Secondary Market Practices Committee

Meeting of the ICMA SMPC, November 3rd 2016: Preliminary Draft

The meeting was held at ICMA's London offices, and co-chaired by Sonali Theisen, Citi, and Andy Hill, ICMA

Attendees

In the room:

Sonali Theisen	Citi	(Co-chair)
Stephen Baseby	Association of Corporate Treasurers	
Anne Velot	Axa IM	
Kamya Somasundaram	BlackRock	
Domingo Puertas Trillo	BNP Paribas	
Marco Ferrari	BSI	
Pieter Bierkens	Commonwealth Bank of Australia	
Martina Ben Shaul	CIBC	
Gordan Hoblaj	ERSTE Group	
David Camara	Goldman Sachs	
Godfried De Vidts	ICAP (and Chair of ERCC)	
Andrew Bowley	Nomura	
Pauli Mortensen	Norges Bank IM	
Mathieu Casadevall	SocGen	
Elizabeth Callaghan	ICMA	
Ruari Ewing	ICMA	
Andy Hill	ICMA	(Secretary & acting Co-chair)
Patrik Karlsson	ICMA	
Paul Richards	ICMA	
Peter Eisenhardt	ICSA	

Special guest:

Monika Znidar	ECB

On the line:

Yann Couellan	Axa IM	
Philip Cramp	BGC Partners	
Harald Endres	BLB	
Thomas Havard	Danske Bank	
Barbara Zittucro	Intesa San Paolo	
Claudio Menghi	Nestle	
Rutger Olthof	NN Investment Partners	
Brett Chappell	Nordea AM	
Pedro Sousa	PIMCO	
Johan Wijkstrom	Swedbank	
Kai Seeger	Unicredit	
Vicky Webster	AFME	(Observer)

Chair's welcome

Sonali Theisen (Citi and Co-Chair) thanked all those in the room and on the call for joining the fourth and final official meeting of the SMPC for 2016, noting the packed agenda that continued to reflect the evolution and ongoing challenges facing the corporate bond markets.

Agenda items

1) **Approval of buy-side Co-chair of the SMPC**

Sonali Theisen reminded the forum that since the revitalization of the SMPC and its opening up to buy-side as well as sell-side representation, it had always been the intention for the Committee to have two co-chairs: one representing the sell-side constituents, and one representing the buy-side. Yann Couellan, Head of Fixed Income, Money Markets, and Repo Trading for Axa Investment Managers in France, had been formally nominated to assume the position of buy-side co-chair, and the forum was asked whether there were any objections. With no dissenters, Yann was confirmed as Co-chair of the SMPC for a minimum term of twelve months, with effect from the next meeting, scheduled for early 2017.

2) **Discussion with the ECB on the Corporate Sector Purchase Programme**[1]

Sonali Theisen welcomed Monika Znidar, Portfolio Manager in the ECB's Euro Area Bond Markets section (within DG Market Operations), who was invited as the SMPC's special guest to lead a discussion on the market impacts and practicalities of the ongoing implementation of the ECB's Corporate Sector Purchase Programme (CSPP).

Monika opened the session with a presentation on the first five months of the CSPP.[2] Some of the key points from the presentation included:

- As of end-October, there had been €38bn of purchases made, covering around 680 bonds, 180 issuer groups, and 18 issuer countries (measured by country of risk).
- The share of primary market purchases increased in September, to 19.7% of total monthly purchases, from 3.7% in June.
- Trade tickets are primarily smaller sizes (around 60% of tickets less than €10mm). Around 10% of trades are in clips above €50mm.
- More than one third of counterparty offers received are in bonds issued in the past year.
- Secondary market yield spreads initially declined and later stabilized, with non-eligible bond spreads also tightening.
- ECB staff analysis suggests that the CSPP has been the main driver of the decline in corporate bond yields in the two-week period after the announcement of the programme in March 2016.

[1] Chatham House Rules were applied to this session to encourage open participation from the members.
[2] Note that this presentation is not available for electronic distribution.

- As of end-October, around 15% of eligible bonds traded at negative yields (compared with practically none at the beginning of the year)
- Overall issuance has increased since the CSPP announcement, while the share of euro-denominated issuance has remained stable, and there has been no notable increase in euro-denominated issuance of corporates outside of the euro area.
- Borrowing costs for non-financial corporates (NFCs) have been declining and converging across countries.

Monika then opened the session for discussion.

Major impacts of the CSPP

The forum noted that the corporate bond market had become more expensive as the CSPP introduced a large, structural buyer to the market. From the fund manager and asset manager perspective this was changing the way that funds were being managed, particularly in terms of selecting between eligible and non-eligible bonds. For example, there was now a preference for lower-rated, subordinated debt, since these assets afforded more protection against interest rate volatility. This was also changing behaviour in the primary market, where fund managers were becoming more selective in terms of target levels, and not participating where issues came below those levels. In general, it was felt that the Programme had been relatively successful to date, and the level of purchases was above expectations without having too much impact on market liquidity. However, ultimately corporate bonds remain an illiquid asset class and so there are some concerns about how much the NCBs can buy, particularly given an individual ISN limit of 70% of issuance.

Private placements

On private placements, the ECB clarified that it does not rule out using private placements, which is a normal market practice, however its maximum 70% issue limit would still apply. This would therefore require other participants to purchase at least 30% of any issue.

Liquidity impacts

The forum suggested that since the announcement of the CSPP, the Programme had helped support the bid-side of the market, and, while this was likely to be a short-term effect, at the margin it could be argued that this has improved liquidity. However, the longer-term impacts may not be so positive, particularly where the ECB does buy 70% of any issue, which will naturally erode liquidity in those lines. It was suggested that the ECB consider not only publishing the ISINs of bonds purchased under the CSPP, but also the quantity of bonds purchased, which would help the market to assess better the potential liquidity of different issues. It was also noted that many buy-side firms who purchase bonds in the primary market can be tempted to sell their bonds back into the secondary shortly after in the event that the bonds tighten through target spreads, and which helps add to secondary market liquidity.

On the 70% ISIN limit, the ECB commented that this was consistent with the other private sector purchase programmes.

The sells-side perspective was put forward which largely corroborated the experiences relayed by the buy-side members. It was noted that there had been a squeeze on spreads and liquidity postannouncement, but it was felt that this was unsustainable and it was expected that conditions would correct. Since the start of the Programme, volumes had held steady, and liquidity had not noticeably reduced. What did seem to be happening, however, was that there was now more focus on client and dealer axes. One concern, however, was going into year-end, with the seasonal thinning of liquidity, and the potential impacts should the ECB continue at its current rate of purchases.

The ECB commented that the overall Asset Purchase Programme (APP) target of €80 billion per month was embedded with some flexibility to reduce or increase monthly purchases taking into account market conditions at specific points in time.

Reverse auctions

A further suggestion was that the ECB consider using a reverse auction mechanism similar to the Bank of England's Corporate Bond Purchase Scheme (CBPS), which would not only provide an advantage to the buy-side who would be able to tender blocks of specific holdings, but would also potentially allow the ECB to purchase more bonds.

With respect to reverse auctions, the ECB's experience with bilateral purchases from the other purchase programmes had been positive and offered a high degree of flexibility. Three of the NCBs did use reverse auctions for some segments in the Public Purchase Programme (PPP), and it was something that the ECB could potentially consider in the future for the CSPP.

Spread compression

One member raised the point about the impacts of the CSPP on spreads on eligible bonds, and asked whether the ECB had considered the outcomes for buy-side firms that are required to match liabilities and generate guaranteed returns, such as insurance funds, who had little flexibility in terms of the assets they can buy.

Extending QE

The point was raised about the possibility of an imminent announcement of an extension of the ECB's APP beyond March, and whether this was something that had been considered by the CSPP portfolio management team.

The ECB responded that the ECB President had tasked the ECB Committees to work on options to ensure smooth implementation of the APP until March, or beyond, if necessary. The ECB did not want to speculate on any outcome which will depend on the Governing Council discussion also considering the input provided by Committees. Should the Governing Council decide to extend the APP, they assume that this could apply to all components of the APP, including the CSPP. They did not foresee any scarcity issues.

A December pause

Returning to year-end liquidity concerns, some of the Committee members asked whether it was likely that the ECB would pause the Programme, as had been done previously with the APP, and, if so, when this was likely to be announced.

The ECB noted that based on precedence any announcement of such a temporary pause would be made well in advance, still in November.

MiFID II

The ECB was asked whether the Programme would be subject to the MiFID II transparency rules due to come into force in January 2018, particularly in light of the scale of the purchases relative to overall market activity, and that this would be significant in terms of liquidity determination and transparency calibrations.

The ECB answered that this was not something they were focused on, particularly as being a Eurosystem entity they are exempt from the MiFID reporting regime. It was also pointed out that the CSPP is expected to have finished before January 2018.

Credit protection features, downgrades, and eligibility

The ECB was asked about the non-eligibility of bonds with certain credit protection features, such as step-up coupons, which had widened with respect to vanilla, eligible issues by the same issuer, and whether they could consider buying these issues.

The ECB noted that such features could be viewed as a positive from an investor perspective, however they were bound by their collateral rules which excluded such bonds, and that issuers would need to consider this if looking to issue eligible bonds. Furthermore, while it was possible that the collateral eligibility criteria could be reviewed in the future, particularly if it was felt it was necessary, there was no indication on whether this could happen within the current projected timeframe of the CSPP.

On a related theme, the ECB was asked what happened in the event of bonds becoming 'junked', and whether they would continue to hold them, or would have to sell the position.

The ECB responded that in the event of a holding being downgraded to sub-investment grade they would assess the appropriate response on a case-by-case basis as also explained on their website.

Changes in participant behaviour

The ECB asked the Committee whether the CSPP had changed the way different firms operate in the market, whether in terms of transaction sizes, approach, or other behavioral aspects, including issuance.

One buy-side member responded that as a 'bottom-up' investor, who is focused on primary market IPTs (initial price talks), they have had to pull-out of several deals where the ECB is thought to be a buyer, and where the IPTs became squeezed

An SMPC member suggested that there had been no discernable change in issuer behaviour, and that corporates were very much still driven by their business or refinancing needs.

Conclusion

Wrapping up the session, it was agreed that it had been a mutually useful and informative discussion, and that it would be beneficial to maintain the constructive and open dialogue between the SMPC and the ECB. Sonali Theisen thanked Monika Znidar for joining the meeting, and extended an open invitation to use the SMPC as an ongoing sounding board for market impact and sentiment.

Action point: ICMA to remain in contact with the ECB with respect to the ongoing implementation of the CSPP and to flag any market concerns or issues.

3) Results of the Consultation on the ICMA Buy-in Rules

Andy Hill (ICMA and secretary to the SMPC) provided the Committee with a brief update on the results of the recent ICMA member consultation on the proposed review and updating of the ICMA Buy-in Rules.

Andy informed the Committee that there had been 74 completed responses to the survey, representing 64 entities. These are made up of a range of different types of firms, including broker-dealers, buy-side firms (both real-money and leveraged), and private banks. The headline results of the survey were:

- 77% of respondents would like more flexible timing for the buy-in process;
- 74% of respondents agree that the appointment of a buy-in agent should no longer be a requirement;
- 93% of respondents approve of the possibility for a buy-in auction mechanism;
- 79% of respondents agree that a cash compensation resolution should be possible;
- 70% of respondents feel that cash compensation should be mandatory after a specified period.

The next steps would be to publish the results, along with proposed amendments to the Rules, and to socialize this among the SMPC and broader membership. ICMA would then organize a call to discuss the proposed amendments, before these were signed-off by the ICMA Executive Committee.

The likely proposed amendments were:

- A degree of flexibility in terms of setting the number of days between the buy-in notice and the buy-in execution;
- Removal of the need to appoint a buy-in agent;

- The explicit provision for the possibility of a buy-in auction mechanism;
- The explicit provision for the non-defaulting and defaulting parties to agree a cash compensation alternative.

Finally, Andy noted that there had been no desire from respondents to align the ICMA Rules with the projected CSDR Mandatory Buy-in Rules, and that it was clear from the responses that in the meantime the market wanted a buy-in mechanism that met market needs and helped to support market liquidity and stability.

Godfried De Vidts (ICAP and ERCC Chair) asked whether the consultation results had been shared with the authorities, suggesting that there was now more willingness in the European Commission to look at regulations that undermined the objective of CMU (Capital Markets Union), including the CSDR Mandatory Buy-in regime. While the Levels 1 and 2 of the regulation were done deals, there was scope in the Level 3 to introduce some flexibility in the Regulation. Godfried added that it would also be helpful to highlight the views of the buy-side expressed in the ICMA consultation, since they had neither been consulted nor considered in the formulation of the CSDR buy-in regime, and it was they who would be most adversely impacted. Furthermore, it was never the intention of market regulation to eradicate market-making, so regulation that further undermined this function had the potential to be modified.

Patrik Karlsson (ICMA and secretary to the AMIC) asked whether there was a view among the market that the CSDR Buy-in Regulation would never be implemented. Andy responded that that was very much the underlying hope, but for now ICMA continued to work off the assumption that it would indeed be implemented, most likely in early 2019.

Marco Ferrari (BSI) raised a concern about corporate actions on failing bonds, which could require expediting the buy-in due to any related deadlines, while acknowledging that short notification periods for buy-ins could also be problematic. Andy Hill responded that this would be noted as a consideration in the review of the ICMA Rules, while agreeing that short buy-in timelines were problematic, particularly in the case of long buy-in chains.

Action point: ICMA to circulate the results of the consultation, along with proposed amendments to the ICMA Buy-in Rules, in the next few weeks.

4) Practical implications of the MiFID II Systematic Internaliser regime

Sonali Theisen introduced the discussion by noting that there had been lots of market dialogue with respect to the introduction of the MiFID II Systematic Internaliser (SI) regime, but there was not yet much clarity in terms of market impact. For example, does it make sense for firms to opt-in to the regime for certain markets, or do they wait to be designated? Also, for the first six months of the application of MiFID II (from January 2018) firms do not automatically become SIs as the data required to support the assessments will not be available, and what will be the transaction reporting implications of this for the buy-side? Sonali opened the discussion up to the forum for their thoughts.

Andrew Bowley (Nomura) suggested caution on the assumption of the SI regime not being applicable for the first six months, as this was not entirely clear, providing the example of pre-trade transparency obligations with respect to firms providing prices on trading venues.

Liz Callaghan flagged a number of related points. Firstly, the application of the SI regime was covered in ICMA's MiFID II Working Group's recent recommendations to ESMA for the Level 3 'Q&As', which she would cover in the next agenda item. Secondly, Liz proposed facilitating an ICMA workshop on the practicalities of the SI regime, and asked the Committee whether they supported this proposal. Thirdly, with regards to buy-side reporting obligations, it was still possible for firms to delegate reporting; however, they could not delegate the obligation to report.

With respect to the SI regime, Sonali Theisen commented that this was likely to be self-delegated, and that she expected dealers to opt-in for certain markets. However, the question was open as to how much this decision would be influenced by the buy-side. Mathieu Casadevall (SocGen) suggested that a firm's size would also be a key consideration, with larger firms more likely to opt-in to the regime across different asset classes. Pauli Mortensen (Norges Bank IM) agreed, adding that many smaller dealers would not be expected to become SIs.

Brett Chappell (Nordea AM) explained the scenario analysis that buy-side firms would need to consider in selecting counterparties for their trades. For example, if a buy-side firm is selling to a non-SI, they will be liable for reporting; in these cases, it is likely that the selling buy-side firm will agree with the non-SI, once the trade is negotiated, to execute on a platform. A further consideration, outlined by Brett, was the application of post-trade deferrals, which can range from 15 minutes to 48 hours to several weeks. He gave another example of executing a large in scale (LIS) trade, in which case it may be desirable to transact this with a non-SI domiciled in a jurisdiction with a longer deferral period.

Johan Wijkstrom (Swedbank) raised the point of negotiating trades OTC and then executing on an MTF, asking whether it was possible to execute bilaterally across an MTF? Brett confirmed that it was possible, and could be done either as an 'RFQ for one' or as a 'pre-approved trade'.

Sonali Theisen suggested that ultimately it may become a domino effect, with a few firms opting-in driving other firms to become SIs. However, it would be helpful to know what buy-side firms see as the pros and cons of trading with SIs? And if reporting was the main benefit, would delegated reporting negate the need to become an SI? Andrew Bowley responded that this is where the proposed workshop came in, not least since the incentives for, and practicalities of, becoming an SI varied across asset classes and entities. Andrew further noted that firms did not necessarily need to volunteer to be SIs, and the FCA was suggesting delegated reporting as a potential solution.

The members agreed that a workshop was welcomed, and that it should be held as soon as possible. Liz Callaghan agreed to explore potential dates, likely to be December 2016 or January 2017, and would revert to the SMPC and MiFID II Working Group.

Action point: ICMA to organize a Systematic Internaliser Workshop by the end of January 2017.

5) Regulatory updates

Liz Callaghan updated the Committee on the recent ICMA suggestions to ESMA related to the projected Level 3 'Q&As' for MiFID II and MAR:

MiFID II

- With respect to the post-trade deferral periods for illiquid or large trades, ICMA recommended that all NCAs apply a consistent treatment, which is the maximum allowable period of 4 weeks.
- With respect to the SI regime definition of 'class of bonds', bonds with different levels of seniority within the capital structure of the same issuer group be considered within the same class, with the exception of convertible debt.
- Clarity be provided on the classification of investment firms acting in an intermediation capacity, trading as principal and applying their own capital, but maintaining zero market exposure at the end of day – since these firms are technically neither SIs nor OTFs (they are an 'investment firm').

MAR

- With respect to the possibility for professional investors to 'opt out' of the MAR Investment Recommendation scheme, if the recipient is a professional investor (and has the credentials to prove this is the case), they are capable and qualified and therefore should not have to receive the required disclosures.
- With respect to the actual instrument scope of MAR Investment Recommendations, it is recommended that where the investment recommendation does not have a specific ISIN or product identifier, then it does not qualify as an investment recommendation under MAR.
- With respect to guidance on how firms are to implement a compliance regime that meets both the SEC and the EU Insider knowledge rules, market participants would like joined-up EU and US regulatory guidance, taking into account both the SEC and ESMA contrary rules so that firms going forward, are prepared and protected.

Andy Hill asked Liz whether there would be further scope for SMPC members to submit additional Level 3 suggestions through ICMA. Liz confirmed that the regulatory Q&As were an ongoing process, both for MiFID II and MAR, and that there would most likely be further ICMA requests for Level 3 clarity on other issues in response to member concerns.

6) European Commission's Expert Group on Corporate Bond Market Liquidity

Andy Hill reminded the Committee that as part of its CMU project, the European Commission was very focused on issues related to European corporate bond market liquidity and efficiency. As part of this focus, and building on the recent *Call for Evidence* consultation, the Commission had held a Roundtable on corporate bond market liquidity in July 2016, inviting around 70 market participants, representing various market stakeholders, to discuss concerns and issues related to the state and evolution of the market. ICMA had participated in and presented at that Roundtable, as had a number of SMPC and other ICMA members. Furthermore, the Commission had designated an independent research company (Risk Control) to conduct a study into the 'drivers of corporate bond market liquidity', the results of which were expected to be published in early 2017. Finally, the Commission had created an Expert Group of 17 industry representatives which was tasked with producing a paper over the next nine months, intended to make recommendations to the European Commission, both regulatory and market driven, to help improve liquidity conditions in the European corporate bond market. ICMA had been appointed to this Expert Group, and Andy looked forward to keeping the SMPC informed of its progress, as well as relying on the Committee to provide valuable input into the Group's work. The first meeting of the Group was scheduled for November 14.

7) Any other business

MiFID II Inducements

Andrew Bowley commented that the unbundling of fixed income research was back on the agenda with respect to MiFID II rules on inducements, with the FCA and AMF both looking more closely at what constitutes research. Andrew suggested that a number of firms were already in the process of segregating their research departments from trading.

MiFID II and SFTs

Godfried De Vidts updated the Group that the ERCC had written to the European Commission seeking an exemption for securities financing transactions from the MiFID II Best Execution reporting obligations under Article 27.

SMPC meeting with the Bank of England on CBPS

Andy Hill reminded the Committee that there would be an ad hoc meeting of the SMPC on November 10th with the Bank of England to discuss its Corporate Bond Purchase Scheme (CBPS). The meeting would take place at the ICMA offices at 11am, and attendance was already expected to be high.

Chair's final comments

Sonali Theisen thanked everybody in the room and those on the call for helping to ensure a lively and interesting meeting, covering a wide range of issues of significant importance to all market participants, in particular the ECB's CSPP. She hoped that members would continue to remain actively engaged in the Committee and its working groups, and looked forward to co-chairing the next meeting with Yann Couellan in early 2017.

Andy Hill, November 2016