Overall trading activity.

Non-Disclosure Agreements

For any type of auction participant, concerns about confidentiality and other risks should be addressed ex-ante as part of the auction design where possible. All potential bidders should be bound by NDAs and/or rules-based provisions preventing them from acting on the information they learned through their participation in an auction.

Additionally, to eliminate any potential conflicts of interest between the client and its clearing member, both of whom may be bidding in the auction, direct participation is the preferred method for a client’s bid submission. The information to be shared, any risk management controls, or limits required or desired by the clearing member and client vis-a-vis each other are captured by the agreements arranged between the clearing member and client. This may include descriptions of bid size, price ranges, as well as information control for such data.⁴

⁴ ISDA clearing members believe that the CCP should appropriately disclose the number or names of all auction participants to all other auction participants. Such disclosure would enable auction bidders to provide better bids as they can better assess how many other firms have seen the auction portfolio.

2.3. CLEARING MEMBERS' CONSENT FOR CLIENTS TO PARTICIPATE IN AUCTIONS

As a clearing member guarantees and clears the trades executed between the CCP and the client, a client's auction participation must be approved by the clearing member for the auction trades of the participant. This can be performed in two ways:

- The clearing member provides a general approval for a given asset class or product, that remains valid until revoked. This can include setting appropriate risk limits ex ante. The client can then be invited to any auction on this asset class without new permission being required.
- A client's decision to offer a bid in an auction is approved by its clearing member for every auction. Again, this may include the clearing member setting appropriate risk limits ex ante. CCPs may assist in this process by promptly disclosing relevant information concerning a potential auction. Such permission should be explicitly required by a CCP before a client submits a bid.

3. NOTES TO THE EDITORS

3.1. ABOUT CCP12

CCP12 is the global association for Central Counterparties (CCPs), representing 40 members who operate over 60 individual CCPs globally across the Americas, EMEA and the Asia-Pacific region.

CCP12 promotes effective, practical, and appropriate risk management and operational standards for CCPs to ensure the safety and efficiency of the financial markets it represents. CCP12 leads and assesses global regulatory and industry initiatives that concern CCPs to form consensus views, while also actively engaging with regulatory agencies and industry constituents through consultation responses, forum discussions and position papers.

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Website	https://www.ccp12.org/
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3.2. ABOUT EACH

The European Association of CCP Clearing Houses (EACH) is a Belgian not-for-profit organisation (AISBL) founded in 1992 which represents the interests of central counterparty clearing houses (CCPs) in Europe. The membership is open to CCPs based in the European Union and in other European countries. The membership of EACH comprises 19 CCPs incorporated in 15 European countries. EACH is registered in the European Union Transparency Register with number 36897011311-96.

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3.3. ABOUT FIA

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA’s membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers.

FIA’s mission is to:

- support open, transparent, and competitive markets,
- protect and enhance the integrity of the financial system, and
- promote high standards of professional conduct.

As the principal members of derivatives clearinghouses worldwide, FIA's clearing firm members play a critical role in the reduction of systemic risk in global financial markets.

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3.4. ABOUT FIA PTG

FIA PTG is an association of firms who trade their own capital on exchanges in futures, options, and equities markets worldwide. FIA PTG members engage in manual, automated and hybrid methods of trading, and they are active in a wide variety of asset classes, including equities, fixed income, foreign exchange, and commodities. FIA PTG member firms serve as a critical source of liquidity, allowing those who use the markets, including individual investors, to manage their risks and invest effectively. The presence of competitive professional traders contributing to price discovery and the provision of liquidity is a hallmark of well-functioning markets. FIA PTG advocates for open access to markets, transparency, and data-driven policy.

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3.5. ABOUT ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 990 member institutions from 78 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association’s website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

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3.6. ABOUT MFA

Managed Funds Association (“MFA”) represents the global hedge fund and alternative asset management industry and its investors by advocating for regulatory, tax, and other public policies that foster efficient, transparent, and fair capital markets. MFA’s more than 150 member firms collectively manage nearly \$2.6 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has a global presence and is active in Washington, Brussels, London, and Asia. www.managedfunds.org.

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