

Consultation Paper for Market Making in Corporate Bonds

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Category: market intermediary/ participant (mention type/ category) or public (investor, academician, etc.) Public – Industry association			
Sr. No.	Proposal	Comments/Suggestions	Rationale
11.1	Applicability	The proposed applicability criteria for issuance are potentially flawed. The scope of applicability should be revised.	As it stands, 11.1(a) does not take account of the possibility that issuers could either (i) come to the market with a large initial issue (or issuances) after the last date of the previous financial year (which would be out of scope of the framework), or (ii) have bonds mature after the last date of the financial year bringing their outstanding debt below the prescribed threshold. Consideration should be given to the possibility of more flexibility to applicability, rather than applying a strict cut-off date.
11.3	Responsibilities of the Issuer	There should be no direct or formal obligation of the issuer to support market making in their debt securities. The role of corporate issuers in supporting the secondary market for their debt securities can in no way be compared to that of sovereign debt management offices.	In most developed corporate bond markets, there are no formal arrangements between issuers and market makers (“MMs”). An exception could be in the case of sovereign debt, where sovereign issuers may maintain a formal structure of Primary Dealers (“PDs”) with specific obligations (such as continuous two-way quoting or attaining specified turnover quotas). Sovereign DMOs may also provide specialist schemes to support PDs, such as repo facilities. However, such issuer

		<p>The one possible exception could be in the case where the issuer pays a fee to the market-maker in return for a commitment to provide secondary market liquidity in nominated bonds (see response to 11.6).</p>	<p>arrangements are usually unique to sovereign debt and are not common for corporate bonds.</p> <p>Historically, primary market underwriting and syndication arrangements with corporate issuers could include a commitment to provide secondary market liquidity, either for the life of the bond, or for a specified initial period (such as the first few years after issuance). More recently, such agreements have become less formal and more implicit.</p> <p>The primary incentive for banks and broker dealers to provide market making services is commercial: providing a holistic service to their investor client base (access to both primary and secondary market liquidity) and the potential to generate revenue from this. The commercial incentive for market makers to perform this service should be the focus of any regulatory interventions, and not the issuer-market maker relationship.</p>
11.4	Inventory for market making in identified ISINs	<p>Option 2 (Secondary market) Model II is the most appropriate model.</p> <p>Option 1 (Reservation in Primary issuance) may be helpful in supporting secondary market liquidity in the initial period following issuance.</p> <p>Option 2 Model I is overly complicated and relies too much on the involvement of the issuer. It is not recommended as a workable model to support secondary market liquidity.</p> <p>A possible exception to this is the suggestion of a fee-based arrangement</p>	<p>Ordinarily, market makers take positions in ISINs for which they are recognized market makers through their normal market making services: providing bids and offers in response to client requests. It is important to note that these positions are not only long (inventory) but can be short. Anecdotal feedback from corporate bond market makers in the European market suggest that around 30% of market maker sales are not supported by inventory, meaning that the market maker is taken short. In other words, roughly 15% of all market maker transactions result in a short position.</p> <p>Given the range of ISINs for which market makers provide liquidity, it is impractical for them to hold inventory for every ISIN. Rather, they will look to take positions (long or short) either in response to or in anticipation of client demand and will subsequently look to trade out of these positions: either offlaying with clients or with other market makers in the interbank market.</p>

		<p>between the issuer and market-maker to provide liquidity in nominated bonds (in Option 2 Model 1). However, this should have no further commitment or involvement of the issuer, and should only result in obligations for the market-maker (see 11.6).</p> <p>The establishment of an interbank market for market makers, with intermediation by inter-dealer brokers (acting as agent or principal), could be a useful addition to the secondary market ecosystem.</p> <p>For conducting active market making activity, MM at times will be selling the bond without having it in the demat account as the same would get credited later either through a repo or from the issuer. We understand this will not be considered as a short sell transaction and there would not be any restriction on the same.</p> <p>In case of secondary market, as the MM would be buying the bond from the secondary market, we would suggest that regulated entities/MMs should be allowed to sell the bonds on the same day once CBRICS reporting and confirmation is done for the buy</p>	<p>Given that most secondary market activity in a corporate bond tends to be in the first few weeks (and even days) after a bond is issued, it may be that market makers elect to take a portion of a new issue onto their trading books to support liquidity during this period (consistent with Option 1).</p> <p>Otherwise, it would seem highly unusual to have any corporate issuer involvement in the provision of secondary market liquidity.</p> <p>It is also worth recapping how market makers generate revenues from their trading activities, which is not risk free (nor commission based).</p> <p>With respect to carry on positions, this is not simply a case of receiving accrued interest (coupon) on long positions, and symmetrically paying accrued interest on short positions. This has to be set against financing costs (repo interest paid or earned) as well as carry costs associated with any hedges. Holding positions (long or short) can result in negative carry as well as positive carry: something that the market maker needs to build into their pricing.</p> <p>With respect to bid-ask spreads, this reflects a number of inputs, including: the cost of capital and liquidity requirements associated with the position; the cost of carry, including hedging costs; the bid-ask spread for the associated repo and hedges; expected price volatility (usually the largest component of the bid-ask spread); any liquidity premium (related to how frequently the bond trades and/or size of the transaction); directional skew (based on any view of market performance); and then any profit margin. In factoring these variables into the price, the market maker will also need to estimate the time required to unwind the position. Any miscalculation of these inputs will have an impact on the trading profits of the market maker.</p>
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11.5	Funds for market making	<p>The capital and financing to support market making activity should be generated independently by the market making entity. The issuer should have no responsibility nor involvement in how the market maker funds itself.</p>	<p>The market making function for bonds is dependent on a number of critical considerations:</p> <ul style="list-style-type: none"> • The ability of the market making entity to provide capital to support its risk-taking activity and its long or short positioning. • The ability of the market maker to finance its long or short positions (usually through the repo or securities lending market). • The ability of the market maker to hedge their risk (both interest rate and credit). This could be through taking opposite positions in government bonds or other corporate bonds, or through derivatives, in particular interest rate swaps (IRS) and credit default swaps (CDS). <p><i>(see also CGFS Papers No 52: Market-making and proprietary trading: industry trends, drivers and policy implications (2014))</i></p>

			<p>In supporting the development of a deep and liquid secondary market for corporate bonds, policy makers and regulators therefore need to give consideration to: the appropriate cost and calibration of risk capital and liquidity requirements for market making activities (such as Leverage Ratio, LCR, and NSFR); the existence of a liquid and efficient repo and/or securities lending market; and the existence of liquid and efficient hedging markets.</p> <p>In the context of access to financing, it is strongly recommend that measures are put in place to support the development of an effective credit repo market (see ICMA: The European credit repo market (2017)).</p>
11.6	Responsibilities of market maker	<p>The responsibilities of market makers in corporate bonds should not be overly prescriptive and should largely be principles based. Market makers should be afforded a degree of flexibility and discretion to manage their risk and capital parameters, as well as to respond to different market conditions (which can also affect their ability to finance or hedge positions).</p> <p>The one possible exception could be in the case where the issuer pays a fee to the market-maker in return for a commitment to provide secondary market liquidity in nominated bonds. Under such arrangements, it may be appropriate for the market-maker to conform to certain obligations and targets with respect to (i) turnover, (ii) quotes, and (iii) bid-ask spreads, while</p>	<p>In most developed corporate bond markets, there are usually no specific requirements for market makers to provide quotes, whether on a continuous basis or in response to an RFQ. Nor is there is a requirement to meet certain quotas, whether with respect to providing quotes or execution thresholds. Rather, firms providing market making services take it upon themselves to provide their clients with the best possible service with respect to pricing and liquidity, recognizing that they are in competition with other market makers.</p> <p>There are a number of factors that affect the ability of market makers to provide competitive pricing and liquidity. As already mentioned, these include the cost and availability of capital needed to support their risk taking and long or short warehousing, access to and costs of hedging, and access to and costs of the repo/securities lending market. All of these elements are also directly impacted by levels of market volatility. Market makers therefore need the ability to modify their activities in response to constraints related to risk, balance sheet, financing, and hedging, all of which are subject to change.</p>

		<p>still affording the market-maker a high degree of discretion.</p>	<p>More principles-based obligations of market makers may be more meaningful, rather than prescriptive, quantitative targets. These could include, but not be limited to:</p> <ul style="list-style-type: none"> • Market makers should make publicly available the ISINs for which they are market makers • Responses to RFQs should be as close to immediate as possible • Electronically streamed or posted prices should be regularly refreshed and as close to actionable prices as possible • Prices flagged as “firm” should be executable in the quoted size • Every effort should be made to settle trades on the intended settlement date <p>A useful basis for market best practice in providing secondary market pricing can be found in the ICMA Industry guide to definitions and best practice for bond pricing (2021).</p> <p>Market makers may also have separate commercial arrangements with trading venues to provide liquidity in certain ISINs, which is common in some jurisdictions.</p> <p>Another important consideration is that in many corporate bond markets, much of the liquidity is centered around market maker positions (or orders or interests), known as “axes”. An axe to buy or sell could be indicated through a more aggressive bid or offer (ie a skewed bid-offer spread), but market makers also communicate axes directly to clients, either bilaterally or multilaterally through specialized trading venue protocols. In recent years, as it has become more costly for market makers to warehouse positions, axes have become a prominent component of the secondary market liquidity paradigm.</p> <p>It is also important to remember that ultimately it will be the market makers’ investor client base that will assess the performance and reliability of the market maker and will direct business accordingly.</p>
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11.7	<p>Compliance requirements for a market maker</p> <p>It is stated that a market maker shall maintain arms-length relationship between its market making activity and any other activity.</p>	<p>Appropriate policies for risk management, governance, and maintaining records for market making entities are highly recommended.</p> <p>While such policies are important for the integrity and stability of the market, they should not be prescriptive, and it should be left to the market-making entity to establish their own governance, risk, and auditing policies and processes, subject to any legal or regulatory requirements.</p> <p>PDs have a trading desk for dealing in G-Secs and corporate bonds. We understand that Traders who are part of the trading desk already dealing into G-Secs and corporate bonds for PDs own trading/investment book, would also be permitted for market making activities as well.</p>	<p>It would not be feasible for PDs to create a separate trading desk only for market making activities. Hence, we suggest to insert a clarification for this in the final guidelines.</p>
11.8	<p>Incentives, dissemination, and monitoring by stock exchanges</p>	<p>Incentives for market makers to provide liquidity on stock exchanges could be helpful. However, it is generally unusual for corporate bonds to trade on exchanges as the market is far more suited to trading bilaterally or through venue based RFQ protocols.</p> <p>A degree of public transparency for secondary market trading activity is</p>	<p>Consideration should be given to providing more meaningful incentives to investment firms to act as market makers. In particular, thought should be given to the calibration of capital and liquidity rules as they apply to market making activity, including related financing and hedging, and assessed against the broader economic benefits of deep and liquid corporate bond secondary markets.</p> <p>Equally, it is important to avoid creating unnecessary disincentives, such as disproportionately onerous reporting requirements, or overly punitive</p>

		<p>helpful and can support market integrity and liquidity. However, calibrating what information is made available and when requires careful consideration, since too much information can create risks for both investors and market makers, thereby reducing liquidity and widening bid-offer spreads. What is proposed in the consultation paper (11.8b) is likely to be counterproductive.</p> <p>Most importantly, any information that is made publicly available should not compromise the risk of market-makers.</p> <p>Monitoring and enforcement of compliance of market makers to their regulatory obligations is important for the integrity of the market.</p>	<p>provisions for failed settlements (such as the recently aborted EU mandatory buy-in regime proposal).</p> <p>Perhaps one of the most important considerations with respect to disincentivizing market makers (as well as investors) relates to the public disclosures of trading activity and transaction information. The regulatory promotion of trading transparency is one of the IOSCO Principles of Securities Regulation (IOSCO 2017), with public transparency and accessibility to information viewed as key components of robust capital markets. This can be important in supporting price discovery, evidencing best execution, and providing confidence to market users. This in turn can help to underpin market liquidity and resiliency. However, the calibration of publicly available information needs to be viewed in the context of market structure and the potential impacts this can have on the ability and willingness of market makers to assume risk.</p> <p>Compared to equity or even government bond markets, corporate bond markets are highly illiquid by nature, with most ISINs trading rarely. Even in developed corporate bond markets such as the US or EU, it is not unusual for some bonds not to trade for weeks or even months. Secondary market liquidity is therefore heavily reliant on the ability and willingness of market makers to take the other side of a client trade and taking a long or short risk position in doing so. They will then look to hedge and finance this position until a time when they are able to unwind it (either with another client or in the interbank market). This could take days, weeks, or even months. In the meantime, they will be very sensitive to information leakage. Public knowledge that they are holding this position could adversely impact the price as well as their ability to trade out of the position, leading to significant trading losses.</p> <p>In this context, making publicly available the trading activity of market makers, including the volume and price of transactions in a particular ISIN, at the end of day, would significantly increase the risk borne by</p>
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11.9	Implementation	It is recommended that issuers do not have any direct responsibilities to or involvement in the obligations of market makers.	