Secondary Market Practices Committee

Meeting of the ICMA SMPC, February 4th 2016: Draft Minutes

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

Attendees

In the room:

Sonali Theisen	Citi	(Co-chair)
Monica Cammarano	Banca IMI	
Michele Lanza	Banca IMI	
Kieran Davis	Barclays	
Stephen Fisher	BlackRock	
Volker Lach	Daimler	
Antony Baldwin	Daiwa Capital	
Dominic Holland	Deutsche Bank	
Nicola Marcusa	EIB	
David Camara	Goldman Sachs	
Godfried De Vidts	ICAP & Chair of ERCC	
Peter Eisenhardt	ICSA	
Kristina Godau	Lloyds Banking	
Andrew Bowley	Nomura	
Elizabeth Callaghan	ICMA	
Patrik Karlsson	ICMA	
Katie Kelly	ICMA	
Paul Richards	ICMA	
Andy Hill	ICMA	(Secretary & acting Co-chair)

Guest in attendance:

Jonathan Haynes	DG FISMA

On the line:

Marco Ferrari	BIS Bank
Aaran Rowsell	Commerzbank
Robert Verrillo	DBV-X
Alice Beavan	Lloyds Banking
Brett Chappell	Nordea IM

Secretary's welcome

Andy Hill (SMPC secretary and acting co-Chair for this meeting) thanked everybody for attending or dialing-in, and introduced the special guest for this meeting who would also be leading the first agenda item. Jonathan Haynes works for the Directorate General for Financial Stability, Financial Services, and Capital Markets Union (FISMA) of the European Commission. Jonathan is part of the CMU Team, with specific focus on the state and liquidity of the corporate bond secondary market. Andy Hill thanked Jonathan for joining today's meeting, not least since corporate bond secondary markets were at the heart of the SMPC's work and interest.

1) **Presentation and discussion with the European Commission: the corporate bond liquidity challenge**

Introduction by Jonathan Haynes

Jonathan Haynes thanked the SMPC for providing him and the Commission with the opportunity to discuss the perspectives of the members of the group on the current state of the corporate bond markets. He noted that the CMU Action Plan had committed to a review of the European corporate bond markets by 2017 and that the Commission wants to gain a comprehensive overview of the market's functioning. The presentation and subsequent discussion outlined that there are clearly many developments impacting on the market at the same time. This includes regulatory initiatives, such as those relating to capital requirements and the new rules that will be introduced under MiFIR/D II, but also other forces, such as monetary policy and the changing structure of the investor landscape. Through this review the Commission wants to get a comprehensive understanding of all these interrelated factors.

The first stage of the Commission's work focuses on obtaining more and better quality data and evidence on market liquidity. As different available indicators point to different results it was not immediately clear to policy makers that there is a liquidity problem. The intention was to seek more information from the market and regulators to better understand the dynamics, causes and implications. The Call for Evidence exercise, which included a question on market liquidity, is part of this. The Commission was reading through the 300-or-so responses, which they hoped would also provide some useful data and analytics (Jonathan also stated that he had already read the ICMA's response).

The second stage involves attempting to better understand the policy implications for the market. The Commission is considering setting up an 'Expert Group' of market stakeholders as a vehicle to facilitate this process. The focus for the Group would be forward-looking, with the aim of identifying practical solutions that could enhance market functioning and resilience. The Commission expected to put out a Call for Interest for the Group in due course, with the group likely to be operational from Q3 of 2016. Jonathan invited members of the SMPC to apply once the document had been published. To help identify and better understand some of the market developments, such as around electronic trading, and the potential for greater standardisation, the Commission might hold a workshop later in 2016.

The plan was that the Expert Group would produce a final report in the Q3 of 2017, which would help to complete this action of the CMU Action Plan.

Jonathan highlighted that in terms of the various different regulatory initiatives highlighted in the Call for Evidence, such as MiFIR/D II, CSDR, CRR/DIV, the CMU Team was working closely with the relevant policy teams within the Commission.

In terms of where the SMPC could help in this discussion, Jonathan outlined four specific areas of interest for which he welcomed views from the various constituents, including the buy-side representatives:

(i) Standardisation: what should the Commission do or not do?

(ii) Eletronification: what is the potential for electronic trading and other technological solutions in terms of helping market efficiency and liquidity? (Jonathan referenced the very helpful mapping exercise of the ETP space by ICMA.)

(iii) Investors: to what extent is immediacy needed? And was there an argument that expectations needed to change?

(iv) To what extent are liquidity conditions different across different currencies?

Standardisation

Sonali Theisen (Citi) opened the discussion on standardisation (or 'benchmarking') for corporate issuance by stating that from the perspective of a large dealer, the market ought to be able to evolve as appropriate to serve best the needs of all the participants, including investors, issuers, and liquidity providers. If we take a step back and consider why the corporate bond market looks the way it does today, we can see that it was for a very good reason and has evolved in order to customize to the tailored needs of both issuers and investors. In other words, corporate debt markets are not supposed to look like equity markets, and any attempt to change issuance practice should be considered in this context.

Volker Lach (Daimler) explained that from the issuer perspective there were two key considerations. On one hand there was the need to give the market what it wanted, which, if it did help create liquidity, could justify larger issue sizes, where this was feasible. However, this had to be balanced with the additional refinancing risk that issuers would have to assume with more concentrated, larger issuance.

Stephen Fisher (BlackRock) explained that when the idea was first floated by BlackRock, the intention was really to prompt discussion, rather than to provide a solution. Ultimately, any move towards more standardised issuance has to be consistent with the capital structure of the issuing entity. Stephen added that he welcomed the involvement of the European Commission in the debate, and that there was a need for an independent arbiter that could provide a forum for discussion on this and other issues, involving all of the key market stakeholders. While he sympathised with many of the arguments against standardisation, it was vital that the discussion moved on, and that two years from now we were not having the same conversation.

Godfried De Vidts (ICAP and ERCC Chair) suggested that when looking at the issue of market liquidity, it was important not to view bond markets in isolation, but to consider other aspects such as the condition of the underlying repo market, and even the post-trade structure of the market. For example, in a recent meeting of the European Parliamentary Financial Services Group (EPFSF) the role of the central bank with respect to CMU was discussed. While it was appreciated that CMU is a long-term project, in the short-term, at least, the ECB's quantitative easing was not helping, as investors outside of Europe were deterred by zero or negative sovereign bond yields. Meanwhile, from a post-trade perspective, a further deterrent in the immediate term was the fact that Europe's back-office remained innately silo-ed, with 28 different CSDs (central securities depositories), as well as different settlement practices in each jurisdiction. When one then adds the impact of different regulatory initiatives, such as CRD, CSDR, and MiFID, these are not the ingredients for liquid markets. He added that we had a liquid bond market before, so where did it go? He suggested that the starting point might be to see where we went wrong, and to what extent we can change direction to help re-liquefy the markets.

David Camara (Goldman Sachs) stated that he broadly agreed with many of the points raised so far, however, he felt that in the context of bond market liquidity it was also important to consider the state of the derivatives markets. A reduction in single name CDS liquidity was impacting market-making for cash bonds. Returning the discussion to the issue of standardisation, David suggested that there could be a lesson to be learned from the CDS market. Originally single name CDS were relatively disparate, with different, tailored terms. With the increased standardisation of the 5yr CDS structure, this helped create liquidity in the CDS market, which in turn improved liquidity in the cash bond market.

Sonali Theisen agreed with this point, noting a bifurcation of bond and derivatives liquidity in the US. In assessing liquidity, it was essential to view the overall market ecosystem, focusing not only on balance-sheet and turnover related to cash bond inventory, but looking at the net and gross risk per name.

Volcker Lach commented that it was difficult to assess accurately market liquidity in Europe due to the lack of available data. In the US there was TRACE (Trade Reporting and Comnpliance Engine), so it was easy to monitor secondary market volumes and turnover. Also, in the absence of reliable data, the sense of declining liquidity may be more a question of perception. For example, there could be very different liquidity conditions for executing small orders as opposed to large orders. Similarly, secondary market liquidity looks very different when compared with primary market liquidity. It would therefore be critical to have a better handle on secondary market data to form a solid base for meaningful analysis.

Stephen Fisher added that another important indicator was ETF (exchange traded (bond) fund) turnover. Furthermore, it would also be important to look at the bond holders, since the type of investor would also impact secondary market liquidity. But the challenge was how to access this. Sonali Theisen wondered how much data would be provided after the implementation of MiFID (II), however, this was looking likely to be delayed. Jonathan responded that ESMA had collated data from the various NCAs (National Competent Authorities) to support their MiFID analyses; however, the Commission did not have access to this, although they were exploring the possibility. He explained that this was part of the thinking behind the Call for Evidence, as obtaining European market data is challenging and it was hoped that this was an opportunity to collate good data and analyses.

Andrew Bowley (Nomura) suggested that liquidity was at the centre of the need for data. European markets were digesting so many different regulations, many of which had not yet kicked-in, as well as the effects of extreme fiscal and monetary policy, and the impacts needed to be monitored carefully and scientifically; in essence, this was essentially a regulatory experiment. Market liquidity was at the core of this, and it would be important to identify or develop meaningful metrics, or even to create a liquidity index, to monitor market evolution. The next question would then be, what should the market look like? What should be the role of market-makers? Or the role of trading platforms? But again, this comes back to a defined aspiration for a level of market liquidity.

Godfried De Vidts added that already the effects of regulation were being felt in the corporate bond repo market, where liquidity had reduced significantly. He further noted that even where regulation was not yet being enforced, the market was already complying.

Jonathan Haynes flagged the difficulties for policy makers given the poor quality of data publically available. For example, for the MiFID II work to determine the required parameters, ESMA had needed to work very hard with data providers to build up a sufficiently large dataset in order to come up with its calibrations. Jonathan highlighted that different data provides different evidence of the situation of market liquidity, sometimes contrary to the anecdotal evidence provided by dealers. For example, he noted that published quotes were at a recent high, according to some data sources: although it was hard to obtain data on unexecuted quotes, to get a sense of the reliability of these quotes. Dominic Holland (Deutsche) confirmed that looking solely at the number of published quotes was indeed misleading, and could be interpreted in a number of ways, particularly if the quotes were purely indicative and not actionable. There was a mutual understanding of the importance of using data appropriately.

Electronification

Sonali Theisen explained that 'electronification' of markets can mean many different things: automated order books; trade processing; data management; etc. The adoption of automation in the credit markets had been lagging, compared to other markets, but it was beginning to evolve at a greater pace. In particular, it was helpful for wider distribution and for reaching 'low touch' clients that would otherwise require more resources. This was at the crux of the liquidity debate: given the limitations of capital and resources to support market-making, dealers were having to become more discerning as to whom they provided balance sheet and immediacy; platforms therefore allowed greater connectivity to the market for clients that could not be adequately covered by banks' down-sized sales desks. The US markets were probably experiencing their third or fourth evolution of electronification, and platforms were going beyond connectivity and execution to include order management and other automated services. However, the question still remained as to what extent this was helping liquidity.

Dominic Holland added that the electronic platform space for corporate bonds was extremely diverse, and that no single platform provided a solution to all market needs; rather there were multiple solutions available to address different market segments.

Stephen Fisher thought that from the buy-side perspective electronification certainly had the potential to help in terms of improving connectivity between buyers and sellers, as well as providing more execution and post-trade efficiencies, and so it seemed as if more buy-side firms were moving in that direction. But this was not necessarily a solution for liquidity in itself. Brett Chappell (Nordea IM) agreed that electronification was helping from a pre-trade perspective in terms of greater efficiency in sourcing pricing, but it became more sensitive in terms of execution. Where traders needed to execute large ticket sizes, this process needed to be very 'high touch', and there was no readily available electronic solution for this. Volcker Lack offered the general observation that electronic trading seemed to provide a modern replacement for the old voice broker or sales system, but it did not replace the intermediation that market-makers provide.

Immediacy and investor expectations / measuring liquidity and the value of data

Stephen Fisher felt that immediacy was important, particularly for UCITS that provided daily liquidity. However, it was important for investors to understand that liquidity is not free, and that there is usually an immediate exit price from a fund, but it might not be the price the investor was hoping for. So while immediacy was an issue, it is quite a complex discussion.

Liz Callaghan (ICMA) asked whether impaired secondary market liquidity would eventually be a cost to primary issuance. Volcker Lach confirmed that this was absolutely the case. For pricing, primary markets take their lead from secondary markets, and if the secondary market is not functioning investors will have little confidence in the pricing reference point and will demand a higher premium, resulting in higher borrowing costs for issuers. This is the same effect as higher secondary market volatility, when, again, primary issuers have to pay a premium. This also explains why there has not been much corporate issuance to date this year.

Sonali Theisen stated that from the dealer perspective it was ultimately up to investors to decide how important the intermediation role is, but she also saw that this role was declining. However, it was also important to keep this in context since, as highlighted by the ICMA 2014 study, secondary market liquidity may have been too excessive and too cheap pre-crisis. But this said, it was clear that investors were beginning to get nervous about dealers pulling back. This was likely to be most problematic in a sell-off. Whereas previously there might be three or four large banks stepping in to absorb some of the flow and redistribute risk, if this reduces to just one or two, then this shock-absorber mechanism breaks down.

Antony Baldwin (Daiwa) commented that much of what appeared to be liquidity was illusory, and that whilst one might observe lots of prices on screen, these are not necessarily executable. Jonathan Haynes re-referenced data that showed average dealer quotes on platforms at their highest level since September 2014. Antony Baldwin and Sonali Theisen both questioned the validity of this, again pointing out the difference between quotes and actionable interests. Dominic Holland elaborated, explaining that dealers often provided static quotes for every bond for which they might be a market-maker, and that this was effectively nothing more than advertising to attract clients to check them for prices. However, these prices were not firm, and so gave a false sense of liquidity. Brett Chappell explained that to measure true liquidity it was important to delve deeper into the data. For instance, one should take a look at (Bloomberg's) 'ALLQ' and see what was the actual hit ratio, and which dealers stepped away from their price. It was also important to consider how good a dealer's repo desk is; for example, trying to lift a price in sizes of under 1 million is often not possible since the repo desk will refuse to cover it.

Jonathan Haynes asked whether it was possible to obtain evidence on the reliability of published quotes. Godfried De Vidts suggested that the platforms had this information. David Camara added that this would also need to be considered in light of other data, such as whether trades relate to existing positions, as well as how prices react in response to a trade. Brett Chappell suggested a potential triangular approach, combining platform execution and price data with follow-up interviews with the underlying dealers.

Kieran Davis added that there was another level of complexity that needed to be considered, which related to dealer sensitivities around hit rates. Often dealers aim to maximize hit rates with their top tier clients, or may want to be more dominant in particular sectors or currencies, which influences behaviour. Therefore, looking at hit rates across all bond quotes does not tell the full story nor highlight underlying dealer strategies in relation to certain investors or issuers.

David Camara suggested that it was also important to think not only about dealer behaviour, but to view this in the context of the development of overall market infrastructure. He drew on the analogy of consumer retail markets. Historically these relied on stores being able to warehouse a large range of goods. But as the infrastructure to get goods to the consumer improved – the roads and the trucks – so the need to warehouse goods reduces. In a way, the bond market is similar, with the market-makers acting as the warehouses, and electronic platforms acting as the infrastructure and distribution channels. What we are seeing is a marked reduction in the capacity to warehouse bonds, but not an offsetting improvement in the infrastructure. Hence the difficulty to find liquidity in bond markets.

Kristina Godau concurred with this analogy, adding that CSDR mandatory buy-ins posed yet another fundamental threat to overall bond market liquidity, as not only are dealers being forced to hold less inventory, but this would effectively prevent them for taking short positions.

Antony Baldwin suggested that if the Commission is looking for corporate bond market data, a good starting point would be the three largest trading platforms: Bloomberg, Market Axess/Trax, and Tradeweb. Their data should cover most of the market as traded on platform, and could also provide colour on quotes that are traded on or not. Furthermore, Trax should cover around 60% of all trades for corporate bonds.

Liquidity by currency

Volcker Lach stated that in terms of the European corporate bond market, the euro denominated market was much broader, with more participants, and so was more liquid than, for instance, the sterling denominated market, which was much smaller. In this sense, the creation of the euro certainly helped liquidity.

Godfried De Vidts added that this was part of the problem with ESMA's work on calibrating liquidity in MiFID, and the risks of aggregating across different markets. For instance, Polish Government Bond liquidity is not the same as that for euro sovereign issuers, but the regulation makes no distinction.

Nicola Marcusa (EIB) explained that as the largest supra-national issuer in the world, they issue bonds in multiple currencies, and see significant differences in liquidity premia. Effectively it was cheaper issuing in markets that were more liquid and transparent. However, given that rates were so low for AAA issuers, new issue premia were not a significant issue. Nicola Marcusa elaborated, adding that one also had to think about the underlying investors. For instance, reserve currencies tended to be dominated by international institutional investors and larger central banks, while smaller, localized currencies tended to rely far more on a domestic investor base.

Wrapping up: Expert Group and Workshop

Jonathan Haynes wrapped up the discussion by thanking ICMA and the SMPC members for an engaging and extremely helpful discussion. He assured the Committee that the Commission was taking the Call for Evidence exercise very seriously and that he looked forward to following up with ICMA and the SMPC members in the near future with the call for Expressions of Interest for the Expert Group. He stated that the Commission was keen to engage with market participants, and to help the market as far as it could, but it was important that information and perspectives provided by the market remain evidence based.

From a strategic perspective, he would explore how the Commission could best help facilitate bringing together market stakeholders from the respective viewpoints to aid the progress towards market-led solutions. In terms of immediate support from the SMPC, data and sources of data would be very helpful, as well as reference points to indicate better the health of the market, both in Europe and the US. This would also help inform and guide the outline of the projected Workshop for later in 2016.

Action Points

- ICMA to provide Jonathan Haynes with contact details of those attending the meeting, as well as the identified relevant trading platforms, for the Commission to follow-up with requests for data or further discussion.

- ICMA, after consultation with SMPC members, to follow-up with further thoughts and suggestions for the Commission as to potentially helpful data reference points to determine and monitor better the health and liquidity of the corporate bond market.

2) Update on proposed changes to the SMPC Chair structure

Andy Hill informed the Committee that Asif Godall, longstanding Chair of the SMPC, left his position at HSBC following the last meeting in October, and had been expected to join a prominent buy-side firm. In the meantime, and in light of the opening-up of the SMPC to become a broader, sell-side and buy-side forum, something initiated by Asif Godall, ICMA had felt it appropriate to create a Co-chair structure, with two Chairs: one representing sell-side members and one representing buy-side members. Accordingly, it was proposed that Sonali Das Theisen (Citi) assume the role of sell-side Co-chair for a term of minimum one year. In the meantime, the position of buy-side Co-chair would remain open, in the hope that Asif Godall would be able to assume this position. However, if Asif Godall was not able to take the position of Co-chair by the time of the next meeting (provisionally scheduled for May 2016), ICMA would look to identify other potential candidates.

Andy Hill asked those present and on the phone whether they had any objection to the proposed change of Chair structure, or to Sonali Thesien assuming the role of Co-chair forthwith. There were no objections to either.

Andy Hill reminded the Committee that the plan was to retain the open structure of the SMPC for the foreseeable future, and for it to remain an open forum for both sells-side and buy-side members with an interest in the pan-European corporate bond investment grade secondary markets.

Action Points

- ICMA, in consultation with the Co-chair and other members, identify a potential buy-side Co-chair by the time of the May 2016 meeting.

3) 2016 ICMA Corporate Bond Secondary Market study

Andy Hill informed the Committee that following the highly successful, and largely seminal European corporate bond market study published at the end of 2014, ICMA intended to undertake a new study in the first half of 2016. Whereas the earlier study had focused on identifying and articulating the key challenges to the market, and the underlying reasons for diminishing liquidity, it was hoped that the new study would focus more on how the market is responding and attempt to be more forward-looking. Furthermore, while the 2014 study was largely qualitative in its structure, it was intended that the new study would be more quantitative and analytical. Ahead of drafting the Terms of Reference for the new study in the coming weeks, ICMA was keen to garner the views and suggestions of the SMPC as to what they would like to achieve from the study, and where members thought it could provide most value.

Sonali Theisen welcomed the initiative, and noted that the 2014 study did in fact include some data, in particular that provided by Trax. She agreed that quantitative analysis would be more pertinent, but underlying this was the question of how easy is it to obtain relevant data, and whom to ask. But, as a starting point, it might be good to speak with Trax and other platform data providers to see what is available and what they are willing to share.

Godfried De Vidts suggested that the study should also consider the corporate bond repo market, since there is an inherent link between repo and bond market liquidity. It would therefore be interesting to look at demand and supply dynamics in the credit repo market, as well as liquidity across different term structures. Kristina Godau suggested exploring the possibility of broadening the scope of the study, perhaps to include sovereign and agency debt. The pressures on liquidity are not necessarily market specific, and can be felt across all bond markets, such as the impacts of QE on the SSA (supras, sovereigns, and agencies) markets. Andy Hill asked whether this should perhaps also be extended to cover the CDS market. David Camara agreed, suggesting that there could be a strong correlation between CDS and cash bond liquidity.

Sonali Theisen wondered if case studies could be a powerful component, perhaps tracking the liquidity of certain bonds during their lifecycle, and how this changes as they drop out of an index. A further idea could be to try to draw parallels with the loan market. This seems to have relatively stable turnover, despite no transparency, and so could provide lessons within the context of MiFID transparency. Another suggestion was to compare liquidity between equities and corporates: taking a large issuer with one equity and many hundreds of lines of bonds, but with similar market capitalization and outstanding debt. This could help highlight the challenges facing bond market liquidity, while also illustrating how equity and debt markets are fundamentally very different. Godfried De Vidts commented that this last point was still not widely understood by policy makers.

David Camara commented that he still references the original study regularly, but one problem is using the data represented in a number of the charts. He suggested that a helpful addition to the next study would be the provision of the raw data, perhaps in an annex.

Antony Baldwin suggested a two-tiered approach to the study, starting first with the data analysis, after which interviewing market stakeholders to better explain what the data shows. He further recommended checking to see what metrics the various platforms could provide.

Andrew Bowley felt that this could be an opportunity to take the discourse around liquidity to the next level. It could be the chance to ask what we mean by liquidity, and how does this apply to different markets or conditions. What is the best data or most appropriate metrics? The study could explore the alternative definitions and measures used by different stakeholders, and could help inform the development of a standardized liquidity index. Andrew Bowley added a further consideration was the importance of including the buy-side in any analysis, particularly from the perspective of holdings and the ability to liquidate.

From the issuer perspective, Volcker Lach agreed with the idea of a standardized liquidity benchmark, which he felt would be extremely helpful. Nicola Marcusa also suggested that it could be interesting to compare liquidity conditions in the secondary and primary markets and to identify if there is a potential correlation, and if deteriorating secondary liquidity led to primary issuance premia.

As a final suggestion Sonali Theisen thought it would be useful, though challenging, to try to establish dealers' capital commitments to the market, and to attempt to quantify this.

Andy Hill thanked the Committee for its valuable input and excellent suggestions, and confirmed that he would continue to reach out to members as he prepared the Terms of Reference for the study over the coming weeks. Paul Richards (ICMA) further suggested that Andy and ICMA keep the European Commission informed of the study, and share an advanced draft when in a position to do so (likely to be late in Q2 2016).

Action Points

- Andy Hill, in close consultation with Sonali Theisen and other SMPC members, to prepare a draft ToR for the ICMA 2016 Secondary Market study.

- ICMA to share the ToR with the broader SMPC, as well as with the EC. ICMA also to share an advanced draft of the final report with the EC, probably02 in late Q2.

4) BRRD and the potential impacts on the secondary market for bank paper

Katie Kelly, Director at ICMA and Secretary to the Corporate and Financial Issuer Forums, as well as the Bail-in Working Group, briefed the Committee on the work of the Bail-in Work Group and relevant issues related to BRRD.

Investor concerns

Katie Kelly informed the Committee that the Bail-In Working Group (BIWG) – a buy-side working group of ICMA's Asset Management and Investors Council – had previously compiled a discussion paper setting out buy-side views on the operation of the bail-in mechanism, which was sent to the ECB in July 2015. In general terms, it stresses the need to create conditions that allow investors to assess the range of potential risks involved in investing in bank capital, with the overarching high level concern being that extra layers of regulatory complexity may make it more difficult for banks to raise capital in the first place, and may negatively impact investor demand and investor behaviour, and thereby render bank capital uninvestable. The paper also addresses specific areas of concern, including: opacity surrounding the number of triggers and regulatory discretion surrounding their operation; the lack of available information by which investors can price risk; concerns surrounding the high stock of bad loans remaining on the books of many of the euro area banks and the perception that investors may be called upon to fund legacy problems; a lack of standardization or homogeneity, including as to the manner in which subordination of TLAC-eligible (total loss absorbing capital) instruments is achieved; the need for a consistent, predictable approach to bail-in; and the avoidance of retroactive application of any further changes to the bail-in mechanism. As a direct response to recent regulatory actions in Portugal (related to Novo Banco), the BIWG again wrote to the ECB again highlighting the more general and specific concerns and concluding that investors, who are now expected to shoulder the burden of any future bail-in of a failed financial institution, be in a position to properly evaluate and price risk.

BRRD Article 55

Katie Kelly reminded the Committee that Article 55 of the European Bank Recovery and Resolution Directive (BRRD) was implemented in Europe on 1 January 2016. Article 55 of the BRRD requires the inclusion of a contractual term in any relevant liability governed by the law of a third country whereby the holders recognize that the liability may be subject to write-down and conversion under the BRRD and agree to be bound by any such write-down and conversion. The national implementing rules require a 'contractual recognition of bail-in' clause to be included in a wide range of non-EEA law governed debt issuance documentation. In the bond space, this will include certain non-EEA law governed subscription agreements, dealer agreements, auditor arrangement letters and confidentiality agreements. When banks act as managers of bond transactions for other issuers of debt securities such as corporates, financial institutions, sovereigns and supranational entities they will enter into a number of contracts relating to their role as manager, both at the time of a bond issue and the time that an issuer establishes or updates a debt issuance program. Managers' liabilities under typical bond issues are, potentially, within the scope of BRRD Article 55, meaning a contractual recognition of bail-in may be required in various contracts that managers enter into from January 1st 2016. In light of this, a model clause for 'Other Liabilities' (i.e. not debt securities but other contractual documentation) has been developed by Cleary with input from A&O, Clifford Chance, and Linklaters, which you may start to see in a range of non-EEA law governed contracts. This clause has been prepared so that it can be used as a starting point under any non-EEA governing law contract (with appropriate review by local counsel), by any European in-scope entity as well as where both sides to the contract (e.g. the issuer and managers) are in-scope entities. The clause is subject to finalization, but is available as a starting point for use on deals.

Relevance to the SMPC

Katie Kelly suggested that members of the SMPC may want to give some consideration to any effects or unintended consequences of the bail-in mechanism under BRRD to their business.

David Camara questioned the logic of the need to include the clause in contracts such as with data vendors, even if there was no underlying risk. Liz Callaghan pointed out that this would also impact MTFs (multilateral trading facilities) that were owned by banks, as they were also subject to the same regulations as the owner bank, including BRRD. Independent MTFs, however, would not be; although David Camara explained that they would be where they were subject to New York Law.

The Committee agreed that there could be knock-on impacts for secondary market liquidity and pricing of bail-in provisions for bank paper, and that this would be monitored and discussed at future SMPC meetings if relevant.

5) Update on SMPC Working Groups and work-streams

MiFID II/R Working Group

Liz Callaghan updated the group on the recent ICMA MiFID II/R workshop, held on January 19th 2016. The workshop was a one-day event for the most active participants from the MiFID II/R Working Group, and addressed what were largely recognized as being the five most difficult or ambiguous aspects of the draft RTS from the perspective of bond markets. These were: the application of a COFIA ('class of financial instrument approach') liquidity calibration immediately following new issuance; the calibration of waivers and deferrals under the transparency regime; the application of the systematic internaliser regime; best execution obligations; and the extent to which repos were in-scope of the transparency obligations.

Quickly summing up the issues, Liz explained that the application of 'COFIA' for between two-and-a-half and five-and-a-half months immediately following issuance would most likely result in a significant increase in incidences of 'false positives' (i.e. bonds being classified under the regulation as liquid, and so in scope of pre-trade transparency, whereas applying the instrument by instrument approach – 'IBIA' – would determine the bonds as illiquid). This could lead to perverse incentives for issuers (as it would impact secondary market liquid immediately following issuance), such as issuing in sizes less than 500 million nominal and tapping at a later date, timing issuance to minimize the time period for the application of COFIA, or syndication desks targeting short-term, fast-money investors to enhance secondary market liquidity. The proposed solutions were firstly to increase the COFIA threshold for corporate bonds to 1 billion nominal, and secondly to reduce the window before the graduation to IBIA; ideally no more than six weeks.

With respect to the SSTI ('size specific to the instrument') calibration for pre-trade transparency waivers, it was felt that the 60th percentile threshold for fixed income (based on the distribution of trade sizes) was somewhat arbitrary and not appropriate. The Level 1 defines the SSTI threshold in terms of causing 'undue risk' to the purchaser. Therefore, more granular analysis to determine appropriate thresholds was necessary, or at the very least the threshold should be reduced to the 40th percentile. A further suggestion was to apply a 40th percentile threshold for the first 18 months post issuance, including trade sizes of less than 100 thousand nominal in the determination.

Liz Callaghan informed the Committee that it was widely understood that the application of the systematic internaliser (SI) regime had been amended in the draft delegated acts, and that it was now intended that investment firms that qualified as a systematic internaliser for any individual security, they would become systematic internalisers for every security within that class of instrument. In effect, an investment firm that became an SI for just one bond could, in theory, de facto be an SI in up to 31,000 different bonds. Michele Lanza (Banca IMI) explained that the logic behind this amendment was based on the fact that otherwise no firm would be an SI for new issues; this ensured that the SI regime could be applied to new bond issues. Liz Callaghan pointed out that this was inconsistent with the Level 1, however Michele Lanza explained that the European Commission was aware of the potential conflict with Level 1, but was in favour of the broader SI regime to capture new issues.

With respect to best execution obligations, Liz Callaghan reported that it was generally felt that firms were required to provide too much information, much of which was of no value to anybody, and in some cases could even lead to potential 'gaming' of sell-side positions and orders.

Finally, Liz Callaghan highlighted the confusion and ambiguity related to the application of MiFID II/R to securities financing transactions (SFTs). Among the potential issues were whether or not the SI regime would extend to SFTs, whether or repo trade data would be excluded from various determinations, and where SFTs are reported, what is actually reported: rate or price? These and other ambiguities would need to be clarified. Godfried De Vidts noted that ESMA had confirmed that with respect to transaction reporting, ESMA had already clarified that SFTs would be out of scope where they were already covered by the SFT-Regulation. Andy Hill added that most of the ambiguities related to pre- and post-trade reporting under the transparency obligations, rather than to transaction reporting.

Electronic Trading Working Group and Platform Working Group

Liz Callaghan reminded the Committee that under the SMPC umbrella, ICMA now hosted two electronic trading working groups. One (the Electronic Trading Working Group) was for sell-side and buy-side members. At its last meeting (January 25th 2016), the ETWG planned a series of interview sessions for the various platform providers to understand better and assess their product offering, connectivity, and functionality. To this end, the Group had agreed on a list of ten critical questions that they would pose to the vendors at the interview sessions. These would be conducted over the next few months. Liz further explained that the driver behind these assessment interviews was the recent collapse of startup platform Bondcube. Sell-side and buy-side platform users not only needed to have a broader understanding of what products and electronic solutions were out there, but also needed to determine better both their relevance and viability, not least since connecting to platforms required investment in technology. The assessment criteria devised by the Group was intended to facilitate this, and to create a level playing field for the electronic trading ecosystem to interact with potential users.

The other (the Platform Working Group) was for the platforms providers themselves, and had its inaugural meeting only the day before (February 3rd 2016). Liz Callaghan informed the Committee that he meeting had been very well attended, and participants had successfully agreed on the Terms of Reference for the Group as well as outlining key objectives. Key issues discussed included: how to manage potentially different interpretations or implementing standards of MiFID II across the various European jurisdictions; reporting under Market Abuse Regulation (MAR) and the requirement to develop new ISINs for a number of products where they do not exist, such as repo; developing harmonized trading error rules for MTFs; and the development of a consolidate date for fixed income.

On the last point about a consolidate tape, Andy Hill commented that this would be a fantastic outcome of the PWG, and would be an example of the market establishing a solution where the regulation had missed an opportunity.

CSDR/Buy-in Working Group: CSDR Settlement Discipline update

Andy Hill reminded the Committee that ESMA had finally published the draft RTS for mandatory buy-ins under CSD-Regulation. ICMA, working closely with AFME, had been highly engaged in advocacy work both with ESMA and the Commission over the previous twelve-to-eighteen months to help ensure that the eventual RTS established an appropriate balance between the intent of the regulation and as little damage as possible to bond market liquidity and functioning as a result of what was a highly contentious and widely opposed regulatory initiative. It did not help that the Level 1 text with respect to mandatory buy-ins was broadly perceived to be flawed, and so this presented further challenges for ESMA in drafting workable RTS.

Andy Hill stated that the good news was that ESMA, working with the Commission, and within the constraints of the Level 1, had performed something close to a miracle. For the most part they had addressed many of the challenges thrown up by the Level 1: buys-in would be initiated and managed at the trading level, taking the responsibility and risk off of settlement agents, custodians, and trading venues; the maximum possible extension period (the duration of the fail before the buy-in is initiated) of seven business days had been granted to all fixed income; and SFTs with terms of less than 30 business days were granted an exemption.

However, Andy Hill explained, there remained a significant problem in terms of the provisions for the payment of the buy-in differential: the difference between the buy-in or cash compensation reference price and the original trade price. Due to the wording in the Level 1, there is an explicit asymmetry in the direction of the payment of this differential, which under CSDR can only be paid by the selling party to the purchasing party when the buy-in or cash compensation reference price is higher than the original trade price. This causes a problem in the event that the buy-in or cash compensation reference price is lower, since this would unfairly penalize the seller and unduly benefit the purchaser. In effect, this was the equivalent to any seller of securities writing a free put option, struck at the sale price, that would become active in the event of a buy-in. Andy Hill informed the Committee that ICMA would continue to work with the Commission and ESMA to highlight this issue and address the problem. Godfried De Vidts added that this should be possible in the Level 3, but it was important to communicate the issue in an understandable way, particularly given its highly technical nature.

Andy Hill summed up by stating that despite the significant improvement in the Level 2, the broader issue of the unintended impacts of mandatory buy-ins on bond market liquidity and pricing, particularly for less liquid markets such as the corporate, high yield, and emerging markets, remained a grave concern for both investors and issuers, and that ICMA would continue to try to push eventual implementation indefinitely beyond the projected date of early 2018.

Action Point

- Andy Hill to circulate a draft paper highlighting the problem with the asymmetry of the buy-in/cash compensation price differential.

6) Any other business and closing remarks from the Chair

There were no other points of business.

Sonali Theisen wrapped up the meeting by noting that the SMPC and related Working Groups were engaged in a diverse range of important initiatives. Furthermore, the SMPC was a unique forum in that it brought together sell-side, buy-side, and other key market stakeholders, to speak as one voice for the European corporate bond market.

She thanked Jonathan Haynes for his attendance and participation in the meeting, which she hoped he found useful and constructive. Sonali confirmed that the SMPC would follow-up with Jonathan on the agreed action points, and that the SMPC looked forward to further engagement with the Commission on this important issue of market liquidity. Furthermore, the SMPC would be sure to share its analysis and findings from the projected study in the coming months.

The date for the next meeting of the SMPC was confirmed as May 17th 2016, which would be the same week of the AGM. Sonali Theisen stated that she looked forward to seeing everybody at both, before formally bringing the meeting to a close.

Andy Hill, March 9 2016