Secondary Market Practices Committee

Meeting of the ICMA SMPC, February 6th, 2018

The meeting was held at ICMA, London, and Chaired by Sonali Das Theisen, Citigroup Global Markets

Attendees

In the room:

Sonali Das Theisen	Citi	(Co-chair)
Umberto Menconi	Banca IMI	
Matthew Coupe	Barclays	
Arran Rowsell	BGC Partners	
Silas Findley	Citi	
David Camara	Goldman Sachs	
Eduardo Epperlein	Nomura	(Guest speaker)
Paula Alves	Société Générale	
Sanjiv Ingle	Société Générale	
Paul Cable	T. Rowe Price	
Elizabeth Callaghan	ICMA	
Gabriel Callsen	ICMA	
Leland Goss	ICMA	
Andy Hill	ICMA	(Secretary)
Bogdan Pop	ICMA	
Paul Richards	ICMA	

On the line:

Yann Couellan	BNP Paribas AM	(Co-chair)
Charles Deslandes	AFME	
Mark Watters	AxeTrading	
Philip Cramp	BGC	
Andrea Abbott	BMO Capital Markets	
Domingo Puertas Trillo	BNP Paribas	
Martina Ben-Shaul	CIBC	
Marco Ferrari	EFG Bank	
Goran Hoblaj	ERSTE Group	
Stephane Malrait	ING	
Nicholas Hamilton	JP Morgan	
Neelam Saini	JP Morgan	
Mathieu Casadevall	Société Générale	
Pritesh Tank	UniCredit	

Agenda items

Co- Chairs' welcome

The first SMPC meeting of 2018 was opened with an introduction and welcome from Sonali Das Theisen, who thanked those present and on the phone for their ongoing support and engagement in this important group. It was also noted that it was now one month since the 'go-live' of MiFID II/R, and despite a few glitches and ongoing challenges, it was very much business usual. The Co-chair also thanked Eduardo Epperlein, Managing Director and Global Head of Risk Methodology at Nomura International, for joining to provide an overview of the challenges of implementing FRTB, something that would almost certainly have critical implications for fixed income market efficiency and liquidity.

1) **Fundamental Review of the Trading Book and the fixed income markets**
   Presentation and discussion

Eduardo Epperlein talked the Group through the presentation, Fundamental Review of The Trading Book – The road to IMA. It was explained that the proposed changes to the internal model approach (IMA) were very intrusive, restrictive, and created numerous implementation challenges, not least since it would require approval at the trading desk level. The two key issues that banks were grappling with are Non-Modellable Risk Factors (NMRF) and P&L Attribution (PLA). The Group was also reminded that originally FRTB was set to be in force from January 2020, but following an announcement by the Basel Committee in December 2017, this would now be January 2022.

NMRF

NMRF attempts to address the 'missing risk' elements in the IMA, essentially 'risk not in VaR'. It was explained that this was very much left to last by the Basel Committee in outlining FRTB as it is perhaps the most difficult element and largely a data issue; there was some hope that by the time NMRF was tackled, data availability would have been improved. The critical aspect is that the IMA relies on observable data points for underlying instruments, which includes strict criteria on the number of data points and minimal gaps between observations. Where observable data is not sufficient, the model is subject to a capital 'add-on' (under the Expected Shortfall Factor, or ESF). Given the lack of data availability, the proportion of banks' NMRF is significant (67% in the case of Nomura), and, depending on how strict an interpretation of the model is applied, could see ESF capital increase by anything between 100% and 1000%.

A question was asked about new bond issues, and the impact of NMRF, given that by the very nature of new issuance there would not be sufficient data points. It was confirmed that this was indeed problematic, and somewhat ironic in that while new issues were at their most liquid in the first few weeks, they would be subject to higher ESF charges, and that only when they were seasoned, and at their least liquid, would they potentially have enough modellable data.

A further question was raised about whether the problem was more a data problem than a model problem, suggesting a need for more market data. It was also asked whether MiFID II/R would go some way to solving this. It was argued that a lack of reliable data was a critical issue, and that even post MiFID II, the data so far was not broad or granular enough to meet the requirements. However, it was also questionable whether the calculations were appropriate, particularly as they seemed to suggest at least 100% uncertainty in banks' VaR engines, and potentially up to 1000% uncertainty.

PLA

The driving impetus behind P&L Attribution seems to be the intention to create a risk engine that replaces the traditional desk-level mark-to-market ('mtm') process. Essentially, for trading desks to get IMA approval, their front-office P&L needs to match that produced by their VaR engine. However, the challenge is that there are many reasons why desk-level and risk engine P&Ls may not be the same, for instance different data sources, or different timings for data snap-shots, particularly where trading desks are locally based and risk management is centralized.

It was explained that the industry had been vocal in outlining the challenges, and it seemed as if the message was being taken onboard. However, it was still going to be a tough test, and ultimately this was going to drive risk management and the front-office closer together. Apparently, some firms were already integrating these areas, but at the very least, the relationship would need to become more robust. In this respect one could argue that this was a valuable, albeit challenging, contribution of FTRB.

Advocacy

The question was raised as to how engaged the SMPC should be in advocacy around FRTB, particularly from the perspective of fixed income markets. It was noted that AFME and ISDA had been highly active in leading advocacy work for some time, as well as IIF and GFMA, and that ICMA did not want to duplicate any existing efforts. The Committee was informed that ICMA had already reached out to AFME to see if it could play a supporting role, particularly from a fixed income view point, and had attended a recent meeting of the AFME/ISDA working group that is looking to respond to the EBA Discussion Paper on the implementation of revised market risk and counterparty credit risk frameworks. It was agreed that ICMA should aim to be engaged in these work-streams, and that a further critical role would be for the SMPC to raise awareness of the technicalities, challenges, and potential impacts among members.

Action point: SMPC to continue to raise awareness of potential challenges and implications of FRTB for fixed income, and to support the broader market advocacy effort where relevant.

2) **MiFID II/R: the first month**
   Discussion

ICMA MiFID II – the Early Days

The ICMA secretariat provided a brief overview of the key issues coming out of the MiFID II/ Working Group and Platform Working Group meeting, 'MiFID II – the Early Days', hosted by Nex on February 1st 2018. The salient take-aways of that meeting are: electronic trading (or execution) for fixed income has increased; bond trading volumes were subdued in the first week, but have otherwise been relatively stable; there has been increased uptake of 'move-to-venue' protocols, although there is a lack of widespread agreement on what can and cannot be done under the regulation; there is a need for wider understanding and consensus on some interpretations of various regulatory requirements; there seems to be a lack of regulatory 'education' among some sell-side salespeople; and the number of firms optingin as systematic internalisers (SIs), outside of London, has been lower than expected (although the lack of a complete centralized SI database does not help).

SIs

It was asked whether initial member feedback suggested that buy-side firms were preferring to trade with SIs (for reporting reasons), but it was felt that it was too soon to tell. It was also pointed out that due to the increased use of move-to-venue protocols it was difficult to identify whether firms were preferring SIs as counterparts, since the trades are ultimately consummated as platform trades.

TOTV

A point was made with respect to 'traded on a trading venue' classifications for certain securities, and the challenge of establishing whether securities are TOTV. It was noted that certain securities could be inadvertently dragged into being classed as TOTV, and therefore reporting requirements for EU firms (a US single-name CDS that might be traded with a MiFID regulated IDB was suggested by way of a practical example). It was asserted that buy-side firms need to be more aware of the potential impacts of trading decisions that could bring non-EU securities into scope of TOTV. However, it was also noted that while IDBs are aware of the implications, and have discussed this with a number of firms, they are not in a position to refuse client orders.

Knowledge gaps

A point was raised about the seeming lack of regulatory knowledge and understanding of some client facing sell-side personnel (primarily salespeople), which can be frustrating, or even misleading, for buy-sides. Some of the Group agreed that it was a potential problem that while many firms had MiFID II regulatory experts, normally located in risk management or regulatory policy, this well of information was not necessarily filtering down to the trading and sales desks. It was broadly agreed that some firms could do more to train their front-office staff, although it was also recognized that adapting to the new environment and regulatory requirements was a process.

How can ICMA continue to help?

It was asked how ICMA could do more to support more harmonized implementation. Immediate suggestions raised by the Committee included best execution reporting and inducements. It was suggested that there was still a high degree of ambiguity with respect to buy-side reporting obligations under RTS 28 ('best execution'), and ICMA could potentially play a role in establishing some clarity and consensus. It was further suggested that from an operations perspective, it would be helpful to have a better understanding of transaction reporting requirements, since ultimately this fell to the middle- or back-office. Another suggestion was to understand better the differences and nuances in terms of regulatory interpretation and implementation across the major jurisdictions, since MiFID II was not a blanket regulation, and so it was important and helpful to understand its variances. Finally, it was mentioned that despite the ESMA 'Q&A update' in November 2017, there was still a degree of ambiguity on transparency and trade reporting obligations.

In terms of next steps, the SMPC agreed that a (fixed income) research specific event in the near future would be helpful. Secondly, there was scope to try to steer the market toward more uniform pre- and post-trade data reporting. Meanwhile, the Group was informed that ICMA would continue to hold a number of regional 'post-implementation' workshops for members, to identify the key issues and challenges across the various jurisdictions.

3) **Research unbundling: ICMA survey results**
   Briefing and discussion

The ICMA secretariat provided a brief summary of the results of the Asset Management and Investors' Council (AMIC) survey on FICC research unbundling, which was published in November 2017.

It was explained that the AMIC had previously produced a survey-of-surveys on expected buy-side approaches to research unbundling, however these tended to be quite broad or equities focused, hence AMIC decided to undertake its own member survey focusing on FICC research. The study was undertaken in October 2017 and published in November 2017.

Key highlights from the survey findings include:

- 96% of respondents were aware of the application of the new research unbundling rules and guidance, and 63% were already compliant (as of October 2017), while 89% expected to be compliant by January 3 2018.
- Only 52% of respondents had received guidance with respect to FICC research from their national regulators.
- 67% of firms intended to pay for FICC research out of their P&L; 8% did not intend to pay for external research; 4% intended to use an RPA funded by client charges; 4% intended to use a combination; while 17% were undecided.
- 58% of respondents expected their spending on FICC research to increase and 21% expected it to decrease. Meanwhile, 83% if respondents expected the number of providers whose FICC research they consume to decrease.
- 65% of respondents agreed that the demand for FICC research will decrease, with independent research providers expected to get a larger slice of the shrinking pie.
- 55% of respondents feel that the rules will have no impact on the quality of FICC research, while 32% think that it will deteriorate. However, 86% are no concerned that this will have a negative impact on fund performance.
- 68% of respondents indicated that they already have, or intended to, increase their in-house FICC research.

Discussion

The SMPC agreed that this would be a helpful ongoing project for the AMIC, and that the 2017 survey could serve as a useful benchmark for a further survey later in 2018. It was also noted that since January 3 2018, the biggest challenge seemed to be determining what constituted a minor non-monetary benefit (MNMB), something that seemed to vary across firms, with some taking more extreme stances than others. One member expounded that some buy-side firms switched-off consumption of all information from distributors, without discerning whether it constituted research or a MNMB. This could partly be attributed to firms being overly cautious, but it was also felt that firms were making erroneous calls on what is classified as research. Another member noted that at a recent ICMA meeting with the FCA, the UK regulator was alarmed to hear that buy-side firms had no interest in being 'wallcrossed' for new issues soundings given the required compliance infrastructure to support this, and that it seemed as if some buy-side firms were simply 'switching off' information flow with their sell-side counterparties across the board.

Action point: AMIC to keep SMPC informed of its ongoing work on monitoring buy-side implementation of, and adaptation to, the research unbundling obligations.

4) **ICMA SN-CDS study**
Briefing and discussion

The secretariat updated the SMPC that the report of the ICMA study into the state and evolution of the European corporate single name credit default swap market was almost finalized, and that those SMPC members that had participated in the study would be receiving an advanced draft of the report for fatal flaws comments only in the next two days. The plan was to publish the report on February 15 2018.

The Group was also updated that while ISDA had made a significant contribution to the report, providing extensive data and quantitative analysis, the report would be published as an ICMA paper.

5) **ICMA's FinTech mapping directory**
Briefing

Sanjiv Ingle, Managing Director at Societe Generale and Chair of ERCC Operations FinTech Working Group, briefed the Group on an important recent ICMA FinTech initiative.

The SMPC was reminded of the important contribution its Operations constituents (namely through the ERCC Operations Group) have made to a number of secondary market initiatives, including the move to T+2 settlement and the operation of buy-ins. Toward the end of 2016, the ERCC Operations Group had begun to look more closely at various FinTech initiatives, in particular from the perspective of the repo lifecycle. At this stage they identified around 40 initiatives. By the end of 2017, this had grown to over 100, and was still not exhaustive. While primarily repo focused, around 90% of these also supported improved post-trade efficiencies in the cash bond market.

A mapping of the various initiatives had now been made available on the ICMA website, and the plan was to keep this updated as an important helpful resource for members. SMPC members were encouraged to make their interested colleagues aware of this and encouraged to share the resource internally within their firms. Furthermore, they were very welcome to become engaged in the ERCC Operations FinTech Working Group, if they were not already. It was further pointed out that this FinTech mapping, along with the ICMA secondary market Electronic Trading Platform mapping, were unique initiatives, and the only directories of their kind in the European fixed income markets.

Nicholas Hamilton, Executive Director at JP Morgan, Chair of the ERCC Operations Group, and newly appointed Chair of the SWIFT UK Securities Advisory Group (SAG), briefed the Group on the new group. One of the key objectives of the SAG is to identify opportunities for increasing transparency, standardization, and straight through processing (STP) for securities transactions across the trade lifecycle. This requires focusing on settlement, clearing, confirmation, and execution aspects of the securities processing lifecycle across all asset classes. It would further provide feedback to SWIFT regarding on-going development and implementation of a securities market strategy, including opportunities related to industry and regulatory initiatives, such as CSDR, as well as in supporting the CMU initiative. SMPC members were asked to update their post-trade colleagues, and to encourage them to join the Group if interested. Meanwhile, the SMPC would be kept informed of all relevant work of the SAG.

6) **SMPC ToR**
Proposal and approval

The ICMA secretariat introduced the proposed updated terms of reference for the SMPC. It was explained that this is not a radical departure from the previous ToR approved in 2015, and that in essence it helped to align better the scope and remit of the SMPC with the ICMA Secondary Market Rules and Recommendations. While IG credit would remain a key focus for the Committee, it was not restricted from other cash bond asset classes, and, were it related directly to bond market efficiency and liquidity, other asset classes, including derivatives.

The SMPC duly approved the new ToR.

7) **Merger of ETWG and PWG**
Proposal and discussion

The ICMA secretariat explained the background for the proposal to bring together the existing Electronic Trading Working Group (ETWG) and Platform Working Group, to become a single 'Council' focused on the evolution of fixed income market electronification and technology initiatives related to European bond market structure. The potential interest and value of such a merged group were illustrated by the attendance and engagement in the recent joint-working group 'Early Days' event in London to discuss the initial impacts of MiFID II/R.

It was explained that the draft Terms of Reference were still being formulated and would be shared with the SMPC for approval in the near future. However, it was intended that the focus of the new Council would be to provide a forum for discussion and information sharing on relevant topics and issues, which could also form the basis for best practice or minimum standards, in certain circumstances, or potential advocacy. Given the constituents of the new Council, it was proposed to have three co-chairs, representing sell-side, buy-side, and venue members. It was intended that the Council meet four times a year. The suggested title for the new Group would be the 'Electronic Trading and Market Structure Council'.

A question was raised as to its potential scope, particularly in light of the proposed new title of the merged working groups, and it was pointed out that 'market structure' is extremely broad, going much further than trading venues. It was also noted that the entire fixed income ecosystem was becoming ever more electronified, making it more important to provide clarity on the specific scope of the new Council, outlining how this was distinct from, and added value to, the wider remit of the SMPC. Another question was raised with regard to advocacy, as it was understood that secondary market advocacy was approved and led by the SMPC.

It was suggested that in terms of advocacy, this was not a key objective of the new Council, and that in most cases this was likely to be MiFID related, so more an issue for the MiFID Working Group or SMPC. In terms of scope and title, it was agreed that 'market structure' could mean different things depending on one's perspective, and so was potentially misleading. Since in this context it was specifically intended to refer to the technological aspects of (secondary) market structure, it would be cleaner simply to call the merged groups the 'Electronic Trading Council'.

In terms of reporting, it was highlighted that the new Council would report into the SMPC, which was the umbrella Committee for ICMA's secondary market work. However, the rationale for such sub-committees, councils, or working groups was that while the SMPC was the principal forum for setting the direction and focus of ICMA's secondary market work, it did not necessarily have the time to discuss specific issues in technical detail, and so it was at the sub-group level where members, including specialist experts, could delve into greater granularity; in this case with respect to electronic trading and venues.

It was broadly agreed that the merger of the two working groups to form the 'Electronic Trading Council' was, in principle, a valuable initiative, and that the SMPC would look forward to reviewing a draft ToR in the near future.

Action point: The ICMA secretariat to share the draft ToR for the new Electronic Trading Council with the SMPC for approval in the near future.

8) Approval of the minutes of the last meeting

In the absence of any comments, the minutes from the meeting of November 30th, 2017 were approved.

9) Any other business

The Committee was made aware of the recently established SEC's Fixed Income Market Structure Advisory Committee (FIMSAC). The Committee is made up of 21 market participants, representing a cross-section of the industry. There are also three sub-committees, respectively focused on Transparency, ETFs and Bond Funds, and Technology and Electronic Trading. The meetings and related materials of the FIMSAC and sub-committees are available on the SEC website and should be of interest to SMPC members, as well as potentially informing its European focused work with respect to the direction of travel in the US.

Sonali Das Theisen thanked all those in the room and on the call for participating and closed the meeting.

The next meeting is scheduled to be held in London on the afternoon of May 29 2018 [subsequently rescheduled for May 3 2019]

Prepared by: Andy Hill
February 2018