The New Normal: Welcome to Delayed Compensation 2.0

After announcing a delay of the July 18 go-live date for the new par/near par delayed compensation regime, the LSTA has now issued an updated version, which went into effect on September 1. This announcement came after discussions with several market participants, vendors, and settlement platform representatives.

The primary reason for the delay was due to the issue of Buyer "lead time", which is the LSTA term meaning the time between the date the Agent is ready to close and the date the Buyer can make the funds available. While the July 18 version necessitated having trade documentation executed by T+6, the LSTA Liquidity Committee realized that a T+7 settlement date was virtually impossible. Therefore and moving forward, the requirement is instead to now have all trade documentation executed by T+5. Recognizing the inherent challenge of this requirement, the LSTA has made the decision to implement this new scheme in two consecutive phases.

The first phase will last from September 1 through October 31, 2016. During the first phase and similar to the initial version of the revised delayed compensation scheme, for a Buyer to receive delayed compensation, it must, by no later than T+6, (i) execute the trade confirmation and assignment agreement and (ii) be able to settle the trade by no later than T+7 without interruption until the Settlement Date. These are referred to as the "Basic Requirements." These same Basic Requirements apply to Early Day Trades as well, except that the deadlines for execution of the documents and being ready and able to settle are Trigger Date +12 and Trigger Date +14, respectively. In this first phase, Buyers will be allowed to have "lead times" between the dates when the Agent is able to make the trade effective and the date the Buyer is able to fund. These lead times are indicated by the Buyer on the settlement platforms.

In the second phase, which will start on November 1, the Basic Requirements of signing the trade confirmation and assignment agreement, selecting a settlement date of no later than T+7, and being ready and able to settle without interruption must be met by T+5, not T+6, and "lead times" of more than one day will no longer be allowed. For Early Day trades, the Basic Requirements of signing the trade confirmation and assignment agreement, and selecting a settlement date of no later than T+14 must be met by Trigger Date+10.

Much of the proposed new scheme that went live on September 1 is similar to that which was going to be effective on July 18, and the two phases are similar in most regards as well. It is, therefore, worth taking a look at the two main similarities between the first and second phases: (i) In both the first phase and second phase, as long as the Basic Requirements are met, pending KYC, waiting for the required consents, or agent freeze, will not cause the forfeiture of delayed compensation; and (ii) the Dealer must submit the trade details into the settlement platform by T+1.

When the Dealer is selling and trade details are not submitted by T+1, the Buyer automatically will receive delayed compensation regardless of any subsequent delay. When both parties to a trade are Dealers, however, the Seller is responsible for submitting the trade details to the settlement platform. If the Buyer is the Dealer, then it must be sure to enter the trade into the settlement platform no later than T+1. If the Dealer/Buyer does not do so, then the buy-side Seller can provide notice of such failure to the Dealer/Buyer by T+3, in which case, the Dealer/Buyer must enter the trade details and meet the Basic Requirements by T+5; otherwise, it will forfeit delayed compensation. If such notice from the buy-side Seller to the Dealer/Buyer is not given by T+3, then the Dealer/Buyer is automatically entitled to delayed compensation.

Additionally, and similar to the previously proposed scheme, new CLOs will be able to select a maximum 'Blackout Period' of five (5) business days, during which they will not have to settle trades. However, before and after any such period, the CLO is expected to settle trades, and the CLO manager must advise the settlement platform of the dates of any Blackout Period. If the Blackout Period extends past five business days, and the agent and Dealer are able to settle, but the CLO is not able to settle, then the CLO will forfeit delayed compensation.

Throughout the process of revising the delayed compensation scheme, market participants have expressed concern over a scenario in which there are issues in the documents such as disagreement or errors in the pricing or a mistake in the assignment agreement. If the Buyer reasonably believes in good faith that the calculation of the Purchase Price generated by the electronic-settlement platform is incorrect, the Buyer still will be entitled to delayed compensation so long as it has met the Basic Requirements and provided notice to the Seller of such belief on or prior to the business day on which payment of the purchase price is due. With respect to a material mistake in the assignment, provided that the Buyer has executed the trade confirmation by T+5/6 (or T+10/12 with an Early Day Trade), failure to execute the assignment because of material error will *not* cause the forfeiture of delayed compensation. However, the Buyer *is* required to provide notification and use commercially reasonable efforts to fix such errors within T+3 (or T+6 with an Early Day Trade). If such errors are fixed by T+4 (or T+8 with an Early Day Trade), then the Buyer is obligated to sign the Assignment by T+5/6 (or T+10/12 with an Early Day Trade) and be ready to settle and pay the purchase price in accordance with its obligations under Section 6(b) of the Standard Terms and Conditions, including the timing requirements.

Trades entered into as participations in which participation is selected as the form of purchase under the trade confirmation will be excluded from the new delayed compensation scheme; however, the Basic Requirements will still have to be met for trades that were expected to settle via assignment, but eventually settle via participation. The new scheme also will apply to trades that settle on paper rather than electronic settlement platforms.

Again, and as discussed several months ago among market participants across the industry, along with these changes throughout the market, there will clearly need to be accompanying changes to settlement platforms, including more precise reporting and tracking mechanisms. Many of these changes have already been implemented at this point. Additionally, secondary market parties will need to develop internal procedures to ensure the satisfaction of all requirements, both to receive delayed compensation when buying and to enforce forfeiture provisions when selling. Concurrently, it is wise to assume that there will be several real-time scenarios that may arise as we navigate our way through this new regime. For instance, attaining a signatory at the end of the day, and/or having a party be unreachable or unresponsive would cause parties to have an extra day tacked on to the time frame. Furthermore, the new regime plans to measure responsiveness in non-settlement platform participants through internal email correspondence and Excel spreadsheets, with the onus on those parties to keep their own thorough records. The likelihood of issues arising in cases like these is unquestionably high. A further ambiguity could arise if a Buyer is trading with a Seller that is also the Agent bank. Insofar as there were issues with settlement, one might begin to draw assumptions due to the relationship between an Agent and its financial institution. These scenarios capture some of the discussions that have been taking place over the last few months and have resulted in the launch of several new internal programs. As initially predicted, it appears that the overall implementation will be more of a gradual than an immediate change, and it is likely that some secondary market parties will have to deal with operational and procedural roadblocks while adjusting to the new model. However, in an effort to help educate the market on these changes, the LSTA has traveled around the country and has reached out through webinars, in-person meetings, and conference calls to discuss the new rules. The LSTA firmly believes that this new regime will provide incentives for significant improvement in the functioning of the loan market and is looking to roll out further changes and recommendations for reducing settlement times in the future. For now, we viewed September 1 as a momentous day for our secondary loan-market industry, and we are all along for the ride to see what the effects will be, on both an immediate and gradual level.

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