Secondary Market Practices Committee

Meeting of the ICMA SMPC, May 17th 2016

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

Attendees

In the room:

Sonali Theisen	Citi	(Co-chair)
Dinos Daborn	AxeTrading	
Mark Watters	AxeTrading	
Michele Lanza	Banca IMI	
Kieran Davis	Barclays	
Domingo Puertastrilo	BNP Paribas	
Martina Ben-Shaul	CIBC	
Arran Rowsell	Commerzbank	
Hans Henrik Duus	Danske Bank	
Morten Grove	Danske Bank	
David Camara	Goldman Sachs	
Michele Fasio	Intesa San Paolo	
Tom Jenkins	Jefferies	
Craig Colenso	Jefferies	
James Daunt	Mizuho	
Ruchi Gawri	Morgan Stanley	
Andrew Bowley	Nomura	
Pauli Mortensen	Norges IM	
Marcus Hooper	Sarasin	
Matthew Miller	SocGen	
Sam Johnson	UBS	
Josh Masters	Westpac	
Ruari Ewing	ICMA	
Patrik Karlsson	ICMA	
Alexander Westphal	ICMA	
Andy Hill	ICMA	(Secretary & acting Co-chair)

Guests in attendance:

Conception Alonso	ECB
Toma Tomov	ECB

On the line:

Philip Cramp	BGC
Stephen Fisher	BlackRock
Aaran Rowsell	Commerzbank
Oliver Huckel	HVB - Unicredit

Barbara Zittucro	Intesa San Paolo	
Brett Chappell	Nordea IM	
Alexander Shel	Shinkin	
Sylvie Bonduelle	SocGen	
Vicky Webster	AFME	(Observer)
Elizabeth Callaghan	ICMA	

Chair's welcome

Sonali Theisen thanked those in attendance and on the phone for the SMPC's second meeting of 2016. In particular she wanted to thank Conception Alonso and Toma Tomov of the ECB for joining to discuss the soon to be launched Corporate Sector Purchase Programme (CSPP). It was noted that since the announcement of the new purchases programme on March 10th many of the SMPC's initial questions related to the CSPP had already been answered in the subsequent details and 'Q&A' published by the ECB. While the ECB could not be expected to provide any further details other than those already made public, this was still an excellent opportunity for the market and the ECB to discuss the CSPP, as well as to share any concerns, in a constructive and open forum.

Agenda items

1) **Presentation and discussion with the European Central Bank: the Corporate Sector Purchase Programme**

Presentation by Conception Alonso

Following a presentation from the ECB delegation outlining the objectives and modalities of the CSPP, including eligibility, the topic was opened up to general discussion. In particular, the ECB outlined five key questions to frame the discussion:

- What are your views on the inclusion of corporate bonds in the Assets Purchase Programme?
- In your view, what could be done by the ECB to preserve market functioning?
- What are your expectations regarding CSPP purchases in the primary and secondary market?
- What are your views about the parameters of the CSPP communicated on 21 April?
- Which aspects require, in your views, to be clarified further?

Views on extending purchases to corporate bonds

The SMPC members explained that there is a risk of the CSPP causing market distortions in both the primary and secondary market. There is a fear that many asset managers and institutional investors could be crowded out of primary allocations, particularly where they have a duty to their investors and clients to apply due diligence in terms of valuations. If the ECB is trying to maximize allocations, while showing less sensitivity to valuations, this could disadvantage investors. Whilst one of the objectives of the APP is to drive portfolio rebalancing and support for lower grade assets, many asset managers do not have the mandate to move down the credit curve or away from IG/high quality assets. Therefore, there is a concern around return generation for predominantly IG investors.

Preserving market functioning

The SMPC members suggested that employing a systematic (and communicated) measure of security liquidity could be helpful in avoiding causing market distortions. Careful, ongoing monitoring of liquidity conditions could be critical.

Another suggestion related to the repo facility of the CSPP. It is broadly felt that credit repo markets are already suffering from a significant drop in liquidity. Not only is it important that the NCBs make purchases available for repo and securities lending, but they should do so in a harmonized, easily accessible, and, ideally, centralized way. Furthermore, NCBs should be encouraged to make odd-lots (sub 1mm shapes) available, whether directly or through their agent lenders.

Further ideas put forward by the Committee included a recommendation for a degree of price sensitivity, both for primary and secondary purchases, which would be helpful in avoiding market distortions. Also, an 'axe/inventory driven' approach by the NCBs, rather than forcing the market, is preferable for secondary purchases.

The SMCP recommended avoiding overconcentration in individual lines (not least since 70% of an issue very high). Identifying the distribution of holdings of individual bonds in the secondary market could also be helpful, since this is a critical consideration in assessing liquidity and the potential for price distortion.

Finally, it was noted out that keeping purchases to the low-end of expectations would also be helpful (much less than €5bn per month).

Expectations

SMPC members suggested that estimates of the average size of monthly purchases would point to close to €5bn, with a skew toward primary market purchases over secondary market purchases. The general view was that the majority of purchases will have to be in the primary market since this is relatively liquid, while secondary market liquidity is largely impaired; especially if trying to execute larger sizes.

The general sentiment, however, is that at the outset the purchase programme will focus on the secondary market, before shifting the skew to primary purchases as the programme evolves. It was broadly felt that for secondary market purchases, a pragmatic approach of accumulating smaller ticket sizes and adopting a more responsive, axe/inventory driven approach will be necessary.

Communicated parameters

The SMPC members felt that many of the market's questions and concerns were clarified in the release on April 21 and the subsequent Q&A. It was noted that these had been very helpful. Furthermore, applying a benchmark portfolio approach to guide purchases was widely welcomed, and it was felt that this should go some way to avoiding distortions in some segments of the market. Keeping the pool of eligible assets (including maturity range, domicile of issuer, and non-bank financial issuers) as broad as possible was also welcomed.

Further clarification

The SMPC members appreciated that it was not possible (or even appropriate) for the ECB to provide full disclosure on the modalities of the CSPP. That said, the SMPC felt that any information the ECB is able to share in the following areas would give the market additional clarity and help to support market stability: (i) any valuation models applied to determining pricing in the primary and secondary market (ii) the intended size of purchases, both in primary and secondary; (iii) how the ECB will manage any holdings that are downgraded to sub-IG ; and (iv) how the ECB intended to measure and monitor liquidity in the various eligible securities.

Summing up

The co-chairs stated that the SMPC was keen to continue close and constructive dialogue with the ECB as the Programme is implemented. It was explained that as the principal market forum for European IG Corporate Bonds, including both buy- and sell-side firms active in that market, the SMPC is well placed and very happy to put itself at the ECB's disposal as a sounding-board for the ongoing market impact and potential refinement of the CSPP, and to help ensure that it achieves its objectives with minimal market disruption.

The ECB delegates thanked ICMA and the SMPC for the opportunity to discuss the CSPP with market participants, and to hear some of the concerns and suggestions of key stakeholders.

Action point: SMPC to remain in contact with the ECB and provide regular feedback on market impacts of CSPP, particularly with respect to secondary market liquidity.

2) Managing fund liquidity in Europe

Patrik Karlsson, ICMA Director and secretary to the Asset Management and Investors Council (AMIC) provided a brief overview of a paper published jointly by the AMIC and the European Fund Managers Association (EFAMA) on managing European fund liquidity.[1] Patrik Karlsson explained that the paper was written in response to public concerns that liquidity has become more fragmented, whether as a result of the reduced role of banks as market makers and liquidity providers or the prolonged accommodative monetary policy of the world's most prominent central banks. The paper argues that the existing EU regulations and tools available in most European jurisdictions prove both comprehensive and appropriate for liquidity management in both normal and exceptional circumstances and were positively tested throughout various market conditions. He explained that the paper also explores the

[1] Managing fund liquidity risk in Europe: an AMIC-EFAMA report, April 2016

current widespread use of complementary market based liquidity risk management tools available in a number of EU jurisdictions. Some of the tools described include: swing pricing; dual pricing / redemption fees; dilution levy; in-kind redemptions; out of the money gates; suspension of dealings; side-pockets; and temporary borrowing from non-government sources. Recourse to these tools is common across many jurisdictions and they have proven successful by enabling fund management companies to counter all sort of market events.

The paper proposes three recommendations that should lead to improvements in the general liquidity management environment in Europe. Firstly, it encourages the wider use of available non-legislative recognized market-based tools to all European jurisdictions. Secondly, it strongly encourages the use of existing data already currently reported to national authorities in Europe for improving the analysis of liquidity risk by the European Securities Markets Authority (ESMA) and the European Systemic Risk Board (ESRB). Last, it encourages the continuing efforts by European and national trade associations to develop further guidelines for best practice in liquidity risk management.

In terms of reaction to the paper, Patrik Karlsson explained that there had been some interest from policy makers and regulators with respect to disclosures, in particular that of different asset classes, and not just liquid versus illiquid holdings. Also, not all regulators agreed with the positive assessment of the risk management framework and felt that this had not been fully tested.

Action point: AMIC to keep the SMPC informed of further work undertaken on the issue of fund risk management, particularly with respect to corporate bond fund liquidity

3) MAR Investment Recommendations

Andrew Bowley (Nomura) provided the SMPC with an update on the current status of discussions with the FCA with respect to the MAR provisions for investment recommendations. He explained that the definition of 'investment recommendations' under MAR, was 'information recommending or suggesting an investment strategy, explicitly or implicitly, concerning one of several financial instruments or the issuers, including any opinion as to the present or future value or price of such instruments, intended for distribution channels or for the public'. He also noted that the previous exemption in MAD for 'short-term investment recommendations' had been removed in MAR.

What constituted as investment recommendations was critical, since MAR provided for extensive and onerous tracking and disclosure obligations for these recommendations.

Andrew Bowley explained how this created an unclear position for short-term sales commentary. The UK FCA has suggested that they believe all sales communications fall into one of three buckets: (i) a fact; (ii) an investment recommendation; or (iii) investment advice (and so falling under MiFID II). This creates ambiguity in terms of determining what is an 'investment recommendation' and 'investment advice'. Key to this is determining what constitutes distribution channels. This was particularly important since the FCA view was that any communication with more than one client constituted a distribution channel. He noted that ESMA were expected to provide guidance on this in a projected 'Q&A', but this would not be published until after MAR was due to go live on July 3rd.

Andrew Bowley stated that Nomura's view was that distribution channels would need to consist of multiple recipients of the advice, but the FCA seemed reluctant to accept this argument, feeling that anything that did not constitute a fact or was classified as investment advice, should be classed as an investment recommendation. Their fear was that otherwise there would be a regulatory black-hole.

Sonali Theisen raised the point that there was in fact a fourth bucket, which was a non-personal recommendation, and that was neither investment advice nor an investment recommendation. She pointed out that otherwise it would be difficult for anybody to have a market discussion with their client. Andrew Bowley concurred, stating that in many cases sell-side firms would have to stop providing advice. Pauli Mortensen (Norges IM) added that sell-side firms might only be able to have market discussions in response to client enquiries, and so only related to specific individual topics. Andrew Bowley commented that in this case, it could then fall under investment advice. Patrik Karlsson explained that this was likely to be more of an issue for buy-side firms that relied on investment recommendations from their banks, but in many cases this would not necessarily be a problem, a sentiment that was echoed by Brett Chappell (Nordea AM).

Andrew Bowley and Liz Callaghan (ICMA) informed the group that there would be an FCA Roundtable the following week to discuss this issue, in which ICMA and some representative members would be participating.

Action point: ICMA to update SMPC on the outcome of the FCA Roundtable

4) Review of the ICMA Buy-in Rules

Andy Hill informed the SMPC that ICMA proposed to launch a consultation of its members related to the Buy-in Rules in ICMA's Secondary Market Rules and Recommendations. This is in response to member feedback suggesting that buys-in are becoming increasingly more difficult to execute, primarily as a result of the more challenged market liquidity conditions, particularly for credit, emerging markets, and sub-investment grade bonds.

The consultation would be designed to inform a review of the Buy-in Rules, which is expected to result in revised rules, designed to improve the efficiency and flexibility of the buy-in process. Key areas under review will be the timeline of the buy-in process, particularly to the extent that ICMA buy-ins are analogous with other buy-in mechanisms, including repo terminations under a GMRA, and the requirement to appoint a buy-in agent. Furthermore, the new Rules are expected to provide for the possibility of a buy-in auction process, which could be facilitated by trading venues.

Andy Hill noted that while CSD-Regulation provides for a harmonized buy-in mechanism across the European Union, the regulatory technical standards are still to be finalized and are not expected to be enforced until late 2018.

SMPC members agreed that executing buy-ins was becoming more challenging, and that many firms now refused to act as buy-in agents. It was agreed that ICMA should conduct the proposed consultation, and that the Buy-in Rules should be reviewed and improved where possible.

Action point: ICMA to launch consultation of the Buy-in Rules as soon as possible, with a view to putting proposed amendments to the SMPC in H2 of 2016

5) Secondary market regulatory updates

MiFID II/R

Liz Callaghan provided a briefing on latest developments with MiFID II/R. Firstly, with respect to RTS 2, she noted that the European Commission has proposed a 4-year phase-in process for average daily trades and SSTI percentiles (size specific to the instrument). ESMA has accepted this but has strongly recommended an automatic phase-in where there is no chance of a delayed trigger to the next stage. She explained that the Commission's assessment was that a phase-in will not be automatic and move to the next stage without an ESMA approved procedure and a new or amended RTS. So the market cannot proceed to the next stage (of average daily trades or SSTI) until a 'green light' is given. The ESMA assessment, however, is that a phase-in will be automatic and move to the next stage without a new or amended RTS. So the market can proceed to the next stage on an annual basis (average daily trades or SSTI percentiles) automatically unless a 'red light' is given, indicating there are significant negative impacts that warrant a halt to the next automatic stage. 'Significant' is not defined.

With respect to package transaction*s,* Liz Callaghan explained that the European Parliament had accepted the Council drafting on packages. The outline compromise is that a package order should be considered as large in scale (LIS) if at least one of its components is large in scale, unless the package overall is deemed to be liquid.

Liz Callaghan also informed the Committee that securities financing transactions ('repos') are now exempt from MiFID II regarding pre-trade and post trade transparency requirements in relation to trade and transaction reporting. However, she stressed that it was important to note that repos are in scope for Best Execution obligations under MiFID II and still seem to be in scope for MiFID II transaction reporting for repos that are exempt under SFTR (in particular repo transactions with central banks).

Liz Callaghan suggested that once the final RTS have been approved, the MiFID Working Group would hold another workshop, this time more focused on implementation and advocacy related to the Level 3.

CSDR settlement discipline

Andy Hill informed the group that ICMA had met with DG FISMA the previous month to discuss the draft RTS of CDSR at it relates to mandatory buy-ins. Of particular concern was an explicit asymmetry in the settlement of the buy-in, or cash compensation, that only allowed for the differential between the buy-in/cash compensation price and the original trade price to be paid by the failing seller in the case where the latter is higher than the former. Andy Hill explained that this asymmetry does not exist in most buy-in mechanisms (such as under the ICMA Rules) and is the economic equivalent of the seller of securities simultaneously writing an at-the-money put option that becomes active in the event of a buy-in (the so-called 'CSDR put'). He reported that the Commission was relatively responsive, and understood the issue. They were also keen to discuss the potential implications of the 'CSDR put' for market behaviour and liquidity, and the SMPC, in conjunction with the European Repo and Collateral Committee (ERCC), would follow up on these issues. However, it was made clear that the asymmetry was imbedded in the Level 1 regulation, and that it was therefore unlikely to be addressed.

Andy Hill also noted that with regards timing of implementation, the RTS had been expected to be accepted by the co-legislators already, but this was now looking as if it would be delayed until Q3. Assuming that the recommended 24-month delay in implementing the settlement discipline measures is accepted, this could mean that mandatory buy-ins do not come into force until late 2018.

6) Best practice for clarity of what is being in the grey market

Ruari Ewing, ICMA Senior Director and secretary to the Primary Market Practices Committee (PMPC), introduced the topic of market best practice for trading in the grey market. He provided the example of a recent Bahrain issue that was expected to be tapped. When the issuer was subsequently downgraded to sub-investment grade, a number of funds who were expecting to receive primary allocations of the new tap sold ahead of this in the secondary market. When the issuer then decided to pull the tap, this left the funds short, as it was not clear whether they had sold the existing issue, or the 'when and if issued' tap allocation. This raised the question of whether there should be different ISINs, or identifiers, for the tapped portion of existing issues ahead of issuance and subsequent fungibility.

It was commented by some of the SMPC that Bloomberg and others use the same identifiers/ISINs for immediately fungible taps. James Daunt (Mizuho) noted that when trading issues expected to be tapped, one is assuming the whole ISIN risk, and that adding tap settlement conditionality to the terms of the trade would be overly complex, not least from a legal perspective.

In conclusion, the general opinion of the SMPC was that when trading in to-be-tapped issues, it was important to be clear as to one's intentions and communicating accordingly. In the meantime, there seemed to be no string desire to create separate identifiers for the to-be-tapped portion of a fungible issue.

7) 2^{nd} ICMA IG Corporate Bond Secondary Market Study

Andy Hill informed the Committee that a number of interviews for the study had already been conducted, with more to do, and he encouraged SMPC members to reach out to him if they had not already participated. He further added that ICMA was investigating the possibility of collaborating with a data provider to produce a market liquidity indicator. Finally, he expected the final report to be published, on schedule, in early July.

8) Approval of the minutes of the meeting on May 4^{th} 2016

There were no objections, and the minutes were approved as a fair and accurate representation of the meeting.

Closing remarks

Sonali Theisen thanked everybody in the room and on the call for their active participation, and ongoing engagement in the SMPC. She looked forward to seeing them again at the next meeting of the SMPC which would be scheduled for August.

Andy Hill, May 24 2016