Secondary Market Practices Committee

Meeting of the ICMA SMPC, November 26th, 2019

The meeting was held at ICMA, London, and Chaired by David Camara

Attendees

In the room:

David Camara	Goldman Sachs	(Co-chair)
Yannig Loyer	AXA IM	
Nic Cox	AxeTrading	
Mark Watters	AxeTrading	
Andrew Wallhead	Barclays	
Nick Robinson	Insight Investment	
Anthony Baldwin	LCH Limited	
Danielle Sibony	Societe Generale	
Andy Hill	ICMA	(Secretary)
Liz Callaghan	ICMA	
Gabriel Callsen	ICMA	
Rene Karsenti	ICMA (President)	
Paul Richards	ICMA	
Rowan Varrall	ICMA	
Sanj Ingle	ICMA Consultant	

On the line:

Aalok Gupta	BAML
Umberto Menconi	Banca IMI
Martina Ben-Shaul	CIBC
Chris Orr	Credit Suisse
Barbara Zittucro	Intesa San Paolo
Angela Lobo	Morgan Stanley
Sylvie Bonduelle	Societe Generale
Paul Cable	T. Rowe Price
Adam Weidner	Wellington
Paul Gover	Westpac

Agenda items

The Chair welcomed those in the room and on the call to the final meeting of the SMPC for 2019. He noted that he agenda, as always, covered a diverse range of topics reflecting the interests of members and the work of the SMPC and related working groups. The last meeting had included a highly informative presentation and engaged discussion related to fixed income ETFs and given the interest of members the SMPC would aim to support similar presentations and discussions in future meetings.

In this case, it was a pleasure to introduce Yannig (an SMPC regular) as the lead presenter. Often discussions around electronification and automation of markets reflect sell-side or trading venue initiatives; rarely do we get to hear a buy-side perspective.

1. A buy-side electronification journey: toward automation?

Presentation and discussion led by Yannig Loyer, Global Head of Trading at AXA IM

Overview

The pace of regulatory change, with initiatives such as MiFID II/R the past two years, and CSDR buy-ins coming next year, as well as the continuing shrinkage of dealer balance sheet and capacity is driving the electronification of the fixed income markets. Over the past few years we have seen new technologies, platforms, and protocols, and a continuing migration of trading from OTC onto venues. However, despite this, market infrastructure may be changing, but market structure has not. In fact, one could argue that the bond market model has remained unchanged since the 1980s. Historically, investors would call five dealers: now they RfQ five dealers. Liquidity is still being provided by market-makers who allocate , and not alternative providers.

Electronification

The use of e-trading has grown significantly, but this is mainly an efficiency tool, supporting STP (straight-through-processing), automating order flows, and minimizing the operational risk associated with manual pre-trade and post-trade processes. To the extent that some of these tools are provided by external vendors, these can be bought off the shelf, but where the required functionality is not available, the drive is to develop internal systems. AXA-IM has developed a range of internal tools over a number of years, including a new issues order management tool, a derivatives OMS (order management system), TCA (trade cost analysis), and price quoting functionality (data science). To some extent it is relatively easy to automate processes; the challenge is how much can be automated and how far to take it.

Sourcing liquidity from axes (direct connectivity)

Buy-sides are beginning to utilize proprietary and directly connected systems to source enhanced liquidity. This is being facilitated through direct connectivity with liquidity providers (market-makers). This provides visibility of positioning and liquidity in the market, as well as a centralized database used to identify, analyze, record, and maintain counterparties' marks of interest for bonds. The benefits are fewer counterparties being requested for quotes, leading to lower information leakage and market impact, better selection of counterparties (e.g. excluding those axed the same way), and facilitating quicker responses to block interests.

Data science

The objective of data science is to build predictive indicators to support quantitatively enhanced execution. AXA-IM has developed a unified measure of execution performance, intended to identify where trades are executed with respect to the bid-ask spread. This measure is based on four factor types, leading to 37 factors and 705 cross-factors accounting for correlated effects. They then select and quantify important factors using an *Orthogonal Matching Pursuit*.[1] Applications of the analysis have helped to emphasize how the number of dealer axes positively impact execution performance, as well as other market effects, such as credit sentiment, size bias, and the impacts of quantitative easing.

Toward automation

One can identify three main trends in fixed income trading: (i) market access is becoming more technical and focused on expertise; (ii) client and regulator expectations are increasingly demanding; and (iii) the growing need for a stronger ecosystem around trading, including controls, TCA (trade cost analysis), reporting, data science, and regulatory monitoring and compliance. AXA-IM's project aims ae to industrialize trading, contribute to alpha, and strengthen the global trading system.

In terms of next steps, there is an identified need to extend electronification and develop new tools for money market products, new issues processes, and uncleared OTC derivatives trading. Expanding on direct connectivity is also a priority, encompassing new trading protocols, data sharing, and e-trading for OTC derivatives.

The identified challenges in this journey include establishing data standards (e.g. for axe distribution), data ownership and confidentiality, costs and limited resources, on-boarding new systems, managing increased volumes of data, understanding market structure in automating processes, and calibrating the appropriate level of transparency in order not to hinder risk transfer.

Discussion

Members commented that it is often overlooked by regulators and commentators that while the market infrastructure is evolving rapidly, the market structure for bonds has not changed. Whether liquidity is sourced through calling or messaging their dealers, placing RfQs on MTFs, or requesting quotes via direct connectivity, these are all variations of the same process.

There was interest in whether AXA-IM's model was being replicated more broadly across the buy-side. It was felt that firms are at different stages along their journey to electronification and automation, employing hybrid solutions based on vendor offerings and in-house development. Members commented that direct connectivity and data science were likely to feature prominently in the next stages of market evolution.

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[1] Matching pursuit (MP) is a sparse approximation algorithm which finds the 'best matching' projections of multidimensional data. An orthogonal matching pursuit (OMP) is a popular extension of the MP that computes the orthogonal projection of the coefficients to obtain enhanced results.

2. Fixed income Consolidate Tape

Briefing and discussion

Liz Callaghan (ICMA) updated the group on the ongoing work to prepare an interim report for the European Commission on the considerations and feasibility of an EU consolidated tape for bonds.

ICMA had originally planned to publish a discussion paper on a consolidated tape for European bond markets in Q1 2020, building on its response[2] in September 2019 to the ESMA Consultation Paper on the *MiFID II/R review report on the development in prices for pre- and post-trade data and on the consolidated tape for equity instruments.* In light of the request from the Commission to produce an 'intelligence report' to support the case for an EU consolidated tape, this has effectively replaced the discussion paper as the output.

Efforts to produce the interim report by mid-December were well under way, and largely driven by a dedicated Taskforce representing sell-side, buy-side, trading venues, and data providers. As the report developed it will also be shared with a larger consultative working group, part of the wider MiFID II/R Working Group.

The focus of the report included an analysis of FINRA's Trade Reporting and Compliance Engine (TRACE), including lessons learned, a review of the current MiFID II/R post-trade reporting framework, and the market preferred 'end state' for a consolidated tape (CT). As with the consultation response, this was an opportunity to highlight the differences between bonds and equities, and the different requirements of a CT.

Discussion

The question was raised as to what the European Commission specifically wanted from the report, and whether this was intended to feed into the projected MiIFID II 'refit' in early 2020. The sense was that the objective was really to provide background information, in particular an analysis of TRACE, and not to be overly prescriptive in terms of a specific industry ask. Also, it was an opportunity to highlight some of the nuances between a useful bond and equity tape. It was suggested that there would naturally be differences in terms of what certain members or constituencies would want from a CT, just as there has been with the development of TRACE, and while disagreement and discussion are healthy, the report should take care not to reflect one particular viewpoint.

It was noted that one of the valuable lessons from the TRACE experience was the phased approach to introducing both new products and new reporting fields. In light of the data quality challenges with MiFID II reporting, this could be a strong recommendation for the EU CT.

There was a suggestion that the current MiFID II/R transparency framework was overly complex and did not adequately or meaningfully reflect 'liquidity'. While the market and the authorities had spent a lot of time and effort in establishing the liquidity calibrations, there was a good case for an overhaul and a much simpler approach. While there was some sympathy for this observation, there was also a general

[2] See: www.icmagroup.org/assets/documents/Regulatory/MiFID-Review/ESMA-CP-on-CT-ESMAMDAICMARESPONSEFORM-5-Sept-2019-060919.pdf

view that recommending changes to the existing regulatory framework should be beyond the scope of the report and better addressed in the expected MiFID II/R consultation in 2020.

3. ICMA European IG corporate bond secondary market study

Update

Andy Hill provided the group with an overview of the findings of ICMA's 3rd study into the state and evolution of the European IG corporate bond secondary market. The final report was expected to be published in early 2020.[3]

As with previous reports, the research underlying the study employs a triangulation approach focused on both quantitative and qualitative data. The research utilizes three main sources of data: market data provided by trading venues and data providers; surveys of market participants; and interviews with market participants

Liquidity

The survey responses suggest that, in general, market liquidity has declined since the previous study in 2016. This was consistent across both sell-side and buy-side respondents, although sell sides, on balance, seem more negative. The responses further indicate that liquidity has remained relatively unchanged for smaller trades (i.e. nominals less than €1mm), but has deteriorated for larger transaction sizes, in particular block trades (greater than €10mm). This is also reflected in the longer time taken to execute larger tickets.

Market evolution

While the surveys and interviews strongly suggest that liquidity conditions in the European corporate bond secondary market are becoming more challenging, this is part of a bigger story of changing dynamics and evolving market structure. While the capacity of dealers to provide liquidity is becoming more constrained and increasingly selective, asset managers are looking to new approaches to sourcing liquidity, either becoming more sophisticated in their interaction with market-makers, or through diversifying their use of trading venues and protocols. Regulation, for better or worse, is also helping to reshape the market, while overly accommodative monetary policy plays its role, too. Increased automation, connectivity, and the harnessing of data are seen as potentially empowering both sell-side and buy-side participants in their pursuit to get trades done. Meanwhile, the emergence of new entrants in the trading landscape, particularly through the growth of the corporate bond ETF market, are providing alternative sources of liquidity to be tapped.

[3] The final report was published on March 4 2020: https://www.icmagroup.org/assets/documents/Regulatory/Secondary-markets/Time-to-act-ICMAs-3rd-study-into-the-state-and-evolution-of-the-European-investment-grade-corporate-bond-secondary-market-040320.pdf

Looking forward

The surveys and interviews highlight participant concerns and expectations for the next three years. In general, most expect market liquidity to decline. In terms of driving factors, the expectation is that enhancements in data management and algorithmic trading will be positive for the market, along with the ongoing growth of the ETF sector. Buy-sides also point to new trading venues and protocols as potential plusses, although the sell-side are more neutral. When it comes to the biggest challenges to market liquidity, both constituencies identify increased capital costs for market makers and CSDR mandatory buy-ins as the stand-out considerations.

4. ICMA's Fintech Work

Update

Gabriel Callsen (ICMA) provided the group with an overview of ICMA's ongoing FinTech work related to fixed income markets.

Engagement with regulators

As regulators struggle to come to terms with regulating and supervising the new technology solutions, we have built our regulatory contacts extensively in this specific area over the last two years through meetings and dialogue with a number of key regulators, including: the FSB and BIS (who ICMA met again the previous week); IOSCO (where ICMA is part of the FinTech Network that was launched last year); the European Commission (both DG FISMA and DG Connect); EU MEPs (Sorin Moisa, Social Democrats); ESMA; and the ECB. At the national level, ICMA is also engaged with: the FCA (who also participated in the ICMA FinTech Forum); BaFIN; AMF; Finansinspektionen Sweden; FINMA; and the Singapore Monetary Authority.

The aim is to establish a dialogue, to get insight into their thinking on how to address FinTech, and to understand how they see the impact on international debt capital markets; for example of blockchain, initial coin offerings, means of raising capital.

In parallel, ICMA published a series of updates to members on FinTech regulatory developments on a quarterly basis since April 2018, as well as a paper summarising the differing regulatory approaches to financial innovation by the main regulators (Regulatory approaches to Fintech and innovation in capital markets, September 2018).

Participation in regulator-led working groups

ICMA now participates actively in a range of regulator-led working groups:

The ECB FinTech Task Force is a subgroup of the ECB AMI-SeCo (Advisory Group on Market Infrastructures for Securities and Collateral), which focuses on innovation from a post-trade perspective. There are two key deliverables: a mapping of blockchain initiatives in the post-trade space; and a note on tokenisation: securities post-trade processes in a DLT environment.

The IOSCO DLT workstream, part of the IOSCO FinTech Network, is focusing on selected developments, including: the World Bank's bond-i issuance, real and hypothetical regulatory responses (for which ICMA drafted the technical annex on DLT; and a paper on DLT interoperability, combined with scalability of DLT networks, and quantum computing (to which ICMA contributed).

Digital standards / CDM for repo and bonds

Following the meeting of the ERCC committee two weeks ago, it was agreed to explore the CDM for particular use cases, such as open repo lifecycle events, and other processes that are not standardised. It is planned to organise a workshop in the coming weeks.

ETP mapping directory update

On November 22, 2019 ICMA updated its mapping directory of Electronic Trading Platforms (ETPs). The directory now lists a total of 41 electronic execution venues, Order Management Systems (OMS) and information networks. It is intended to help market participants understand what execution and non-execution venues are available for cash bonds. Included within the directory are brief descriptions of the system/platform, products in scope, price discovery mechanisms, trading protocols, geographical coverage, regulatory status and other additional services such as regulatory reporting under MiFID II/R.

FinTech Advisory Committee

ICMA is in the process of setting up a new FinTech Advisory Committee, expanding the ICMA Board subgroup on technology to its core constituents across primary, secondary, repo and collateral markets. The aim is to bring together front office, middle/back office, legal and technology expertise. Following on from roundtable discussions, and given the continuing rise of electronification, the purpose of this committee will be to provide guidance on our FinTech work, promote connectivity/STP along the securities lifecycle, standardisation and machine readability of data, amongst others points.

5. Mandatory buy-ins: ICMA impact study

Preview

Andy Hill provided the group with a preview of the results of the ICMA CSDR mandatory buy-in impact study for EU bond markets.[4]

In total, there were 44 responses to the underlying survey, representing 16 buy-side firms, 16 sell-side firms, and 12 repo and securities lending desks.

[4] Mandatory buy-ins under CSDR and the European bond markets: an Impact Study, was published on November 27, 2019

Overall, the mandatory buy-in regime is expected to have significant negative impacts for bond market liquidity and efficiency.

More than half of respondent firms have plans to adapt their operational processes as well as their approaches to trading and risk management, with repo and securities lending businesses leading the field. However, the general view across all constituents is that there is limited or little market awareness of the regulatory requirements and likely impacts.

In terms of price impacts of the regulation, bid-ask spreads of all bond sub-classes are expected to more than double, with covered bonds and illiquid IG credit seeing the biggest impact. In absolute price terms, the impact is most notable at the lower end of the credit spectrum, with significant increases for emerging market, high yield, and illiquid IG credit bonds.

The new buy-in regime is expected to impact the capacity of market-makers to show offers across all bond sub-classes, with core sovereign markets the least affected. Again, it is the lower end of the credit spectrum that is most impacted, in particular illiquid IG credit and high yield.

Buy-side expectations for the impact on pricing are largely consistent with the indications of price adjustment from sell-sides. While they expect a general worsening of offer-side pricing across all sub-classes, there is a realization that the biggest impact will be at the lower end of the credit spectrum.

The survey responses suggest that for the most part, lending and repo activity will continue as normal for SSAs. For other sub-classes of bonds, however, the indication is that borrowing securities will become both more expensive and more difficult.

While currently there is industry work being undertaken to find a contractual solution for the differential payment asymmetry as well as to establish a pass-on mechanism, both of which may be possible within the provisions of the regulation, sell-side and buy-side respondents generally see these enhancements as only helping to an extent (although repo and securities lending constituents attribute more relevance to these initiatives). Removing the requirement to appoint a buy-in agent is also seen as helping, although there is also a fair degree of uncertainty among respondents. Introducing a longer extension period (with a suggestion of 30 business days) is broadly viewed as being a more helpful initiative, however, removing the mandatory requirement, if only for illiquid bonds, is overwhelmingly seen as being the most constructive modification.

There is little expectation among respondents that the regulation will improve investor protection.

Discussion

Members felt that CSDR mandatory buy-ins was possibly the most important issue for bond markets in the next 12 months, and that it should be a regular priority agenda item for the SMPC. The major concerns flagged by members included the impact that the regulatory initiative would have on market liquidity, the huge operational and legal lift to support implementation, the challenge of finding buy-in agents, potential issues and conflicts of interest related to determining cash compensation, and the inevitable costs to end investors. It was generally agreed that the ultimate losers would be smaller investors, and that the consequences for market liquidity and functioning were likely to be greater than that of MiFID II.

6. ICMA Secondary Market Forum

Briefing

Andy Hill reminded the group that following on from the success of the inaugural Secondary Market Forum, that took place in Paris in March 2019, the second Forum would be held in Amsterdam on the afternoon of March 4, 2020, hosted by InsingerGilissen Bankiers. The Forum would follow a similar structure to the Paris event, with two keynote speakers (ideally including a senior representative from the Dutch AFM), and two panels: one focused primarily on market trends, and one more focused on evolving market structure.

ICMA was currently looking for potential panelists and would welcome volunteers and recommendations from the SMPC. ICMA was also keen to ensure that there was balanced gender representation among its panels and speakers.

7. 2020 SMPC priorities

Discussion

The group discussed and proposed potential key priorities for the SMPC and ICMA's secondary market work for the next 12 months:

- CSDR Settlement Discipline: including market preparedness and industry solutions
- Ongoing developments in market structure (such as direct connectivity)
- Liquidity conditions in the sovereign bond markets
- Readdressing the MiFID liquidity assessments for bonds
- Data ownership and use
- The growing importance of China's bond markets

❖ The SMPC secretariat would share its proposed 2020 priorities and action plan with the SMPC in early 2020.

8. AoB

There were no other points of business.

Key calendar dates

27 November 2019 **ICMA Asset Management and Investors Council (AMIC) Conference**
12-5pm BST
Hosted by BlackRock, London

3 March 2020 **Next meeting of the ICMA SMPC**
Amsterdam, tbd

4 March 2020 **ICMA Secondary Market Forum**
Hosted by InsingerGilissen Bankiers, Amsterdam

24-26 June 2020 **ICMA Annual General Meeting and Conference**
Vienna

The next meeting of the SMPC is projected to be held in Amsterdam on March 3, 2020, to coincide with the Secondary Market Forum. ICMA will confirm host and times in the very near future.

Prepared by Andy Hill
December 2019