

Secondary Market Practices Committee

Meeting of the ICMA SMPC, July 2nd 2015: Minutes

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

Attendees

In the room:

Asif Godall	HSBC	(Chair)
Yann Couellan	AXA	
Stephen Fisher	BlackRock	
Martina Ben-Shaul	CIBC	
Sonali Thiesen	Citi	
Volker Lach	Daimler	
Mark Barber	GE Capital	
David Camara	Goldman Sachs	
Faiyaz Bashar	Goldman Sachs	
Adam Bate	Morgan Stanley	
Andrew Bowley	Nomura	
Peter Eisenhardt	ICSA	
Elizabeth Callaghan	ICMA	
Ruari Ewing	ICMA	
Paul Richards	ICMA	
Alexander Westphal	ICMA	
Andy Hill	ICMA	(Secretary)

On the line:

Umberto Menconi	Banca IMI
Andy Wallhead	Barclays
Jeffrey Hogan	BGC Partners
Kashif Riaz	BlackRock
Marco Ferrari	BSI
Mariano Goldfischer	Credit Agricole
Marco Pouw	Credit Suisse
Dom Holland	Deutsche Bank
Abhishek Sharma	HSBC
Godfried De Vidts	ICAP / ERC Chair
Emanuele Caloia	Jefferies International
Sanjay Jhamna	JP Morgan
Nik Louwye	KBC AM
Alice Beavan	Lloyds Banking
Graham Halliday	Mizuho
Fredrik Jenestrland	Nordea
Alex Struc	PIMCO
Kathy Gibson	Pioneer
Sylvie Bonduelle	SocGen
Anthony Peters	Swissinvest

Welcome and approval of minutes from meeting on March 26th 2015

On behalf of Asif Godall (Chair of the SMPC), Andy Hill (secretary to the SMPC) opened the meeting by welcoming those attending and on the line. With no comments from those present or on the line regarding the minutes of the meeting held on March 26 2015, which had been circulated prior to the meeting, Andy Hill declared the minutes passed, before handing over to Stephen Fisher and Kashif Riaz of BlackRock to lead the first key agenda item.

1) Corporate bond standardization and benchmarking

Overview: the BlackRock proposal

Stephen Fisher, ahead of introducing Kashif Riaz on the line, opened the discussion by setting the context for corporate bond standardization. Firstly, the concept was nothing new and had been discussed for more than three years within the broader discourse around the corporate bond market liquidity challenge. In many respects, it was just one leg of a stool that included other initiatives to enhance liquidity, such as developing new e-trading protocols. Furthermore, it had been discussed in the recent EU CMU and UK FEMR consultations. While there seemed no instinct to legislate for standardization, the authorities were clearly concerned about liquidity conditions in the bond markets, were monitoring the situation, and were supportive of market standards and practices that could help address some of the issues.

Kashif Riaz explained that BlackRock had been working on this concept for many years. The underlying driver was the fact that post-crisis bond markets had changed. Meanwhile, a number of issuers were already standardizing certain features associated with benchmark issues. So this was not a new discussion, and lay very much in the evolving post-crisis bond market dynamics, which were largely due to the combined results of regulation, market environment, changing business models, and structural changes. For example, bond issuance was 25% higher year-on-year, and the size of the market has doubled in the last seven years. Meanwhile, the OTC market-making model has become outdated and requires changing to cope with the new market structure. This had been the driver for BlackRock to embark on a project to see how liquidity could look in a more challenged environment.

Currently, BlackRock felt that bond market liquidity was okay, but not great, and tended to exist only for smaller tickets, on-the-run issues, and more agented trades. Meanwhile, secondary market volumes and turnover were declining, while issuance outstandings continued to increase. The thinking was how to address this liquidity fragmentation, not just in the current environment, but through the cycle; and it was this that led to a number of recommendations. Some recommendations related to e-trading, however it was recognized that while this can transfer liquidity, and improve efficiencies, on its own it does not create liquidity. They expected an increase in the development of e-trading protocols, particularly all-to-all, and already we are seeing many market players moving into the space, driving more innovative solutions, although it would need to be seen how many will succeed. Also, to what degree will this help? More protocols, and greater all-to-all connectivity should help, but only a little.

Equally important, Kashif explained, is behavioral change. This required a reset of expectations and operational protocols, particularly for the buy-side who were being driven to become price-makers for positions that they want to trade, rather than traditional price-takers. This paradigm shift poses challenges, particularly for buy-side firms that are institutionally constrained, for instance requiring

multiple dealer quotes to prove best execution, but in time they will need to adjust, as will the sell-side that will have to concede some of its control in price-setting.

Dealing with these challenges is complex, and there is no single step that will lead to an overall, sustainable sea-change. Rather, it will require multiple, incremental steps.

It is with this in mind that BlackRock published its paper last year ('The Liquidity Challenge: Exploring and Exploiting (Il)liquidity', Blackrock, June 2014). While the paper accepts the intrinsic heterogeneous nature of bond markets, which is a result of issuer needs as much as investor preferences, some degree of standardization could be beneficial and help support increased electronic trading and all-to-all protocols. This would also be in keeping with how corporate bond markets evolved fifteen years ago, where issuers began to issue large global bonds in a market that had previously been characterized by a prevalence of MTN issuance. Similarly, in the current market evolution, there was scope for larger, more regular, corporate issuers, that enjoyed established benchmark curves, to consider standardizing some features, such as coupon dates or exchange listings, which would be supportive of more homogenized platform trading. In turn, this would free up balance sheet for OTC market makers to provide liquidity in more heterogeneous, less liquid bonds. This was not the same as corporates issuing to a calendar schedule similar to sovereigns, rather it was taking the opportunity, at one or two points in the year, to issue 'super liquid benchmarks'.

Kashif acknowledged that there had been a lot of attention on proposals for standardization as a possible solution for improving market liquidity. BlackRock had learned from their discussions with the market, recognizing both the pros and cons, and in doing so had refined their proposals to become more constructive and innovative; for example, employing ETF technology to create benchmark liquidity that would not be a cost to the underlying issuer. However, he wanted to emphasize that standardization is not a solution in itself, but rather part of a suite of possible innovations and behavioral change that was part of a larger process of industry 'brainstorming'.

Discussion

Asif Godall then opened the meeting up to comments and reactions.

Anthony Peters made the point that one issue that never gets raised is the decentralization of the European market-making community. In the US, the five biggest bond houses account for 50% of corporate bond secondary market trading, and the ten biggest account for 80%. In Europe, ten market makers account for 50% of trading, and 25 for 80%. This lack of centralization in European bond markets suggested that there were too many houses competing for too little volume, which was contributing to liquidity fragmentation. Asif Godall responded that the US and Europe were very different, in the sense that Europe was not one single market or even a single currency, so perhaps comparisons were unfair.

Paul Richards directed a question to Kashif and Stephen, asking whether they felt the possible solutions they discussed should be industry led, involving sell and buy-side, or whether they should be regulation driven. Kashif responded that there are many areas where market participants can drive standardization, such as electronic trading, pricing protocols, and other behavioral aspects, but where standardization is not possible, regulation can help.

US vs global

Alex Struc asked the BlackRock representatives whether the view they presented was global, or only relevant to the US. Kashif replied that this was addressing a global problem, although it may be more applicable in Europe, despite the fact that much of the analysis was based on US data, mainly due to a lack of available market data in Europe. However, for the recommendations to work would require critical mass as well as markets where there existed the possibility for tapping bond issues, which very much limited the scope to the US and Europe. Alex agreed that there was perhaps a data bias toward the US market. He further suggested that a study on the retail bond market in Europe would be of interest. Stephen Fisher responded that data and anecdotal evidence did suggest that European bond markets were less deep than the US; for example to sell 5-10% of a tranche of a bond is much more difficult in Europe. European legislators were becoming more concerned and were now of the view that no change was no longer an option; however, more regulation was not in the spirit of CMU. Rather, the recommendation from the authorities was that the market work through a trade association to drive and monitor the necessary change.

Sell-side perspective

Asif Godall summed up the discussion so far by outlining five key observations. Firstly, electronic trading was driving innovation, but required the development of standardized protocols. Secondly, cash ETFs provided a source of credit market liquidity, particularly for the larger asset managers; and the more ETFs and market-makers the better. Thirdly, available market data in Europe is not the best, particularly compared to the US, so measuring liquidity was difficult (e.g. estimating how long it would take to sell 5% of an issue). This is likely to improve post-MiFID II/R with post-trade reporting requirements, but even then this could be fragmented. Fourth, market-makers would be happy to trade super liquid corporate benchmarks, but this was really a discussion for the issuers. And finally, it felt as if the buy-side was trying to solve the issue of its asset-liability mismatch through sell-side solutions, which do not address the underlying structural problems.

The issuer perspective

In answering the point related to issuers, Kashif Riaz stated that it was not an intention of the recommendations for bond standardization or benchmarking to increase refinancing risk or to reshape issuer curves. Mark Barber, from the issuer perspective, commented that BlackRock should be applauded for promoting dialogue and recognized that something needs to be done, as the liquidity problem was not going away. As a representative of a large issuer, he was in favour of doing whatever they could to help secondary market liquidity, but would stop short of where this impeded the flexibility of issuing, or increased refinancing and roll-over risks. There are lots of different ways to issue debt, and while benchmarks can be helpful, issuers need the flexibility of different sources of funding. Therefore, a middle ground needs to be found. Volker Lach added that roll-over risk was indeed a major concern for issuers. Furthermore, he was concerned that in Europe at least, there was a limited number of issuers who issued in the size or with the regulatory that would warrant standardization. He pointed out that Daimler already issue benchmarks, but this was limited by what the market could absorb. There seemed little benefit in creating new issuance beyond what they did already. Similar to Mark Barber, he felt that the discussion needed to focus on some form of 'middle ground'.

Kashif Riaz responded that the proposal was not that all issuance should be subject to standardization, but rather this was proposing a subset. Furthermore, the proposal was driven by through-the-cycle

analysis: currently there is no new issuance premium for secondary market liquidity, but, when this changes, issuers will be more incentivized to consider changing issuance practice. Asif Godall asked if there is any quantitative analysis to illustrate where larger issue sizes increase liquidity, particularly as this would be essential in pushing corporates toward bigger issue sizes. Kashif explained that this was not clear, particularly given the current bull market where demand for new issuance outstripped supply. Volker Lach suggested that in the current market, issuers have to pay-up to issue in bigger size, rather than receiving a liquidity premium. Mark Barber added that the buy-side is also bifurcated, and that perhaps does not need the degree of secondary market liquidity as is generally feared.

Capital and liquidity provision

Sanjay Jahmna offered four perspectives on the discussion. Firstly, he agreed that benchmarking had some advantages and could have a constructive impact for secondary market liquidity. Secondly, it could be difficult to persuade issuers of the benefits, particularly where tapping of benchmarks led to spread widening. Thirdly, it will be key to establish whether it would have a positive impact on the capital deployed by liquidity providers. On the last point, Asif Godall commented that the cost of capital is now very much set by regulators, and for larger banks standardizing protocols could drive a structural shift of capital across a bank's entities. Sanjay added that it is not just the cost of capital that is important, but also the return on capital, which is driving the reduction of capital being allocated to liquidity provision. Mark Barber asked if we were seeing new sources of capital for liquidity provision. Asif responded that in the US, one large hedge fund was applying to become a market-maker for Treasuries, so we may see the start of a shift to buy-side liquidity. Kashif, however, felt that we would not see capital come back to support liquidity, and the focus needed to be on innovation as a replacement for capital.

David Camara commented that the proposal had some parallels with the work undertaken by ESMA to calibrate liquidity. What becomes apparent is that increasing issuance size does not create liquidity, and that there is only a small correlation. Asif added that there is probably a greater liquidity correlation for bonds in ETFs or indices. David agreed that the underlying elements driving liquidity were quite complex, and that factors such as market structures, technology, communicating axes, and inventory velocity were all part of a possible solution. Asif concurred that inventory velocity, rather than inventories as a static snapshot, were better indicators of liquidity, which was not often considered.

In conclusion

In wrapping up the discussion, Asif Godall restated the view that standardization was very much an issue that needed the input of the issuer community, more so than the dealer community, stating that it had been very helpful to have the views of two key European issuers in the room. Ruari Ewing, representing the ICMA Primacy Market Practices Committee, commented that he felt the broader issuer perspective was very much aligned to that represented by Daimler and GE. Paul Richards, referring to Stephen Fisher's earlier point related to CMU and the possible recommendation to move this forward, asked whether the SMPC could be a suitable forum to facilitate this. Asif and others concluded that it was.

As a final thought, Alex Struc put a related question to the BlackRock representatives asking for their thoughts on market transparency. Asif thanked Alex for his question, but felt that in the interest of time, and within the confines of the agenda, this would be a suitable discussion topic to table for the next meeting.

Actions:

- ***The SMPC to support ongoing discussions between key market participants related to corporate bond benchmarking and standardization, within the broader context of liquidity solutions.***
- ***Corporate bond market transparency to be tabled as a discussion item for the next SMPC.***

2) Systematic internalisers

Referring to the PowerPoint circulated with the agenda, Andy Hill explained briefly how MiFID II/R extended the Systematic Internaliser (SI) regime to cover fixed income, as well as stipulating volume based criteria which would qualify entities as SIs for individual securities. Furthermore, under the transparency requirements of MiFID II/R, SIs would be subject to the same pre-trade transparency obligations as regulated markets, MTFs, and OTFs.

Asif Godall thought that the size specific to instrument (SSTI) and large in scale (LIS) thresholds for transparency waivers would be a key factor in determining the overall impact of the regime. Andrew Bowley added that the critical difference to MiFID I was that becoming an SI was no longer discretionary, and that this may drive market behavior. Andy Hill asked the question to the participants whether there were any benefits to becoming an SI. Nobody could think of any. Liz Callaghan raised the fact that several buy-side firms have mentioned their concerns about SI quotes from registered SIs for different securities, in support of their internal liquidity scorings and as part of their portfolio management activities, becoming a potential Best Execution mandatory requirement.

Andrew Bowley commented that when it was introduced for equities, it had no material impact, and the same may be true for fixed income. The thresholds to qualify as an SI seemed relatively high, so it is likely that only a few market-makers would qualify, if any. Also, it is questionable how valuable the pre-trade price information of SIs would be. Given that they have a high degree of discretion with whom they transact, this obfuscates the value of their pre-trade price transparency. Yann Couellan added that from a buy-side perspective, pre-trade transparency provides no advantage, so there was no value that he could see in an SI regime. Stephen Fisher concurred that decent post-trade transparency was good enough. Asif wondered if it would most adversely impact retail trades, since market-makers might be unwilling to quote sizes below the SI reporting exemption thresholds. Andrew concluded that an outcome of the regime might lead SIs to trade more on platforms, since their quotes would only be shown as part of an average, and for non-SIs to trade mostly OTC, so they can avoid publishing their quotes.

3) The UK Fair and Effective Market Review

Paul Richards provided the Committee with a brief overview of the final report of the UK's Fair and Effective Market Review (FEMR), published on June 10, which aimed to raise standards in FICC markets. The report made a number of points, of which three were critical to secondary corporate bond markets:

- (i) The report recommends the creation of a FICC Market Standards Board (FMSB) based in London. This would not in itself be a standard setter, but rather it would assess and endorse market standards. This was of particular significance to ICMA in light of its Secondary market Rules and Recommendations.

Elizabeth Corley, chief executive of Allianz Global Investors, would be interim Chair of the new body, which would be made up of market practitioners, rather than trade associations.

- (ii) The scope of the Senior Managers and Certification Regime would be broadened (under the overview of the FCA).
- (iii) There will be an FCA competition review into investment and corporate banking, conducted with market users, and which would include the transparency of primary allocations. The terms of reference were published in May, and a report with the conclusions of the study would be expected in one year.

A crucial point for the UK authorities is that FEMR is very much London based, but to be truly effective requires international buy-in. The Bank of England and the FCA had used the recent IOSCO conference held in London as an opportunity to get broader international support, but it was not yet clear how successful this had been.

Paul concluded by saying that ICMA would keep the Committee updated on future developments related to FEMR and the FMSB.

4) Review of the ICMA Secondary Market Rules & Recommendations

Andy Hill informed the Committee that, as per an earlier action point of the SMPC, and pertinent to the points just raised by Paul Richards, ICMA was currently reviewing its Secondary Market Rules and Recommendations, particularly in light of the changing market environment and various regulatory initiatives. Of particular interest to members was a review of the current buy-in rules, which were seen as becoming harder to implement in the current market environment, principally due to the reliance on appointing a buy-in agent. Andy explained that market-makers were becoming less willing to act as buy-in agents, and a number of reasons had been attributed to this, including the additional time and hassle, a reluctance to take on the associated risks, or a lack of understanding of how the buy-in rules work. In a bid to create a more transparent and efficient process, the ultimate goal would be for a rule-change to support the creation of a buy-in auction mechanism. Andy further explained that as a precursor to this, a working group of SMPC members was currently engaged in an initiative to create an aged-fails auction mechanism, which, once finalized, could serve as a prototype for a buy-in auction. He added that there would be a working group call the next day to move this forward, and welcomed interested SMPC members to participate.

Paul Richards asked whether the projected buy-in auction would be compliant with CSDR, and if the new ESMA Consultation Paper on mandatory buy-ins would have an impact. Andy confirmed that the intention was to create a mechanism that was supportive of the CSDR provisions, but that until the Level 2 RTS were finalized, it would not be possible to ensure that this would be the case as there could be potential issues related to buy-in timelines, and also to whether buy-ins would take place at the trading or CSD level. In terms of the new CP, Andy explained that this presented three potential options for how buy-ins could work under CSDR, but which pointed toward a compromise option between trading-level and CSD-level buy-ins. Perhaps more significant would be the expected delay in implementation, which the market hoped would be at least until mid-2017. Asif Godall commented that it would be important

to move the initiative forward, and that a functioning buy-in mechanism would be helpful even in the run-up to CSDR.

5) The ICMA Electronic Trading Platform mapping initiative

Liz Callaghan, who is leading the ICMA European fixed income ETP mapping initiative, began by comparing the evolution of electronic trading for fixed income with that of equities, some ten-to-twelve years previously. Since then we have seen the survival of the fittest, with some platforms falling by the way-side and others merging. Liz stated that while we do not know how the evolving market structure will look five years from now, what we do know is that electronic trading in and of itself does not provide liquidity. The notable exception is High Frequency Trading in equities. As when they are participating in a platform, there is additional liquidity. The growth of equities electronic trading raised the game in terms of pricing protocol. The establishment of FIX protocol (financial information exchange), which became the market standard for electronic messaging related to equities, enabled market participants to electronically trade end-to-end. While FIX for fixed income exists, it is not yet widely utilized.

Liz explained that while the development of fixed income electronic trading protocols and practices is the eventual objective, the first stage actually is to establish what the electronic market structure looks like now. Hence, ICMA's project to map the capabilities and unique selling points (USPs) of existing and new-entrant trading platforms (and technologies) in the European fixed income space. The output will be a 'living, breathing' directory posted on the ICMA's website for one-stop shopping to research electronic trading skills available in the market. This initiative is intended for September, as well as a 'thought leadership' report outlining key trends and developments in fixed income electronic trading. In the meantime, Liz encouraged SMPC members to reach out to her to share their thoughts and to help inform this ICMA initiative and the eventual 'thought leadership' paper.

Mark Barber welcomed the initiative from an issuer perspective. He understood there to be somewhere in the region of 52 different e-trading projects, either established or in the pipeline, but as an issuer he did not understand what was required to have his bonds eligible to be traded on these various platforms. Liz responded that the resulting mapping directory would indeed provide information on how the various platforms worked. However, going forward, the initiative was focused more on what the best practices should be for e-trading. This would not be an overnight task, but would take time, and would require smaller, focused working-groups. Liz compared the process to that of the original equities FIX Committee (Liz was a founding member) where rules of engagement and best practices were agreed between the buy-side and sell-side for equities electronic trading. Andrew Bowley also was on that early FIX Committee and helped to create early stages of the equity electronic trading market.

David Camara commented that while platforms do not drive liquidity, they do play a role in how liquidity is distributed. He therefore wondered whether the mapping exercise would highlight the concentration of liquidity across the various platforms. Liz responded that while it would certainly be interesting, asking various platforms to provide market-share data could be sensitive. Asif commented that the directory and a 'white paper' would be the right starting point to frame the discussion, then analysis of the growth and evolution of the electronic trading space would be the next stage. Andrew Bowley added that the key value would relate to the regulatory agenda, and the changes being driven by regulation such as MiFID II/R with respect to behavior, market dynamics and structures, and the related

pressure points, which in turn will drive liquidity. Asif agreed that this had certainly been the case for the equity market, and that there was a lot that the fixed income market could learn in order to avoid making the same mistakes. David Camara thought there was certainly an asymmetry of information, and centralizing this through the mapping initiative would be extremely helpful.

In conclusion, Liz confirmed that the white paper would be published in September, but reiterated that in the meantime she would appreciate the support and input of the members. Asif called on the Committee to connect Liz with their electronic trading teams and to share views.

6) SMPC Working Groups

Andy Hill informed the Committee that in the previous months, two identifiable working-groups had evolved out of the secondary market work-streams: firstly, the working group to support the ICMA MiFID II/R Level 2 consultation response, which was still highly engaged in the ongoing advocacy process; and secondly, a working-group supporting the development of the aged fails-auction mechanism, which, as previously mentioned, was due to meet the next day. The question he put to the Committee was: are there other potential working-groups that could be mobilized to drive more focused and technical SMPC work-streams?

Asif Godall suggested the formalization of three working groups:

- (i) a MiFID II/R working group- currently focused on the RTS, but eventually implementation aspects (supported, as now, by Liz Callaghan);
- (ii) a CSDR/buy-in working group – focused on both the RTS and implementation of CSDR mandatory buy-ins, but also on the development of firstly the aged-fails auction, and secondly a buy-in auction mechanism (supported by Andy Hill);
- (iii) an electronic-trading working group, focused on e-trading protocols and practices (supported by Liz Callaghan).

Asif further encouraged active member firm participation in these working groups, including buy-side representation.

7) Any other business

MiFID II/R Level 2

Liz Callaghan, following her recent meeting with Kay Swinburne (UK MEP and member of ECON), updated the Committee that in recent developments it seems that the ECB had told ESMA that there was no reason why they could not develop a hybrid COFIA-IBIA model for determining pre- and post-trade transparency calibrations. Liz further noted that a hybrid-model had been the recommendation of ICMA in its response to the Level 2 consultation.

Close

With no further comments, Asif Godall thanked all those in the room and on the line for their participation, and closed the meeting.