ICMA

International Capital Market Association

Axe Distribution Best Practice Standards

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Disclaimer

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Introduction

To some outside the fixed income trading world, the term ‘axe’ is an odd name to use for advertising buy or sell bond interests. In equities the self-explanatory term that is used to advertise buy or sell interests is “Indication of Interest” (IOI). Whereas in fixed income the common term used to advertise buy or sell interests is ‘axe’. ‘Axe’ originates from the phrase “axe to grind”. This does not explain why this term is used in bond trading as the phrase “axe to grind” has usually meant one person having a grievance with another and seeking retribution, so they sharpen their ‘axe’ in preparation. However, in bond trading the term ‘axe’ has over the years come to represent a sell-side’s advertisement of buying or selling interests. These interests are traditionally tied in some form to the sell-side’s book but can also be driven by client orders and even a trader’s market view/valuation.

For many years in fixed income, and particularly in the sphere of electronic trading, there has been keen interest in axe distribution practices. This is because axes are vital to bond trading. Counterparties use axes to source liquidity, form initial price points and price improve price quotes already received, potentially bringing the price inside the bid-ask spread.

Axes are indeed important and greatly assist traders. Yet not all distribution behaviour is uniform and this is causing much consternation amongst buy-side market participants. Some behaviour is substandard, although not always intentional. Sometimes a case of thoughtless practice. As a result, there is scope for axe distribution practices to be misleading and unfortunately there has never been a guide to best practice for axe distribution. Through discussion and investigation into acceptable and less acceptable axe distribution practices, ICMA’s Axe Standard Working Group (a subgroup of ICMA’s Electronic Trading Council [ETC]) aims to address this situation and stabilise axe distribution practices.

Background

Today, axes are communicated from sell-side to buy-side through trading venues/vendors and axe networks. Several distribution methods allow for targeting of axes and they can also connect to the buy-side trade lifecycle (portfolio management and post-trade activity) through OMS and EMS software. While the distribution methods can vary, the communication is considered bilateral. The 'owner' of an axe is the sell-side who is advertising the buy or sell bond interest to potential counterparties, who do not interact with each other.

Frequently experienced today is confusion as to what the difference is between runs and axes. Runs are considered a basic indication of where a market might be in relation to a bond or bonds and axes are a stronger indication but the line between the two is often blurred. Clear guidance and definition of the differences between runs and axes are needed in order to not mislead potential counterparties or create false markets (see industry accepted understanding below for runs, axes, streaming prices/quotes (and variants)).

With trustworthy guidance in relation to axe distribution, the sell-side can advance their product offerings in the market. The same holds true for trading venues and technology providers.

Yet, without set axe (and run) distribution standards, there will continue to be instances of misleading axes, leading to misleading market representation. Robust axe distribution standards could decrease the cases of stale axes (old or out of date prices are widely experienced today) and promote real-time electronic axe distribution. Surprisingly, there is still manual spreadsheet updating of axes. Solid axe distribution practices would enable the buy-side to have the confidence to take advantage of auto-pricing tools and trends in electronic trading. If they trusted the prices, they would trust the associated technology.

The buy-side has also found order management systems have improved enough in recent years to handle actionable and targeted axes. However, buy-sides strongly suggest a standardised axe/run structure needs to be put in place to organise the market before actionable or targeted axes can become standard practice in secondary bond market trading.

With set axe distribution standards, internal scrutiny in buy-sides will be easier to manage. Traders will be able to provide snapshot evidence as to where and when they dealt, compared with the market at time of trade. They won't be in the position of having to 'justify' decisions internally in audit/best execution meetings, which is occurring today.

From a buy-side perspective, set standards for axe distribution will lead to more trust.

Definitions, as understood today

Many market participants believe the crux of the confusion with axe distribution is that some sell-sides do not have the same understanding as to the difference between axes, runs, streaming prices and their variants; or worse, they do understand the difference but are vague in communicating those differences to the market.

The understanding in the market today regarding axe distribution is that runs, axes, streaming prices, have nuanced characteristics or at times obvious differences. It is those nuanced characteristics/obvious differences that dictate actions when looking to trade with potential counterparties.

For example, **Runs** are considered indicative. No size or direction is mandated with a run. There is also no relationship to a position, and they are often electronic but more of a scatter gun approach. However, they can be distributed through more manual methods such as emails and electronic chat messaging. The updates are infrequent, and runs are often sector based.

Something that is frustrating to many buy-sides is what is referred to today as a *'two-way axe'*. Buy-sides have reported that they consider this term misleading and would prefer any reference to a 'two-way market' be referred to as a '**Market run**'. This would then be a correct reflection of a '*working market indication*'. Direction is shown as bid <u>and</u> offer and the updates are infrequent. There is also no clear relationship to a position.

Axes are by far the most prominent pre-trade bond indication of interest. However, they are often used incorrectly when meaning runs. Axes often are targeted to clients based on specific needs. Importantly, they are indicative but much firmer than runs. Direction is shown as bid or offer and there is a relationship to a position. Axes are updated frequently, demonstrating the sell-side is truly keen to buy or sell.

Streaming prices/quotes are considered indicative. However, they are most often specifically targeted based on counterparty need. The distribution can be through vendors, networks, or a direct buy-side/sell-side connectivity channel API. The direction is bid and/or offer and the updates are distributed electronically, and the frequency is high.

Benefits of axe analysis

Buy-sides and sell-sides gain benefit from analysing axes. However, the axe analysis benefits are different from buy-side to sell-side. Improving axe distribution standards and creating best practice axe distribution protocols will only improve axe analysis.

The primary analysis the buy-side would like to carry out is, who stands up to their axes and who does not and how often. They would also like to see historical inventory, price slippage and which liquidity provider price improved most often. Furthermore, for liquid bonds, they would like to spot routine differences between axes and streaming prices.

Ultimately, the buy-side would like to carry out analysis that will help to stop any perceived exploitation of leaked information for gain, speculative behaviour, or SPAM axe behaviour e.g. LATAM axes being sent to desks that do not trade LATAM.

The sell-side would like to see what specific data point drove the execution, who in the buy-side firms are looking at the axes (PM, trader, others?). The sell-side would also like to determine how the use of automated axe and pricing flow can better service their clients. In addition they would like to further dig deeper to better understand dealer selection reasoning, in order to improve products. Finally, of critical importance is to analyse why sell-side firms might not be getting business, when the perception is the firm is doing all the right things.

Guide to best practice

In order to clear up any confusion amongst bond trading market participants related to advertised bond interests, halt axe related misleading markets, realise the benefits of axe analysis and allow axe distribution to evolve, a guide to best practice is needed. One that is referenceable, consequential (similar to ICMA's ERCC guide to best practice for repo markets) and meets all existing regulatory obligations, such as MiFID II/R and Market Abuse Regulation (MAR).

Currently, ICMA's Axe Standard Working Group (ASWG) is carrying out axe distribution practices analysis. Through rigorous discussion amongst ICMA's market participant members; buy-side, sell-side, trading venue and technology providers, the plan is to determine industry accepted definitions and propose best practices for axe distribution, taking into account the various channels of distribution.

The ASWG is looking at unique characteristics of runs, market runs, axes, and streaming prices/quotes. Key elements of setting out characteristic-based definitions for these various pre-trade indications of interest, is understanding the update frequency level (infrequent, frequent or high) and whether the these pre-trade prices/quotes are 'passive' or 'active' (keen or ready to trade).

The ASWG will first publish its industry agreed axe characteristic findings in the form of a matrix and then in the next stage set out best practices for these runs, market runs, axes, and streaming prices/quotes. This cross-industry supported ICMA 'Guide to Best Practice' initiative will attempt to clear confusion and establish acceptable best practices amongst buy-side, sell-side, trading venue and network market participants for bond market axe distribution.

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