Secondary Market Practices Committee

Meeting of the ICMA SMPC, March 26th 2015: Minutes

The meeting was held at ICMA, London, and Chaired by Asif Godall, HSBC

In the room:

Asif Godall	HSBC	(Chair)
Ludovic Grave	BNP Paribas	
Faiyaz Bashar	Goldman Sachs	
David Camara	Goldman Sachs	
Lee Greenleaf	ICAP	
Michel Canoy	Natixis	
Andrew Bowley	Nomura	
Alex Struc	Pimco	
Nick Robinson	Schroders	
Martin Scheck	ICMA	
Paul Richards	ICMA	
Elizabeth Callaghan	ICMA	
Andy Hill	ICMA	(Secretary)

On the phone:

Marco Ferrari	BSI
Craig Rinder	CIBC
Mark Schofiled	Citibank
Marco Pouw	Credit Suisse
Samik Chandaran	JP Morgan
Bart Nuyts	KBC
Alice Beavan	Lloyds Banking
Minakshi Bartels	Morgan Stanley
Dario Luciano	UniCredit

Chairman's welcome

Asif Godall welcomed all those in the room and on the phone and noted that this was the first time the SMPC had been open to buy-side representation, something that was critical for the future direction and evolution of the Committee and a reflection of the new Terms of Reference approved at the end of 2014. He also noted that the agenda was particularly relevant to the key challenges facing the European credit markets as a result of rapidly evolving innovation and regulation.

1) Discussion on market pricing and request protocols on electronic platforms

Elizabeth Callaghan introduced the first agenda item. She noted that in the process of composing the ICMA response to the MiFID II/R Level 2 Consultation Papers in relation to pre- and post-trade transparency, a theme that had been raised, particularly by the buy-side, was the question of executionable prices as distinct from liquidity and whether the integrity of pricing was a more critical issue for the credit markets rather than a perceived decrease in liquidity.

The discussion was to be held under Chatham House rules.

The argument was put forward that, in essence, the bond markets were not fundamentally different to equity markets. However, by insisting that they are different, the less we are able to learn from the equity markets. Much of the discourse around credit markets relates to the concept of liquidity, which, given the increasing limitations of both sell- and buy-side as a result of post-crisis regulation, is widely perceived to be decreasing. In a sense this is becoming self-fulfilling, as the more market participants talked about falling liquidity, the more reluctant dealers become to show prices. An alternative perspective is to start from the view that for bond markets liquidity does not exist as a natural occurrence, but rather it is something that is created. The real discussion, therefore, is not what is liquid, but what is a price? In equity markets the price is transparent and public. In fixed income markets, a price is purely guidance, and something used by market-makers as a signaling device. Thus the goal should not be to achieve liquidity, but rather to achieve price transparency, which in turn is a product of both conduct and the need for a new framework. The current framework for bond markets is price guidance rather than real prices. This effectively disadvantages the buy-side, who are blind, while the sell-side has the advantages of visibility, the bid-ask spread, and the ability to drive price guidance. Furthermore, the retail market for bonds is far more developed in Europe, compared to the US, which also gives market-makers an advantage in that the institutional buy-side cannot access this client base directly.

Some of the participants took issue with this perspective, pointing out that structurally equity markets and bond markets are very different and in many ways are difficult to compare. Furthermore, in fixed income markets, where dealers are showing firm prices on screens, they are the ones who are blind and disadvantaged. In many instances, when their prices are traded on, they find themselves having to cover at a loss since balance-sheet limitations restrict them from running the position.

The counterview was made that balance-sheet is only one component of price formation, and another was knowledge. The sell-side knows the value of a bond, and while taking away balance-sheet creates problems, it is this knowledge and a 'market-making license' that advantages the sell-side. Meanwhile, the buy-side only has an 'asset management license' and imperfect information. This point was challenged with the assertion that the buy-side can also have access to transact with other buy-side firms through a number of platforms and dark pools. However, the argument was taken back to the power of the dealers' price. While it was appreciated that market-makers could not be expected to support firm prices for thousands of bonds, the prices shown were nonetheless a form of advertising. If a client attempts to trade on these prices the trade should either be accepted or rejected, but in either case this is price information and should be made publically available. What becomes important is managing expectations. If prices are to be used as a 'hook' by market-makers to attract business, then information on how executionable are those prices is essential information.

The issue of market-makers 'front-running' was also raised. If a dealer trades through the bid, it could be for a legitimate reason in the case of a sell-off, but in many instances it could be a deliberate attempt to move the market. This should be considered market abuse, but legally, since prices are not considered to be firm, this is possible.

Another point raised was that part of the underlying problem with pricing is that the credit markets are over-broked, with too many dealers chasing the same dollar, which led to price guidance being too aggressive. This, too, was challenged, and it was explained that in order to provide prices, dealers needed to be incentivized, which meant covering increasing costs of capital. If this was not possible, then the market-making model was unsustainable. The argument was put back that the sell-side no longer had balance-sheet, and so had to find new ways to find upside in what was essentially becoming an agency broking model. This could only be through increased sophistication and education. The sell-side understood the bond market and bond pricing, and could create liquidity through educating the buy-side. The suggestion was made for a new framework: the balance-sheet now sits with the buy-side, while price guidance and transparency belongs to the sell-side, and this provided scope for the sell-side and buy-side to work together and exchange their natural advantages.

Related to the discussion around pricing and liquidity, the question was raised of the MiFID II/R definitions for 'liquid' and illiquid'. One perspective was that post-trade transparency was not an issue, as this already existed in the US, through TRACE, and had no detrimental impact on liquidity. Rather the issue related to pre-trade transparency, as this is where ESMA was misguided. For fixed income, liquidity can only be defined by price. In the case of an equity, everybody can hold a different view on whether it is rich or cheap. With fixed income, there can be consensus that a bond trading at Libor-flat is in demand, and so liquid, while a bond trading at a spread over Libor can be considered less liquid. In other words, the price of a bond is a measure of its relative liquidity. There was some agreement with this perspective, although it was pointed out that using price as the basis for liquidity calibrations was far too complex and dynamic for ESMA to implement.

It was generally agreed that a new framework for market pricing needed to be established, but a number of factors would need to be determined first. For instance, there is no clear definition of what is a 'retail' trade or an 'institutional' trade, or whether this should be based on size or on the underlying client. Also, there now existed a whole range of trading platforms with different pricing protocols, participant access, and price transparency. The balance-sheet and regulatory limitations imposed on market-makers would also need to be part of the consideration, as would the changing regulatory environment. But this was the first step in a process that needed to engage both sell-side and buy-side.

The ICMA initiative to map all the existing (and projected) electronic transaction systems and trading platforms supporting fixed income trading in Europe was flagged as a starting point in identifying what pricing practice and protocols currently existed. The point was raised, which was acknowledged, that designing the new framework should not be driven by platforms, but by their users, although it would be helpful to map the existing landscape first, not least since nobody had already knowingly done this.

Action: Designing a framework for pricing protocols on platforms and best practice for engagement would be the ultimate goal, but this would take time and ongoing engagement between market participants, with the SMPC acting as the forum to support this. As a basis for further discussions, ICMA would push ahead with the proposed Fixed Income Electronic Transaction Systems mapping initiative. [Elizabeth Callaghan and Andy Hill]

2) Fixed Income Research – ESMA/EC proposals under MiFID II

Andrew Bowley provided a presentation on the MiFID II proposals related to 'inducements' and fixed income research.

The presentation highlighted the real possibility that under the regulation, the provision of all research, possibly including desk notes, analytics, and trade ideas, is banned to EU MiFID regulated fund managers unless explicitly and directly paid for. The proposal has little grounding in the Level 1 text, but is established in the draft Level 2 technical standards largely due to an FCA led position founded in equity unbundling. Andrew Bowley highlighted a number of potential adverse impacts for both the sell-side and the buy-side. Not least of these will be a de facto ban on distributing research to a large number of clients, creating an information vacuum, and a competitive disadvantage for EU fund managers relative to their non-EU counterparts. Asif Godall commented that the only solution to this would be for research provision to move away from the trading houses to boutique research houses.

Andrew Bowley talked through the timeline and process for the regulation being finalized and passed into law, as well as the different perspectives held by the European Commission, Council, and Parliament. The Commission believes that research is an explicit component of the fixed income bid-ask spread and that the regulation effectively unbundles this. Apparently, Nomura is the 'first and only' firm to have pointed out that it is not part of the spread, but rather part of a trading house's overheads, in much the same way as building costs or infrastructure. Meanwhile, the Council and Parliament are more resistant to the notion that research can be unbundled from the spread.

Andrew Bowley also outlined some potential solutions, which include revisiting the inducements section in Level 1, which cites research as an ancillary service, ensuring that where research is paid for it is done in a way that does not adversely influence trading outcomes, a 'carve-out' for non-equity research, and a 'carve-out' for RFQ dealer markets.

Paul Richards asked whether there was a common position for both and buy-side and sell-side on this issue. Andrew Bowley explained that both have come to the discussion late, and while he could not speak for the buy-side, there seems to be a mix of opinions among the sell-side as to whether the buy-side should pay for research or not. Paul Richards further asked what ICMA and the industry could do to ensure a favourable outcome in the Level 2 negotiations. Andrew Bowley suggested that it would be good to raise the issue with the FCA, the European Commission, the Council, and Parliament, as well as to broaden industry awareness of the potential outcomes. Asif Godall suggested that it was important to differentiate between published research and desk notes (including trade ideas). His view was that published research could be given up by trading houses and become a paid for service provided by research houses, but desk notes should not be unbundled.

Nick Robinson commented that if the buy-side is asked to pay for research, they will simply reduce the amount of research they currently use. Alex Struc, referring to the previous discussion, noted that at a time when knowledge and information was essential to improve liquidity, this seemed like a counterproductive policy initiative. Andrew Bowley added that another unintended consequence would be the inevitable asymmetry of information between EU and non-EU fund managers. Michel Canoy felt that tier-2 investment firms would be impacted most as these would have to pay for published research since they are not in a positon to produce their own.

Asif Godall summed up the discussion by stating that it was important for ICMA and the industry to educate the FCA, the Commission, and others that research was not an explicit component of the fixed income bid-ask spread and to make them aware of the potential unintended consequences. However, it was also important to differentiate between published research and desk notes as there was not necessarily a consensus view with respect to both.

Action: In its discussions with the various European regulators and authorities, ICMA to raise awareness of the potential issues and unintended consequences of banning all fixed income research (in particular desk noes). [ICMA General]

3) Aged-fails Auction Initiative

Andy Hill updated the Committee on the background and current status of the initiative. The original concept had been for a buy-in auction, which would provide more transparency and efficiency to the current ICMA buy-in mechanism. However, it would have meant re-writing the ICMA Rules, and so instead evolved into an aged-fails auction, essentially to clear up old fails and to avoid buy-ins. Andy Hill explained that the main MTFs had expressed interest in hosting such auctions on their platforms, and the ICSDs were happy to support the process through using their corporate actions messaging functionality to notify holders of securities being auctioned. The next step would be to agree on the appropriate price-discovery mechanism before re-engaging with the MTFs. He added that in time, with the eventual implementation of mandatory buy-ins, the mechanism could be adapted as a buy-in auction, which was something that the MTFs were clearly thinking about.

Faiyaz Bashar commented that it was a good idea, but it could only work if the auctions were for guaranteed delivery. He further noted the importance of ensuring that the process was compliant with the eventual RTS of CSDR if it was eventually to evolve into a buy-in auction. Alex Struc thought that there would definitely be interest from the buy-side, and he for one would be keen to participate. He also wondered whether it needed to be an auction process, and could simply be a direct request-for-quote to buy-side holders. Asif Godall and Faiyaz Bashar felt that an auction process on a platform would be more efficient and transparent, and that perhaps the appropriate price-discovery mechanism would be an order-book whereby holders can provide offers, perhaps without price guidance from the bidder. Andy Hill noted that given this was not a buy-in, the bidder would also have the discretion to lift any offers or not.

Asif Godall suggested that Andy Hill set up a sub-group meeting for interested traders to discuss the mechanism in more detail so as to be able to take a firm proposal to the MTFs. Lee Greenleaf commented that it may have some similarities to ICAP's 'Scrapbook' platform, and he would be interested to provide technical support in developing the mechanism. Andy Hill agreed that this would be very helpful, although the main difference with Scrapbook would be pricing, since the auction would need to clear at some premium to fair value to incentivize buy-side participation.

Action: Follow-up sub-group meeting to finalize details for the proposed auction mechanism which can be shared with the interested MTFs. [Andy Hill]

4) Regulatory updates

a) MiFID II/R

Elizabeth Callaghan provided an update on the recent ICMA response to the MiFID II/R Consultation Papers, in which the RTS for pre- and post-trade transparency requirements had been the key focus. She explained that the principal limitation of the proposed COFIA (‘classes of financial instruments approach’) for calibrating financial instruments was that it would define a significant universe of securities as ‘liquid’, when they were by true definition ‘illiquid’ – i.e. ‘false positives’. The ICMA Working Group for the response, which consisted of senior sell-side and buy-side market experts, proposed a more dynamic COFIA-IBIA (‘instrument by instrument approach’) hybrid, as well as an alternative COFIA model with higher thresholds, which would still not be perfect, but would result in a smaller universe of false positives.

Asif Godall questioned the logic behind attempting to define ‘liquid’ and ‘illiquid’ for fixed income instruments, since all bonds are inherently illiquid. Nick Robinson agreed that the classification of liquid was a total misnomer since anything could change from liquid to illiquid in an instance. He added that he had recently been part of an Investment Association delegation that met with ESMA in Amsterdam, and it seemed apparent that COFIA was a done deal, and that ESMA saw it as the best of a bad job. At best there may be some movement in the proposed thresholds, but IBIA was not on the table. Nick Robinson added that Trax had conducted some work for the IA in its response to illustrate, using market data, the potential impact of using the proposed calibrations, and he hoped that this would at least help move the thresholds. Elizabeth Callaghan pointed out that this was also part of the ICMA recommendation, in the event that the preferred COFIA-IBIA proposal was unacceptable.

Alex Struc raised the question of potential unintended outcomes if the resulting liquidity definitions of MiFID II/R were cross-referenced in other regulatory initiatives. He made the point that if the market was to push for all fixed income securities to be classified as ‘illiquid’, and the same definition was then applied to UCITs Regulation, this would have negative repercussions with regards to the requirements for ‘day liquidity’. Andy Hill pointed out that ESMA was already attempting to cross-reference the MiFID liquidity definitions in CSDR with regard to the extension periods for mandatory buy-ins.

Elizabeth Callaghan elaborated on ESMA’s approach to defining liquidity, stating that they had modeled it based on academic analysis, and had been reluctant to accept market input. Asif Godall asked what were the variables being used in their definition. David Camara explained that it was simply based on static volume of issuance. Nick Robinson commented that this was the reason why so many securities that were essentially illiquid would be classified as liquid under the regulation. Alex Struc stated that, as had been discussed earlier in the meeting, it was impossible to define liquidity without reference to price. David Camara responded that the Level 1 text actually allows for price to be a determinant, however, ESMA had found it too complex to model. Asif Godall wondered if there was still time to develop a price-based framework to define liquidity that could be acceptable to the market and so potentially acceptable to ESMA. David Camara said that he was not hopeful, and cited the example of trying to illustrate to ESMA the dynamic liquidity calibrations of CDS; given the relative simplicity and smaller number of securities in the CDS market, if this was still too complex to implement, it did not bode well for cash bonds.

Elizabeth Callaghan did add, on a more positive note, that the Debt Management Offices were becoming more concerned about the potential impact of the MiFID liquidity calibrations on sovereign bond markets, and referenced an ICMA event in Brussels earlier that week where Anne Leclercq (Head of the Belgian Debt Agency and Chair of the Economic and Financial Sub-Committee on EU Sovereign Debt Market) had flagged such concerns in her lecture.

b) CSDR

Andy Hill provided a briefing on ICMA's ongoing advocacy work related to CSDR Settlement Discipline, in particular mandatory buy-ins. He explained that there were two main objectives of ICMA's work. Firstly it was to ensure a delay in the implementation of mandatory buy-ins, at least until after the roll-out of Target2-Securities, but with an underlying intention of securing an indefinite delay. Second was to ensure that in the event of implementation, the RTS for mandatory buy-ins were as good as they could be, and could be implemented with the least negative impact for the bond and repo markets. He explained that while he was becoming increasingly confident of a delay, something that ESMA was already proposing to the European Commission, he was becoming more resolved to the fact that the RTS would remain a mess.

Andy Hill pointed out that of particular concern to ICMA and others, including AFME, is that for non-cleared fixed income transactions, buy-ins should be managed and executed at the trading level (i.e. between the failing and the receiving counterparties), and not, as ESMA proposed, at the settlement system or trading venue level. This had been made very clear in ICMA's recent response to the Level 2 Consultation Papers, and ICMA had also joined an AFME delegation to meet with ESMA in Paris and CONSOB in Rome to discuss this critical point in more detail. However, the response had not been encouraging, and earlier that week, at an ECON Hearing, Steven Maijoor (Chair of ESMA) had made the point that while ESMA was sympathetic to the market's rationale for keeping buy-ins at the trading level, it was concerned that this may make it difficult to ensure enforceability for non-EU counterparties. In other words, Andy Hill explained, ESMA was taking the view that enforceability was more important than practicability.

Referring to the recent ICMA CSDR Mandatory Buy-in Impact Study, Asif Godall reaffirmed the importance of ICMA pushing for as long a delay as possible before implementation.

5) ETS/ETP Mapping Initiative

As the meeting had reached its scheduled finish time, and given that the proposal to map existing fixed income electronic transaction systems and trading platforms had already been discussed and approved, Andy Hill encouraged the Committee to take a look at the proposed Concept Paper that had been circulated ahead of the meeting, along with the draft survey template. Elizabeth Callaghan added that the secretariat would be following up with the Committee members in the next day or so to help identify the various platforms that they currently used or were aware of.

Asif Godall thanked everybody in the room and on the call for contributing to a highly engaging and productive meeting, and the meeting was closed.