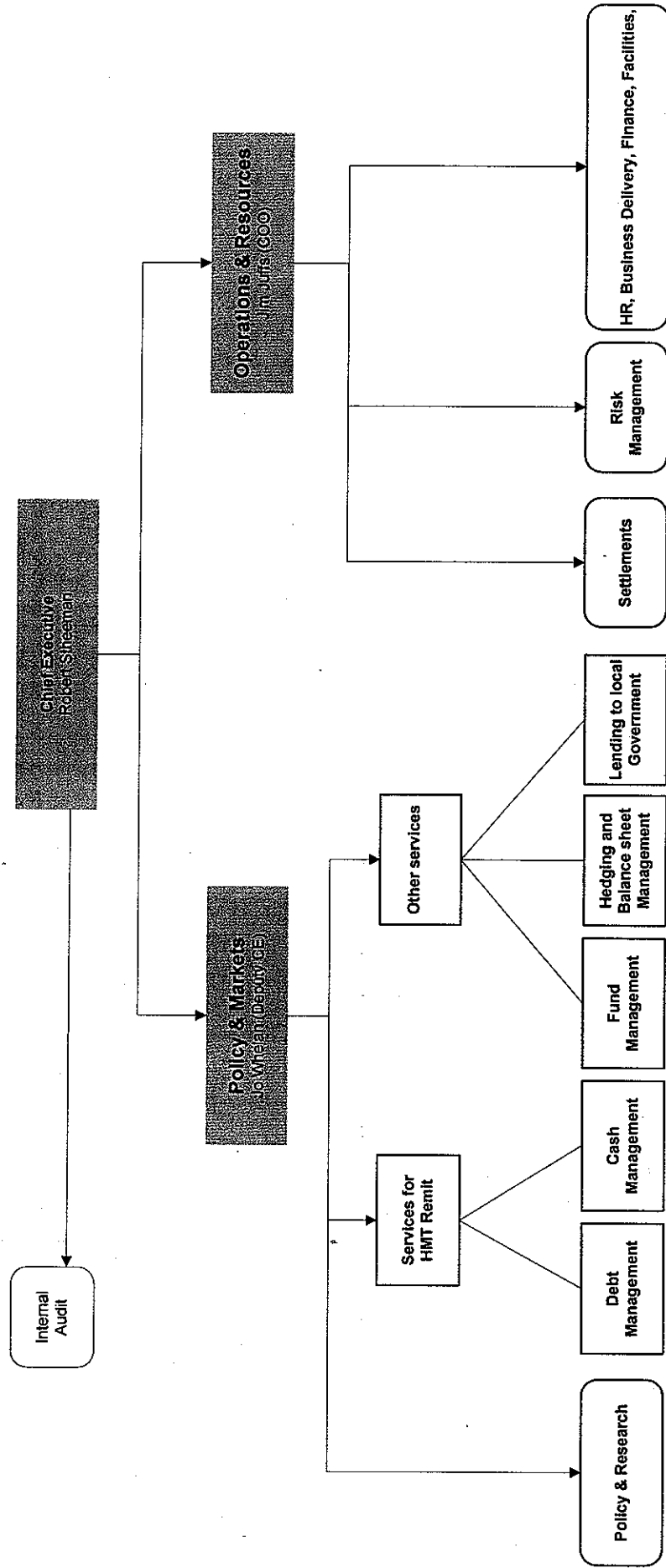


# DMO Functional Structure



# GUIDEBOOK



**“A guide to the roles of the  
DMO and Primary Dealers in the  
UK government bond market”**

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## CHAPTER 1 – INTRODUCTION

1. This 'guidebook' describes in detail the UK Debt Management Office's (DMO) relationship with, and expectations of, its primary dealer firms - Gilt-edged Market Makers (GEMMs) – recognised or endorsed as such by the DMO and a recognised investment exchange (RIE) in the execution of its debt management responsibilities. It updates and replaces previous versions of this document, published in December 2004 and September 2006. Readers should note that the DMO has separate arrangements and counterparty relationships for the execution of its cash management operations.

2. Details are believed to be wholly accurate at the time of publication (May 2007), but practices and regulations may change from time to time in the light of changes in official policy and/or market practice. In such circumstances, revised chapters may be issued to existing market makers, and master documents updated, both in hardcopy and electronic format. The latter will be available on the DMO website at <http://www.dmo.gov.uk>.

3. Further details about the DMO's own dealing and auction procedures are set out in the DMO's Operational Notice "Official Operations in the Gilt-edged Market", also updated in May 2007 and also available on the DMO's website.

4. Any questions or requests for further information regarding the content of this document should be addressed to Martin Duffell, Head of Gilt Dealing, UK Debt Management Office, Eastcheap Court, 11 Philpot Lane, London, EC3M 8UD, telephone number +44 (0)845 357 6517 or e-mail [martin.duffell@dmo.gsi.gov.uk](mailto:martin.duffell@dmo.gsi.gov.uk).

## RATIONALE

5. The DMO continues to believe that liquidity in the gilt-edged market is best preserved by the presence of competing market makers - GEMMs - who undertake to make, on demand and in all market conditions, effective two-way prices in those gilts in which they have committed to deal and to support the gilt issuance programme. Continuous liquidity encourages widespread demand for and investment in UK Government bonds, which in turn reduces the Government's funding costs.

6. GEMMs may specialise in one or both of the following sectors; firstly, in conventional gilts, strips and (if applicable) floating rate gilts; and secondly, inflation index-linked gilts.

7. All GEMMs must be authorised by the Financial Services Authority (FSA), either directly or under the terms of the EEA passport, and be registered as a market maker with an RIE, such as the London Stock Exchange (LSE).

8. GEMMs must also satisfy certain obligations, described below, in order to be granted and maintain primary dealer status with the DMO.

## **DEFINITION OF A PRIMARY DEALER**

9. For the purposes of this document, and for the undertaking of primary dealer privileges and obligations in the UK government bond market, the DMO defines a Gilt-edged Market Maker (GEMM) as a bank or securities firm that has committed to the requirements of the DMO and an RIE, and been recognised as such by the parties involved.

10. As the requirements apply to sterling-denominated government bonds only, it is neither practical nor desirable to confer the privileges and obligations of GEMM status on all trading desks or staff at any such institution. Instead, the appropriate head of department at each firm should discuss and agree with the DMO which members of the trading and support staff are to be covered under the category.

11. The DMO recognises that different firms will have differing trading desk structures and reporting hierarchies. It will try to ensure as much equivalency as possible between primary dealer firms, in order to maintain as level a playing field as possible, in the access rights and obligations of dealers in the gilt market, and the reporting and assessment of turnover, market shares and overall performance as a GEMM.

## **SUMMARY OF PRIMARY DEALER OBLIGATIONS AND PRIVILEGES**

### **GEMMs' commitments**

12. Firms endorsed by the DMO as GEMMs agree to meet a number of obligations on a continuous basis. The aims of these obligations are to ensure that primary dealers contribute to the liquidity of the secondary market and provide appropriate support to the primary issuance of Government debt. The obligations are as follows:

#### **a) Market making**

13. All GEMMs are committed to make, on demand and in all trading conditions, continuous and effective two-way prices to their customers in all gilts in which they are recognised as a market maker. The purpose of this obligation is to ensure that primary dealers provide a continuous pricing service and liquidity to all other market participants. However, GEMMs are not obliged to make prices to customers with whom they have not yet conducted due diligence enquiries. Nor are they obliged to make prices in smaller gilts that have been designated as 'rump gilts' by the DMO.

14. GEMMs have no obligation to quote prices to other GEMMs, although index-linked GEMMs are encouraged to quote prices to any non-index-linked GEMMs, if so requested. Price provision to Inter Dealer Brokers is voluntary, as is the provision of prices to an agency firm or electronic platform dealing on behalf of a third party, where that party is identified as (likely to be) another GEMM desk.

15. GEMMs may commit to making markets in gilts, including strips, and/or to do so in index-linked gilts. They are expected to achieve and maintain a market presence sufficient to earn them an appropriate share of secondary market turnover. Whilst

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<sup>1</sup> Issues deemed too small to be liquid

there is no explicit minimum market share target laid down, the DMO would expect all wholesale market makers to aim to achieve and maintain an individual share of at least 2.5% in both conventional gilts and in the index-linked sector, on a 3-month rolling average basis.

#### **b) Participation in primary issuance**

16. GEMMs are the only institutions able to bid directly to the DMO in gilt auctions, and, as such, are expected to play an active role in the issuance, sale and marketing of UK government debt. All GEMMs are invited to participate in annual and quarterly consultation meetings and all are expected to participate in a meaningful way in the auction process itself.

17. The DMO recognises that it is neither possible, nor desirable, to set minimum allocation targets for individual GEMMs at every auction. Nevertheless, GEMMs should aim to purchase at auctions amounts at least broadly equivalent to their secondary market share, i.e. at least 2.5% of conventional or index-linked gilt issuance on a 3-month rolling average basis.

#### **c) Provision of data and information to the DMO**

18. All GEMMs are obliged to provide the DMO with data in a pre-specified format relating to end-of-day gilt prices, positions and weekly turnover. The DMO also encourages GEMMs to provide real-time prices or accurate mid-market indications to recognised wire services providers and electronic trading platforms. The DMO publishes intra-day composite gilt prices on a real-time basis, averaging feeds from individual GEMM pages, on its own wire services pages, as well as 'official' end-of-day closing prices and aggregated turnover data on its website.

19. All GEMMs and recognised IDBs must install and maintain designated IT (including Bloomberg) and telecommunications links with the DMO. These are used by GEMMs for price, position and turnover reporting, bidding at auctions, secondary market dealing and provision of other market information, and by IDBs for reporting secondary market price and turnover information. GEMMs and IDBs must also be in a position to settle gilt transactions through CRESTco.

20. GEMMs and IDBs are also encouraged to provide verbal and/or written market intelligence to DMO dealers concerning corporate developments, market movements and investor trends, and to respond with due consideration to any market consultation exercises.

#### **GEMMs' privileges**

21. In return for undertaking the obligations detailed above, GEMMs are entitled to certain privileges in the gilt market, as follows:

##### **a) Auction bidding**

22. As mentioned above, GEMMs are the only institutions eligible to submit a competitive bid directly to the DMO. This means that all other market participants

wishing to bid at a gilt auction must route their order through a GEMM which, whilst not permitted to charge a fee for this service, may use the information content of that bid to its own benefit.

23. GEMM firms are each entitled to a combined non-competitive allowance of 10% of the total amount of the bonds on offer at a gilt auction. If applied for, these bonds are allocated at the average accepted price of successful competitive bids in conventional gilt auctions, and at the single strike price in index-linked auctions. In conventional auctions, the 10% allowance is split evenly amongst all GEMM firms, whereas in index-linked auctions each firm's individual allowance will be determined by their successful purchases at the three previous auctions.

#### **b) Preferred counterparty status**

24. As with the auction process, the DMO will only deal with GEMM firms in the gilt-edged secondary market. The DMO is active in the secondary market in a number of areas – bidding for 'rump' gilts, executing transactions on behalf of members of the public<sup>2</sup> or various Government funds managed by the CRND<sup>3</sup> and others, and smoothing redemption cash flows through the purchase of near-maturity<sup>4</sup> gilts. In the latter case only, the DMO may also deal with IDBs. In addition, the DMO will only entertain bids or switch proposals from GEMMs for any stock advertised on its Shop Window pages.

25. Additional dealing privileges associated with GEMM status are the right to strip and reconstitute gilts through CRESTco and, provided that the relevant documentation is signed, the right to request or participate in standing or special repo operations from the DMO.

#### **c) Other privileges**

26. As stated above, GEMMs have exclusive trading and viewing access to the services of endorsed IDB firms, which enable them to unwind or acquire positions anonymously with their peers.

27. Recognised GEMM firms are automatically invited to send a representative to the DMO's quarterly and annual consultation meetings on issuance policy, and to become a member of the Gilt-edged Market Makers Association (GEMMA), a self-governing body that represents the GEMM community's interests in the wider market place and with various authorities.

### **Rules of the Exchange**

28. The DMO's obligations and privileges operate in parallel with the relevant RIE's rulebook, which sets out its own requirements for market makers as members of the exchange.

<sup>2</sup> Members of the DMO's Approved Group of Investors scheme.

<sup>3</sup> Commissioners for the Reduction of the National Debt.

<sup>4</sup> Defined as gilts that have reached or passed their penultimate coupon payment.



## CHAPTER 2 - THE PRIMARY MARKET

### POLICY AND THE GILT REMIT

29. Since 1995<sup>5</sup>, auctions have constituted the primary means of issuance for both conventional and index-linked gilts, as the government regards such operations as the fairest, most transparent and most cost-effective way of issuing gilts over the long run. However, the DMO may, on occasion, issue gilts via a syndicated offering.

30. The auction calendar for an entire financial year (April-March) forms part of the financing remit<sup>6</sup> given to the DMO by HM Treasury. The DMO remit is usually published alongside the Budget, in the Debt and Reserves Management Report (DRMR), every spring and is released after the Chancellor of the Exchequer has delivered his Budget speech.

31. The remit itself is formulated and published after the Debt and Reserves Management (DRM) team at HM Treasury has consulted with the DMO, primary dealers, investors and other market participants. All primary dealer firms are invited to send a representative to annual meetings, chaired by the responsible Minister, the Economic Secretary to the Treasury, in order to air their views on the content of the forthcoming year's remit, the perceived needs and demands of the market, and any other topical issues of the time.

32. The financing remit for each financial year will indicate; (a) the (minimum) number of auctions in each broad maturity band<sup>7</sup> to be held during the financial year; (b) the dates planned for each auction, (c) a range for the sizes of the auctions in cash terms for both conventional and index-linked gilts, (d) the target amounts of cash to be raised in each sector, (e) the planned change in the level of Treasury bills, and (f) any predetermined contingency arrangements to cover an increase or decrease in the Central Government Net Cash Requirement (CGNCR).

33. In 2006-07, the financing remit included a split between pre-committed issuance (the 'core programme') and an 'unallocated' tranche of financing that was allocated throughout the year, on a quarterly basis, in a broadly even-flow manner. This temporary change was intended to allow greater responsiveness in gilt issuance by the DMO during 2006-07, given uncertain prevalent market conditions and a large borrowing requirement. No such measures were contained in the 2007-08 Remit.

34. The issuance programme, and in particular the number and timing of auctions, may be varied during the year in the light of any substantial changes to any of the following: (a) the CGNCR, (b) the level and/or shape of the yield curve, market expectations of future interest and/or inflation rates, (c) market volatility, or (d) any other criteria specified in the relevant annual Remit. In practice, variations are most likely to occur in regular quarterly issuance announcements, or at the time of publication of the outturn of the previous year's CGNCR in late April, and/or at the time of the Chancellor's Pre-Budget Report (PBR), usually in November or December. Any revisions will be announced by the DMO.

<sup>5</sup> See <http://www.dmo.gov.uk/documentview.aspx?docname=remit/report95.pdf>.

<sup>6</sup> Available on the DMO website or in hardcopy upon application.

<sup>7</sup> The DMO defines broad maturity bands as follows: shorts 1-7 years to maturity, mediums 7-15 years, and longs 15+ years.

## **PRIOR NOTICE OF GILT AUCTIONS**

35. The DMO itself hosts quarterly consultation meetings with representatives of GEMMs and end investors. These meetings are normally held towards the middle of March, May, August and November, and are intended to inform the DMO of the market's preferences for the issuance of individual gilts in forthcoming quarters (April-June, July-September, October-December and January-March), within the constraints of the published remit. All GEMM firms are invited, and expected, to send a representative to these meetings, and will be asked to contribute their views in all sectors where they have primary dealer status (ie. non-index-linked GEMMs are excluded from discussions about index-linked issuance). The list of primary dealer attendees is co-ordinated by the secretary to the Chairman of the Gilt-Edged Market Makers Association (GEMMA). Summary minutes of these meetings are published on the DMO's wire services and web pages as soon as practicable the following day.

36. On a quarterly basis, the DMO will announce its plans for auctions (including any switch or reverse auctions) to be held over the following one to four months, typically at 3:30pm on the last business days of March, May, August and November. These announcements will normally indicate the identity of the individual gilt(s) or, if relevant, the creation of any new one(s), although coupons on new bonds are usually fixed closer to the auction date itself.

37. At 3:30pm on the Tuesday in the week preceding a scheduled auction, the DMO will publish the final terms and conditions of an auction, including the nominal amount of stock on offer, ISIN and SEDOL codes etc, and, where the gilt is a new one, the coupon, which will normally be set at current market yields for the relevant maturity, where possible rounded to the nearest 1/4% for conventional bonds, 1/8% for index-linked. Further issues of already existing gilts will usually be fungible with the parent issue from the settlement date of the auction.

38. As any of these announcements may be market sensitive, and in order to protect price providers, the DMO will remind gilt Inter Dealer Brokers to briefly suspend any 'live' dealing prices posted on their screens until after the announcement has been made and digested.

39. Shortly after the announcement of each individual auction, the DMO will e-mail/write to each primary dealer firm to give any further details and to inform each firm of their individual reporting requirements and non-competitive allowance (see below). All GEMMs are required to submit details of pre-auction trading in the relevant gilt, with all counterparty types, by fax on the appropriate form, up until the eve of the auction itself. Faxed reports must be received by the DMO by 8:00am on the morning of the auction, although 'nil returns' may also be made by telephone to the DMO's dealing desk.

## **AUCTION MECHANICS**

40. With the exception of small retail bids from members of the DMO's Approved Group scheme (see Glossary), all bids at gilt auctions must be submitted by, or through, a recognised primary dealer firm, via the Bloomberg Auction System (BAS), or, in emergency circumstances only, a direct telephone line to the DMO's dealing

desk, maintained by all GEMMs. This means that all other investors wishing to participate in the auction process must submit their bid to a GEMM firm of their choosing, who is in turn obliged to submit that bid to the DMO, without charge, although the GEMM may, of course, use the information contained therein to influence their own account bidding strategy.

41. Bids may be submitted at any time from the opening of the bidding window (usually 8:00am on the morning of a scheduled auction), up until the published deadline (usually 10:30am), after which no further bids can be accepted. BAS will automatically generate banner messages to all enabled primary dealer bidders, warning them that the deadline is approaching, and the GEMMs' bid input screens show a countdown, utilising Bloomberg's in-built clock, which shall determine the cut-off timing absolutely.

42. Enabled dealers may submit, cancel and/or amend as many bids as they wish before the deadline when utilising BAS. The bid input screen displays the identity of the bond being auctioned, the size on offer, each GEMM's non-competitive bid allowance and the clock, which counts down to the bidding deadline. The same screen allows dealers to input new bids (size and price), which will then generate the equivalent yield, and, once submitted, will respond with status (eg. SENT), time of submission (HH:MM. Dealers must also populate the 'position' field, which tells the DMO of the GEMM's current position in the bond (WI and/or parent) being sold. Initial bids may be cancelled at any time before the bidding deadline, new ones may be added, or existing ones may be amended, either by re-inputting individual bid prices, or by populating the 'price change' field, which will then update all selected bids by the desired penny price change (e.g. input 1 to move prices up by 0.01, or -2 to move prices down by 0.02). Other functions within BAS allow bidders to view total amounts bid for by themselves and other colleagues at their firm, on an aggregate and individual basis.

43. Each competitive bid must be for one amount and at one clean price, expressed as a multiple of 0.01 of £1 (ie. to two decimal places and including the 'big figure' – e.g. 102.34), for at least £1 million nominal and round multiples thereof. This limitation applies to individual client bids as well as GEMM own account bids, hence it is no longer possible for GEMMs to round client bids in fractions of £1 million to the nearest whole number, by taking the balance on their own account.

44. Dealers bidding on behalf of clients, or other non-GEMM dealers in their firm, must enter the applicable 3-letter client code in the relevant field on the bid input screen. If the system recognises the code, it will return a longer version of the client name, for verification purposes.

45. These codes are allocated and maintained by DMO dealers, and any client intending to participate in the auction should apply directly to DMO dealers for allocation of a code. Applications may be made by e-mail, Bloomberg message, company fax or letter. Such codes are allocated on a once-only basis, and will be retained for use in future auctions. However, the assignation of such a code should not be taken as a signal that the DMO has verified the legitimacy of the client institution, and GEMM firms are expected to conduct their own due diligence validations. GEMM dealers or salespeople may not apply to the DMO on behalf a

client, but the latter is expected to reveal their code when submitting a bid to a GEMM. New applications for codes should be made to the DMO by the close of business on the evening before any auction, otherwise GEMMs will be expected to submit bids from non-registered clients under their own account, which may or not, at the DMO's discretion, affect the GEMM's own account allowance. In such a case, GEMMs should contact DMO dealers immediately to identify the new bidder, and his/her bids.

46. Primary dealers are also offered a non-competitive allowance at each conventional or index-linked auction. The DMO sets aside a total of 10% of the nominal amount on offer to provide the GEMM community with the assurance of a guaranteed minimum allocation, in order that they are more willing to carry short positions into the auction itself. In conventional gilt auctions, the 10% allowance is divided equally amongst GEMM firms, while in index-linked auctions individual firms' allowances, within the 10% aggregate total, are determined by reference to that firm's successful competitive bidding results in the three previous index-linked auctions. In calculating individual allowances here, the DMO makes no adjustment for the price, risk or duration weighting of the different index-linked gilts. Individual firms' allowances will be communicated to GEMM traders by DMO dealers, during the week preceding each auction. The maximum allowance will also appear on each GEMM's BAS bid input screen, after the bidding window has opened. They are calculated to the nearest £50,000 nominal in conventional gilt auctions, and £100,000 for index-linked. Note that non-competitive allowances are not automatic – GEMMs must request an allocation each time, in one single non-competitive bid, for a size that is a multiple of £50,000/£100,000, up to the stated maximum. Non-competitive bids are filled at the average accepted price in conventional gilt auctions, and at the lowest accepted price in index-linked auctions.

47. Further details on all aspects of BAS can be found in the user guide "Bloomberg Primary Market Auction System – user guide for operations conducted by the United Kingdom Debt Management Office", issued to all GEMMs in May 2007, and also available upon request to the DMO.

48. In the case of one or more GEMM firms, or the DMO itself, being unable to access BAS for technology-failure reasons, the DMO may, at its discretion, permit the submission of bids by GEMMs by direct telephone line as a back-up measure. In these circumstances, GEMMs are likely to be limited in the maximum number of bids that they may submit in the final 10 minutes of bidding. GEMM dealers should inform DMO staff immediately they become aware that they are not able to access BAS. In the case of isolated failures, GEMM bidders must be aware that the DMO's input of bids into BAS on their behalf will be on a 'best endeavours' basis, and that no bids may be input, cancelled or amended after the precise auction deadline (eg. 10:30:00 am), regardless of whether or not the dealer is already on the telephone line before then. In the event that the DMO itself is unable to access BAS, or a widespread market failure, the DMO may announce that all bids should be submitted by direct telephone line instead of BAS, along with any other emergency measures (eg. limits on bid numbers). In such (extreme) circumstances, the publication of auction results is likely to take longer than normal.

49. After the designated bidding deadline has passed, DMO dealers will download the complete bid set from BAS into its own allocation systems, which will then

calculate the result and individual GEMM allocations. The bid set and results are then 'sanity-checked' by DMO staff, prior to release, to guard against errors and anomalies, and to determine whether any GEMM or customer institution is likely to exceed the maximum allocation guidelines set down by the DMO (see below), in order to reduce the potential for stock squeezes in the aftermath of any auction. The information will be treated as confidential by the DMO and not released to any third party.

50. In processing auction results, the DMO may, at its own discretion, decline to allot stock to a bidder if it is deemed likely that a large allocation may lead to post-auction market distortion. In conventional auctions, the maximum permitted allocation for any single bidding institution is set at 25% of the nominal amount on offer, and in index-linked auctions the figure is 40%. In the case of GEMMs, the DMO will take account of any net short position already accumulated in the When-Issued dealing period, thus raising their potential maximum allowance proportionally. Note that the term 'GEMM' in this case applies to the group as a whole, with the exception of any 'chinese-walled' entities. Should there be a need to scale back any allotments, the DMO will discard the lowest competitive bid(s) first, up to the relevant cut-off point. Non-competitive bids and bids on behalf of unrelated clients will be unaffected by this measure. The maximum allocation limit for client bidders is absolute, and any client bidding for more than 25/40% may be scaled back by the same method (ie. lowest priced successful bids first) and, if necessary on a pro-rata basis per GEMM, where multiple bids are at the same price. GEMM personnel are expected to inform clients of this likelihood if they suspect that the client is bidding for total sizes in excess of these limits.

51. Allocations at the lowest accepted price are scaled pro rata to the nearest half percentage point, and all such allocations are in multiples of £1,000 nominal of stock. In addition, a small amount of the gilt (typically less than £1 million nominal per auction) is retained by the DMO to cover roundings and any uncertainties in dealing with retail applications.

52. Results of the auction will be released on the DMO's wire services pages, simultaneously to all market participants, as soon as all the necessary calculations, allocations and checks have been performed internally by the DMO. Immediately prior to release, the DMO's dealers will inform Inter Dealer Brokers that results are ready for publication and request that they turn all current live prices on their screens 'subject to confirmation'. This is standard practice, and no indication of the outcome of the auction is given to IDBs. The results announcement itself (see below) will contain sufficient information for GEMMs to be able to calculate their own individual successful allocations, but GEMM traders may also call the DMO's dealing desk for confirmation.

53. Gilt auctions will normally settle on the following business day, in accordance with the T+1 convention in the gilt market. For auction settlement purposes, accrued interest is rounded to 6 decimal places per £100 nominal.

54. All primary dealer firms are expected to match the DMO's settlement instructions in CREST, and to meet their commitments on the day and in good time. In order to settle auction allocations, GEMMs should instruct one single trade, with a nominal size equivalent to their entire auction allocation, including non-competitive bids, and

match the DMO's consideration amount to the nearest penny where possible. The input price is not essential, but will equate to the average price of all the successful bids submitted by the individual GEMM.

55. The procedures described above apply commonly to all conventional and index-linked gilt auctions conducted by the DMO. The following paragraphs identify areas where procedures and regulations may differ from one type of auction to another -

56. The minimum and maximum size range for conventional and index-linked auctions is set out each financial year in the annual Debt and Reserves Management Report, published by HM Treasury at the time of the Budget. As a general rule, the DMO will tailor the sizes of individual auctions to take account of the amount of risk being offered to the market in each operation. This means that auctions for shorter-dated gilts will generally be for larger sizes than those for longer-dated gilts, although there is no formulaic correlation. In determining the size of individual auctions, the DMO may also take into account specific market events (eg. index changes, redemptions, coupon flows etc), perceived levels of demand, plus any portfolio considerations of its own.

### **CONVENTIONAL GILT AUCTIONS**

57. Conventional gilt auctions are held on a bid price basis (ie. successful bidders pay the price that they bid), with non-competitive bids allocated at the average accepted price.

58. Direct bidding is open to all primary dealers recognised as a GEMM in conventional gilts, and permissioned as such in BAS.

59. Approved Group bidders may each submit non-competitive bids for a maximum of £500,000 nominal.

60. The published results of a conventional gilt auction will include details of the highest, average and lowest accepted prices (with the pro rata scaling rate at the lowest accepted price); the gross redemption yields equivalent to these prices; the total nominal value of accepted non-competitive bids (split between GEMMs and non-GEMMs); the total value of all bids received, including those rejected in whole or in part on account of price; and the ratio of this total to the amount on offer (the 'cover').

### **INDEX-LINKED GILT AUCTIONS**

61. Index-linked gilt auctions are held on a single price basis (ie. all successful bidders pay the lowest accepted price), with non-competitive bids also allocated at this lowest accepted price.

62. Direct bidding is open to those primary dealers recognised as an index-linked GEMM, and permissioned as such in BAS.

63. Approved Group bidders may each submit non-competitive bids for a maximum of £250,000 nominal.

64. The published results of an index-linked gilt auction will include details of the common allotment price (with the pro rata scaling rate at this lowest accepted price); the real yield equivalent to that price (and any inflation assumption contained therein); the total nominal value of accepted non-competitive bids (split between GEMMs and non-GEMMs); the total value of all bids received, including those rejected in whole or in part on account of price; and the ratio of this total to the amount on offer (the 'cover').

## **UNCOVERED AUCTIONS**

65. The DMO reserves the right not to allot all of the stock on offer at a conventional or index-linked auction, although it would consider this only in exceptional circumstances, where it judges bids to be at an unacceptably deep discount to the prevalent market level. This is particularly pertinent, but not exclusive, to the index-linked sector, where the nature of the single price auction format means that the entire auction is allocated at the same low price, rather than individual outlier bids. In some circumstances, this could even mean that allocating a larger nominal amount of stock would actually lead to a lower amount of revenue being raised. In such cases, the DMO is likely to reject the lower bids. In other circumstances, an auction may still not be 100% covered, even if all bids submitted are accepted.

66. Where a regular conventional or index-linked auction is uncovered, for whatever reason, it is likely that the remaining gilts will still be created from the National Loans Fund (NLF). The unsold balance will then be held by the DMO on an official portfolio for a certain period of 'purdah' in order to allow market conditions to stabilise. The DMO may then offer the balance for re-sale at a time of its choosing, but no sooner than one week after the original auction, if the market price of the gilt has subsequently risen from the clearing level, or two weeks if the prevalent market price has fallen. These arrangements will be detailed in a screen announcement to be published immediately after the results of an uncovered auction. Depending upon the amount of gilts involved, the re-sale of the unsold balance is likely to be via a tender or the DMO's Shop Window screen (see below, paragraphs 83-88 and 125-126).

## **SWITCH AUCTIONS**

67. Switch auctions were designed to allow the DMO, and the market, to execute large-scale switches out of one gilt into another. This process involves the cancellation of the relevant amount of the source gilt and the creation of an extra corresponding amount of the destination gilt. Switch auctions may be employed in various circumstances – (a) to maintain a supply of current benchmark gilts in a low issuance environment, or (b) to allow the DMO to smooth the immediate gilt redemption profile. Note that switch auctions are no longer employed as a means of facilitating index extension events and the like. The decision on whether or not to offer a switch auction is entirely at the discretion of HM Treasury and the DMO, but any planned operations (date of auction and gilts involved) will be announced in the regular quarterly funding announcement.

68. The DMO will not hold a switch auction that would reduce the amount in issue of the source gilt to less than £4.5 billion nominal in conventionals, or £1.5 billion nominal in index-linked, nor will it hold a switch auction out of any gilt that has been

auctioned in the previous eighteen (six for index-linked) months, or one that is, or has a reasonable likelihood of becoming, the cheapest-to-deliver gilt in any active gilt futures contract. The DMO could, however, switch into such a gilt. The DMO will not launch an entirely new gilt by means of a switch auction.

69. The DMO will only offer a switch auction where the source and destination gilts fall into the same maturity bracket<sup>8</sup>, and the maximum size of any such operations will be limited to the same upper constraints as on regular auctions, as specified in the relevant year's remit. Details of the size of any operation will be announced at 3:30pm on the Tuesday in the week preceding the scheduled date.

70. The bidding mechanics of a switch auction are similar to those of regular auctions, in terms of who may bid directly (ie. GEMMs only), utilisation of BAS, timings, bid denominations etc. Conventional switch auctions are held on a competitive bid price basis, index-linked switch auctions are single price format.

71. The differences are as follows:

- The DMO will fix its bid price for the source gilt 30 minutes before the bidding deadline, at the prevalent mid-market price, and publish this price on its wire services pages,
- GEMMs, either for their own account or on behalf of clients, submit 'bids' in terms of the amount of source stock that they are offering and the clean price at which they are willing to buy destination stock,
- There is no non-competitive bidding facility,
- Maximum bidding and/or allocation limits are discretionary – any limitations would be pre-announced by the DMO on the preceding Tuesday.

72. The DMO will not set a minimum bidding price, but, before accepting any bids, it will be mindful of fair value in the market, and reserves the right to reject any bids it judges to be at an excessive discount. Any shortfall from the pre-announced maximum simply means that less of the destination gilt will be created.

73. The published results of a switch auction will include, where applicable, details of the highest, average and lowest accepted prices of the destination gilt (and the dirty price ratios relating to these prices); the nominal amounts of the source gilt offered and accepted; the nominal quantity of the destination gilt created; the new amounts outstanding following the switch auction; any pro-rata scaling percentage for bids submitted at the lowest accepted price; and the ratio of bids received to the amount on offer (the 'cover').

74. Switch auctions are cash neutral operations, hence successful bidders will be allocated nominal amounts of the destination stock calculated as the ratio of the dirty prices of the two stocks, rounded to the nearest 4th decimal place. Source gilts that were successfully switched will be cancelled at the same time as the new stock is created. The DMO expects all successful bidders to be able to deliver their commitment of the source gilt on the settlement date.

<sup>8</sup> Defined in this case as 0-7 years, 5-15 years, and over 14 years in conventionals. The split is not applicable for index-linked gilts. 7-15 years, and longs 15+ years.



## REVERSE AUCTIONS

75. In times of low financing requirements, the DMO's remit, set out in the annual Debt and Reserves Management Report, may include provisions for reverse auctions, whereby the DMO, on behalf of HM Treasury, will make an offer to buy back, and subsequently cancel, pre-announced amounts of one or more gilts. The scheduling of any reverse auction(s) would be announced as part of the usual quarterly funding announcement.

76. Where offers in multiple gilts are invited, the gilts involved will normally be of a similar duration and/or maturity. The DMO will not hold a reverse auction in any gilt that is, or has a reasonable likelihood of becoming, the cheapest-to-deliver gilt in any active gilt futures contract. The maximum size of such an operation will be limited to the same upper constraints as on regular auctions, as specified in the relevant year's remit— the actual sizes and gilt(s) involved would be announced at 3:30pm on the Tuesday in the week preceding the operation.

77. The mechanics of a reverse auction are again similar to those of regular auctions, in terms of who may offer directly (ie. GEMMs only), use of BAS, timings, denominations, price increments etc. Conventional reverse auctions are held on a competitive offer price basis, index-linked reverse auctions are single price format. Where multiple gilts are involved, GEMMs must be certain to include the identity of each individual gilt in each offer submitted.

78. As with switch auctions, there is no non-competitive facility and the DMO will not set a maximum price, but, before accepting any offers, it will be mindful of fair value in the market, and reserves the right to reject any offers it judges to be at an excessive premium. Any shortfall from the pre-announced maximum simply means that less stock is purchased, and subsequently cancelled.

79. In determining the results of a multiple gilt operation, the DMO will convert prices offered to yield equivalents, subtract from these values the theoretical yield for each gilt, as calculated by the DMO's own yield curve model, and allot acceptances to the highest relative yields offered. Allotment continues until the maximum pre-announced cash amount of stock is purchased. There are no limits on allocation of purchases to particular gilts or bidders. This could mean that the DMO accepts offers in only one gilt and/or from only one GEMM or (indirectly) other holder.

80. Acceptances at the highest accepted price are made to the nearest 1/10th of a percentage point for each gilt, and all such acceptances are in multiples of £1,000 nominal of stock.

81. The published results of a reverse auction will include details of the highest, average and lowest accepted prices of each of the gilts involved; the nominal amounts offered, purchased and remaining in each; any pro rata scaling percentages at the highest accepted price in each; and the ratio of the cash value of offers received to the cash the DMO offered to bid for (the 'cover').

82. Any gilt purchased by the DMO in such an operation will normally be cancelled on the settlement date. The DMO expects all successful sellers to be able to deliver their commitment on that date.

## **TAPS AND TENDERS**

83. Taps (and reverse taps) are tenders, or mini auctions, conducted directly with GEMMs by the DMO's dealing desk. They are no longer used as a routine means of (de)financing, but function primarily as a market management mechanism, in circumstances where the DMO judges there to be excess demand (supply) in a particular stock or sector, temporary or otherwise, such that the secondary market has become, or is likely to become, dislocated. The size of any such operation is unlikely to exceed that of a regular, scheduled gilt auction in the relevant sector.

84. The DMO reserves the right to announce and conduct such operations at any time, but will endeavour to give at least one hour's notice to the market, via a screen announcement. This announcement will detail the identity of the gilt(s) involved; the intended size of the operation; any applicable limitations on participation (eg. minimum (maximum) acceptable prices, number of bids permissible, allocation limits etc); and other operational details. Tenders in both conventional and index-linked gilts will normally be held on a single price basis, with bids (offers) at the striking price subject to the usual pro rata scaling. There is no non-competitive facility.

85. GEMMs will be invited to submit bids (offers), via BAS, either for their own account or on behalf of clients, in the usual denominations, within the timetable outlined in the screen announcement. Results of the operation, including new amounts outstanding, will be published as soon as possible, with settlement and, where appropriate, creation (or cancellation) of the relevant gilt(s) taking place on the following business day. Again, the DMO expects all counterparties to be able to honour their commitments on that day.

86. By their nature, tap (and reverse tap) operations will have the effect of creating (cancelling) stock, which in turn will affect the Government's financing requirement correspondingly. As a result, subsequent auction sizes may be decreased (increased) accordingly.

87. It is also possible that the DMO might offer to conduct a cash neutral switch tap operation as an alternative. Such an operation would work in the same way as a switch auction (detailed above), except that it is likely to be for smaller size and be held on a single price basis, regardless of whether it involves conventional or index-linked gilts. The DMO would pre-announce any such operation at 3:30pm on the day before.

88. The DMO may also use the tender process described here for larger-scale secondary market operations, such as the subsequent sale of unsold auction stock following an uncovered auction, or the acquisition or disposal of stock on behalf of other HM Government funds, under the management of CRND or others.

## **GEMM AUCTION SHARES**

89. The DMO acknowledges that it is neither possible, nor desirable, to set minimum allocation targets for individual GEMMs at each and every auction, recognising that market circumstances and individual positions may discourage certain traders from bidding 'at-the-money' at certain times. Nevertheless, GEMMs should aim to bid for

amounts at least broadly equal to their secondary market share at all times, and to achieve allocations of a minimum 2.5% in each sector where they are a primary dealer (conventional gilts and index-linked), on a 3-month rolling average basis. As meaningful primary market participation is a principal obligation on all GEMMs, any firm falling short of these conditions can expect to be admonished. Conversely, the DMO is likely to give additional credit to those firms or traders who support the auction process in its overall assessment of a GEMM's performance.

## **SYNDICATION**

90. Although auctions constitute the primary means of gilt issuance, the DMO has in the past launched a new gilt by means of a syndicated offer. The relevant annual debt management Remit (contained in the Debt and Reserves Management Report) will make clear whether any such offerings are permitted and/or planned in any one financial year.

91. Should the decision to syndicate an issue of gilts be taken, the DMO would make an announcement to this effect as soon as practicable, on its wire services pages and in a press notice, also detailing any consequences of the decision (such as the cancellation of a scheduled auction), and any available timing or operational details regarding the selection of managers and/or of the actual syndicated offer itself.

92. In allocating managerial roles to investment banks in the syndicated issue, the DMO would expect to offer all relevant GEMMs the opportunity to present their advice and credentials on a fair and equal basis, although other factors (such as primary and secondary market shares, expertise in the relevant sector of the market, etc.) will also be taken into account in the final selection decision. The DMO would not normally expect to appoint any non-GEMM to any role in the managerial group.

93. The precise format of the group and method of sale may vary from issue to issue. The DMO will take such decisions based on its own policy and portfolio preferences at the time and advice from GEMM firms on prevalent best practices and their recommendations for the particular issue.

94. The DMO will endeavour, via screen and web announcements, press notices and/or communiqués from lead managers, to keep all market participants informed of developments in the syndication process at all key stages of the operation.

## CHAPTER 3 - THE SECONDARY MARKET

### MARKET MAKING

95. Gilt-edged Market Makers are expected to make "effective two-way prices on demand to any of their clients, at all times and in any conditions", in all gilt-edged bonds, including strips, in which they have been recognised as a primary dealer. The reason for this obligation is to preserve the depth and liquidity of the market and to maintain investors' confidence in the ability to buy or sell gilts at any time, hence encouraging wider participation, greater turnover and ultimately lower borrowing costs for the UK Government.

96. In practice, the DMO only expects its primary dealers to make prices and execute transactions with those customers who have already previously been subjected to due diligence and other anti-money laundering enquiries by the firm involved, not to all comers. In addition, there is no requirement that a GEMM firm should be forced to make a price to any other recognised GEMM, to an Inter Dealer Broker, or to an Agency broker, although the GEMM firm may, of course, choose to do so. The DMO does, however, encourage index-linked GEMMs to quote prices in these gilts to any non-specialist GEMMs.

97. The DMO regards "effective two-way prices" as a bid and offer made in regular market size with a reasonable spread between the two. 'Reasonable' is not strictly defined here in terms of pence or basis points, as the DMO recognises that prevalent spreads may change in the long or short term, dependent on current market conditions, competition, risk appetites, time of day, the identity of the client and/or the characteristics of the individual bond involved. In the event of any complaint from an end-investor, the DMO would consider these factors in determining whether or not a GEMM was not fulfilling this key obligation for a primary dealer. Similarly, anyone requesting a price in exceptional size (large or small) might expect the price quoted to be adjusted accordingly, to take account of the disproportionate risks or settlement costs involved. GEMM firms are not required to make prices to customers in 'rump' gilts, although they may do so at their own risk (see also paragraphs 117-120 below). If a customer requests a non-standard settlement date, the price(s) may also be adjusted accordingly.

98. GEMM firms are expected to stand ready to make prices at all times between the hours of 8:00am and 5:00pm (UK time) on UK business days. On certain occasions (e.g. Christmas Eve, New Year's Eve) the trading day may be shortened, depending on the opening hours of relevant Exchanges. Whether or not a firm is prepared to deal outside of these hours is that firm's own business decision, usually determined by the global nature of their operation and/or client base. In addition, the DMO deems it reasonable for market-making obligations to be suspended temporarily (for a minute or two) over the release of key economic news or data from the UK, US or Eurozone.

### MANDATORY QUOTING

99. In the past, the DMO has required all GEMMs<sup>9</sup> to supply two-way price quotes in designated key benchmark gilts to Inter Dealer Broker screens over a minimum

<sup>9</sup> ...with the exception of 'retail-only' specialist firms

period of time each week, in a minimum size, and with a maximum spread. This was in order to provide a pool of 'last resort liquidity' to the entire primary dealer community, allowing the sharing of risk, and the ability to acquire or dispose of a position with competing firms, provided that the dealer was willing to pay the price involved. The DMO judges that, in the current trading environment, such measures are unnecessary and, as a result, this obligation is currently suspended. The DMO does, however, reserve the right to re-instigate a mandatory quoting obligation, should intra-GEMM liquidity conditions dictate.

### **INTER-DEALER BROKERS (IDBs)**

100. Inter Dealer Broking firms operate in the gilt-edged market as intermediaries between the primary dealers, and are not permitted to offer their services outside of this community, thus providing an 'inner core' to the market, where GEMMs may trade with each other on an anonymous basis.

101. IDBs must register as such with a Recognised Investment Exchange, such as the London Stock Exchange (LSE), before the DMO will consider 'endorsing' them. Under the rules of the LSE for example, IDBs must provide a service description to all GEMMs and lodge a copy with both the Exchange and the DMO. The service description covers all aspects of how the IDB operates its services. IDBs are not permitted to take principal positions on their own account, except where they are dealing on a matched principal basis, with corresponding buying and selling counterparties. IDBs may also operate on a 'name-give-up' basis, or use a central clearing house for settlement, depending on their choice of business model, which may be voice broking or electronic one, or a combination of the two. In all cases though, the details of trades executed should be posted on the IDB's screens for the information of other members of the GEMM community. IDBs have a duty to offer their services to all recognised GEMMs equally, but there is no compulsion on GEMMs to use them. Note that non-index-linked GEMMs are not permitted to trade in that asset class with IDB firms.

102. There is no compulsion for a firm offering such brokerage services to apply to be 'endorsed' by the DMO, but potential applicants and GEMM users of their services should note that non-endorsed firms will not be eligible as a channel for submitting mandatory price quotes (when applicable), nor will they receive advance warning of market sensitive announcements from the DMO. For the DMO to endorse such an applicant, the broker must demonstrate a demand for their services in the market, and their own ability to deliver with a long-term commitment.

### **INTERMEDIARY AGENCIES**

103. Firms or platforms that operate as intermediary brokers in the gilt-edged market, but whose counterparty list is wider than just the GEMM community are treated as Agency Brokers (or Broker Dealers) by the DMO. These firms may be registered as, or operate as, Wholesale Dealer Brokers, where their client base consists of banks who are active 'traders' in government bonds, corporate bonds or derivatives, or they may broke directly between traders and end-investors. In all cases, GEMMs have no obligation to quote prices to such firms, although they may, of course, choose to do so. An Agency Broker operating under the rules of the London Stock Exchange must

reveal to a GEMM whenever it is requesting a price on behalf of another GEMM, although the counterparty's identity may be withheld.

## **SETTLEMENT**

104. All GEMMs (and Inter Dealer Brokers) are expected to be able to settle all trades that they commit to, in a timely and accurate fashion, and to maintain accounts at CrestCo and other depositaries commensurate with their trading activities and customer preferences. Existing GEMMs are expected to ensure that any changes to their Standard Settlement Instructions (SSIs) are communicated to their customers and the DMO immediately, and new GEMMs must exchange such details with the DMO before assuming market making operations.

## **STRIPS, STRIPPING AND RECONSTITUTION**

105. Since 1997, all new conventional gilts have been issued with coupon and maturity dates in one of two series - 7 June & 7 December, or more recently 7 March & 7 September, in order to facilitate the 'stripping' of different stocks into fungible coupon payments due on a designated date. Principal strips (i.e. the final par redemption payments) are not fungible, even with coupon strips maturing on the same day, but may still be traded as separate securities.

106. The DMO maintains a list, available on its website<sup>10</sup>, of all those gilt stocks that have been declared eligible for stripping, and the amounts currently held in stripped format, which is updated on a weekly basis. A newly-launched line of gilt is unlikely to be declared 'strippable' until a sufficient amount of the gilt has been issued, in order to maintain liquidity in both the stripped and unstripped formats – in recent times this has been interpreted as a minimum of £5 billion nominal in issue.

107. Under current gilt market convention, prices in strips (coupons and principals) are quoted in terms of their yield, usually to three decimal places, calculated on an actual/actual basis, with any subsequent cash dealing prices rounded to the nearest penny. The minimum denomination for trading in strips is one penny, and the minimum amount of source stock that may be stripped or reconstituted is £10,000 nominal (except for cases where the source stock is still within its first coupon period, long or short, where the minimum amount is £1 million, for technical reasons<sup>11</sup>).

108. All recognised GEMMs are expected to be capable of providing prices and settling trades in strips, upon demand from a customer, in principals and/or coupons, from both series.

109. GEMMs, as well as the DMO and the Bank of England, are the only institutions permitted to strip and reconstitute gilts. Strips may only be held or transferred within CREST.

110. Further details on aspects of the strips market can be found in the most recent edition of the DMO's Information Memorandum entitled "Issue, Stripping and Reconstitution of British Government Stock", available on the DMO website.

<sup>10</sup> [http://www.dmo.gov.uk/index.aspx?page=Gilts/Gilts\\_In\\_Issue](http://www.dmo.gov.uk/index.aspx?page=Gilts/Gilts_In_Issue)

<sup>11</sup> This is to allow individual strip instruments still to be tradable in multiples of £0.01 nominal.

## **CHAPTER 4 - DEALING WITH THE DMO**

### **PREFERRED COUNTERPARTY STATUS**

111. In almost all of its gilt market operations, the DMO transacts its dealings with its primary dealers, the GEMMs. This includes the receipt and allocation of (successful) auction bids, as well as any regular dealing or special operations that it might conduct in the secondary market (see below).

112. Dealing with a concentrated but expert pool of counterparties suits the DMO as it benefits from not having to expend major resources in the maintenance of due diligence and other risk management tools, systems, relationships etc with a widespread number and type of (potential) counterparties or investors in the gilt market. Provided that the GEMM community itself is representative of, and provides a service to, the various interested parties in the market, the DMO continues to believe that liquidity in the gilt market is best preserved by the presence of competing market makers.

113. Primary dealers may benefit from this 'exclusivity arrangement' in that GEMM status signals to clients, existing or potential, that the firm has been recognised by the UK Government as a specialist in sterling government bonds, with a long-term commitment to the market. At a more micro level, the fact that the DMO only deals directly with GEMMs means that client orders in auction gilts or rump gilts must be channelled through a primary dealer, giving that firm any information value contained in the order, although the dealer may not charge an execution fee. In addition, any proactive dealing that the DMO carries out (see below), either on its own account or on behalf of other Government entities, will also be restricted to the GEMM community.

114. In the interests of fairness and transparency, the DMO will treat all GEMMs as equals in its dealings, wherever possible ensuring that all GEMMs are privy to the same levels of information when conducting any market-sensitive activities. The DMO may, however, make a distinction between wholesale GEMMs and retail GEMMs, according to the size and nature of the business being transacted.

115. The only other counterparties that the DMO may deal with in gilts are Inter Dealer Brokers (for near maturity purchases only), other Government accounts (e.g. the National Loans Fund, CRND), the Bank of England and Computershare, in the conduct of retail Purchase and Sale dealings.

116. Note that the DMO's cash management market operations - the offsetting of expected cash flows into or out of the National Loans Fund - may involve the use of various sterling money market instruments, including gilts and gilt repo, and may be conducted with a wider and more varied list of counterparties, as can the issue of Treasury bills.

### **RUMP GILT PURCHASES**

117. 'Rump' gilts are those that the DMO considers to have too small an amount in issue to reasonably expect a liquid two-way market to exist (e.g. the residual amounts

of gilts that have previously been subject to a conversion offer). Consequently, the obligation on market makers to provide prices in these gilts is relaxed, although any GEMM may still elect to do so, provided that they are aware of the inherent risks.

118. In order to provide holders of these gilts some form of exit before maturity, the DMO is prepared, between the hours of 8:05am and 5:00pm, to make a bid only price on request from a GEMM. The DMO is also prepared to make bids for forward settlement, up to and including T+5 business days. Note that the DMO will not, as a matter of course, be prepared to offer rump gilts to any GEMM or cash management counterparty who is short, nor will it lend such bonds out on repo.

119. A list of those gilts that have been declared 'rumps' by the DMO is maintained on the DMO's website and in various publications. Any changes to this list will be announced. The current list of declared rump gilts is attached in Annex 3 of this publication.

120. Periodically, the DMO is likely to dispose of some or all of its holdings in rump gilts by selling them back to the National Loans Fund for cancellation. This is most likely to be on an annual basis, usually in March, but the DMO reserves the right to cancel at other times if circumstances dictate. Any cancellations and/or changes to the outstanding amount of any issue will be announced.

#### **NEAR MATURITY DEALING**

121. For purposes of smoothing redemption cash flows, the DMO is prepared, when asked by a GEMM, to bid a price of its own choosing for any gilt that has less than six months left before its maturity (i.e. after a gilt's penultimate semi-annual coupon payment). As these are essentially money market instruments by this stage, the bid price will be dictated by the DMO's cash management operations at the time of request.

122. In addition to pro-actively advertising its prices to all GEMMs, via Bloomberg or some other messaging system, the DMO may also post prices or trade on prices on IDB screens, in near maturity gilts only, in order to preserve its anonymity, where this is deemed likely to be a more beneficial approach.

123. DMO dealers will also endeavour to remind primary dealers when maturing gilts are approaching their final ex-dividend period, in order that any holder, GEMM or client, may, if they so wish, sell the gilt in order to avoid entering into the redemption process. On the final ex-dividend day itself (usually seven working days before redemption), the DMO is prepared to trade with GEMMs in the gilt, up until noon, for same day settlement.

#### **DEALING ON BEHALF OF OTHER UK GOVERNMENT ENTITIES**

124. From time to time, the DMO will be asked to execute market transactions in gilts on behalf of funds under the management of CRND or other UK Government entities. These may be purchases or sales. In such circumstances, the DMO will request bids or offers as relevant from three randomly chosen GEMMs and deal on the best price received, provided that the order is for 'normal' market size. Where the size is smaller-



than-average, the DMO may ask for prices from 'retail' GEMMs only, and where the size is deemed larger-than-average, the DMO may advertise the order on its Shop Window page (see below) or run a mini (reverse) tender, following the process described in Chapter 2, paragraphs 83-88 above.

## **SHOP WINDOW**

125. Where the DMO has larger-than-usual position to sell, or buy order to fulfil, it may advertise the fact on its Shop Window pages on the wire services – DMO/GILTS10/11 on Reuters/Telerate, DMO3<GO> on Bloomberg, 44717/18 on Thomson/Topic. In the interests of transparency, these pages are available for viewing by all market participants, but again the DMO will only entertain dealing proposals from GEMMs, or from index-linked GEMMs only for index-linked gilts, either for their own account or on behalf of clients.

126. The Shop Window pages will be operational between the hours of 8:05am and 5:00pm. Details posted will include the identity and size of any gilt(s) advertised for sale or purchase, plus any restrictions (e.g. minimum/maximum prices or sizes, time deadlines etc) that may be imposed at the DMO's own discretion. The DMO also retains discretion on whether or not to accept bids/offers submitted by GEMMs. These pages will be updated as soon as possible to reflect any resultant transactions.

## **RETAIL PURCHASE AND SALE SERVICE**

127. Since December 2004, the DMO has assumed responsibility for the transaction of orders received from members of the public under the Gilt Purchase and Sale scheme. This is a low-cost, execution-only service in gilts offered to smaller investors who have registered on the DMO's Approved Group. The service was previously operated by the Bank of England, but transferred to the DMO at the same time as the operation of the wider Gilts Register was transferred to Computershare Investor Services PLC from the Bank of England's Registrars Department.

128. Under normal circumstances, the DMO will transact these orders over its own portfolio, but in times of heightened demand to purchase or sell a particular gilt or gilts, DMO dealers may choose to offset the effect on its portfolio by buying or selling stock from primary dealers. Such transactions will normally be on T+3 basis, in line with the settlement convention in the Gilt Purchase and Sale scheme.

129. In the interests of transparency to investors, the DMO will publish on its website, on a daily basis, prices at which Purchase and Sale transactions have been executed on that day. This will take the form of a 'snapshot' of bid and offer prices in all gilts<sup>12</sup>, taken at the time that prices were confirmed to Computershare, regardless of whether or not an order was actually received in each gilt. The exact timing of the snapshot will vary from day to day, but will usually be at around midday.

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<sup>12</sup> bids only in rump gilts

## **STANDING REPO FACILITY**

130. The DMO operates an automatic, non-discretionary standing repo facility, whereby any GEMM, or other DMO counterparty, who has signed the relevant documentation may request the temporary creation of any non-rump gilt for repo purposes. The facility was introduced in June 2000 in order to ensure that market makers could be assured of being able to access and deliver any gilt at any time, albeit at a price, hence maintaining their ability to make two-way prices in the secondary market and avoiding the prospect of delivery failures.

131. The facility is available from 12:30pm on the previous day up until 11:30am on the same day of settlement. Participants may roll the facility on a day-to-day basis, but the DMO does not anticipate accommodating a continuous roll for a period of more than two weeks. The minimum size of such a request is £5 million nominal per gilt, and the DMO will charge a penal overnight rate equivalent to 10% of the Bank of England's prevailing repo rate at the time. (e.g. where the Bank's base rate is 5.00%, the DMO will pay its counterparty 0.50% overnight rate for the cash posted in return for the desired collateral). At the same time, the DMO will normally insist on a back-to-back reverse repo of gilt collateral (GC) at the Bank's official rate, in order to neutralise the effect of the standing repo on funding requirements and its own cash management operations (e.g. the DMO lends the cash received above back to the same counterparty, at an overnight rate of 5.00%, in exchange for other GC collateral).

132. Details of the amount and terms of any standing repo operation will be published on the DMO's wire services pages and website as soon as possible after 11:30am on the relevant day, and the DMO will also publish the return of the gilt(s) on the following day or later, as appropriate. The counterparty(ies) involved will remain anonymous to the market, although the DMO reserves the right to share such information with other official regulatory bodies in appropriate circumstances.

133. None of the stock created for such purposes will be eligible for inclusion, temporary or otherwise, in the calculation of FTSE or iBoxx gilt indices.

## **SPECIAL REPO FACILITY**

134. If the DMO considers that there is sufficient evidence of severe market dislocation or disruption, it may create stock for repo-ing to any GEMM that has signed the required legal agreements with the DMO. Such circumstances will need to have been persistent and are not likely to be tied to any single event (e.g. delivery of a cheapest-to-deliver gilt into a single futures contract) or difficulties encountered by a single market participant.

135. The terms of the facility, including any rate of repo, which may or may not be penal, and the amount of gilt(s) available for creation, will be announced on the DMO's wire services pages and the website. Any subsequent cancellations or withdrawal of the facility will be also announced in a similar fashion. As with the standing repo facility, such operations will usually involve a back-to-back, cash-for-cash reverse repo of gilt collateral with the same counterparty(ies) at the Bank of England's prevailing repo rate, and none of the gilt(s) thus created will be eligible for inclusion, temporary or otherwise, in the calculation of FTSE or iBoxx gilt indices.

## CONVERSION OFFERS

136. From time to time, the DMO may announce a conversion offer, usually with the aim of building up the size of a new gilt benchmark and retiring an old, 'off-the-run' one.

137. In determining which gilts might be candidates for conversion, the DMO will not consider any conventional gilts that have more than £5.5 billion nominal in issue, or any that is, or has a reasonable likelihood of becoming, cheapest-to-deliver into any active<sup>13</sup> gilt futures contract. The DMO will not normally schedule offers so that fixed conversion terms on any two offers run concurrently. Moreover, a conversion offer will not be scheduled to coincide with a gilts auction in the same maturity area.

138. Conversions may be announced on any day, normally at 3:30pm, on the DMO's wire services pages, in a press notice and on the web site. This announcement will contain details of the source and destination stocks, the fixed price terms of the offer, and the timetable and method of acceptance. The price terms of the offer will be decided by the DMO, using its own yield curve model to provide a benchmark (dirty price) ratio and, where necessary, adjusting this ratio to take account of any observed cheap/dear characteristics in the market for the relevant gilts.

139. Conversion offers are open for a period of three weeks from the date of the initial announcement of the fixed ratio. The appropriate amount of accrued interest on both source and destination gilts is incorporated into the calculation of the dirty price ratio, for forward settlement. The conversion itself will involve no exchange of cash flows, and will therefore be free of payment.

140. Holders have until the pre-announced prescribed time on the closing date to notify the Registrar (Computershare) via CREST, of their intention to 'assent' to the conversion. Non-CREST holders should notify the Registrar directly if they intend to assent. Notice to assent, once given, is irrevocable.

141. Any holder who is the beneficial owner of source stock, but who has lent it out in the repo market or elsewhere, still has the right to choose whether or not to accept the offer (and, if the term of the repo/loan goes over the closing date, to receive the destination gilt instead), but the holder must communicate his intention to the borrower in sufficient time for the latter to be able to assent the stock on behalf of the owner.

142. The DMO will usually announce the results of a conversion offer at 8:30am on the first business day following the closing date of the offer. This announcement will include the nominal amount of source stock assented, the percentage rate of take up and any amount remaining unconverted. It will also detail the nominal amount of new destination stock created, and the revised total nominal outstanding in that gilt. If appropriate, the DMO may also announce whether the source gilt has been assigned 'rump' status.

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<sup>13</sup> 'Active' means a contract that already has outstanding open interest.

## **CHAPTER 5 - DATA PROVISION**

### **DATA PROVISION BY THE GEMM COMMUNITY**

143. All GEMMs are required to provide the DMO with certain information – end-of-day prices, positions, weekly turnover, pre-auction reports etc. – in a prescribed format and to a prescribed timetable as detailed in the paragraphs below.

144. In addition, GEMMs are strongly encouraged to provide comprehensive and accurate, real-time price information to their client bases, either through proprietary dealer-to-customer platforms, via pages on the various wire services or by participation on multi-dealer electronic trading platforms. The DMO would expect to be treated as a GEMM's client in respect of being granted access to the provision of such prices, even if this is on a 'view-only' basis.

#### **GiltSWAN**

145. The DMO uses electronic file transfers for the provision of end-of-day prices, positions and weekly turnover reports. Data are transferred over a secure wide area network system, known as GiltSWAN. All GEMMs (and IDBs) must install and maintain/upgrade these systems in order to be able to transmit sensitive data in a secure, accurate and timely fashion. Supply of hardware, software and maintenance of the network is subcontracted to a third party firm, GiltKing, to whom HM Treasury pays an annual fee for the operation and upkeep of the system. Note that all GEMMs and IDBs may be liable to pay an annual fee to HM Treasury relevant to their share of operational, maintenance and support costs, with the DMO paying the much larger balance. Invoices will be sent out annually, usually in August, to all heads of gilt trading at GEMM and IDB firms, and HM Treasury expects prompt settlement.

146. Each GEMM and IDB firm is issued with a unique username and password for logging onto to the system, which is renewed periodically. Personnel transmitting the data should always ensure that they are using the most up-to-date version of the software, that they select the relevant 'send prices' or 'send positions' button, and that the file is accepted by the DMO's database (signalled by an appropriate message and the screen turning green). Error messages (signalled by a red screen) should be heeded and acted upon, and where necessary the file re-transmitted as soon as possible.

147. Whilst the DMO's system can screen for errors in the formatting, and to a certain extent, the content of these files, it is the responsibility of each GEMM and IDB firm to ensure that the transmission of their files is (a) timely, (b) comprehensive, and (c) wholly accurate. Any errors or omissions will inevitably corrupt the integrity of the data and any subsequent output from the database.

148. Any queries regarding operation and maintenance of the GiltSWAN reporting system should be addressed to the DMO's dealers or desk assistant, or, if of a more technical nature, to GiltKing. A document detailing the exact formatting of GEMM files is attached at Annex 4 of this publication.

## **End-of-day prices**

149. On behalf of the Gilt-edged Market Makers Association (GEMMA), the DMO collates and publishes end-of-day prices in all gilts, including strips. These 'official' closes are widely used by market participants, wire services and other media for marks-to-market and historical reference purposes. In addition, they are used by CrestCo for DBV valuations, and by other repo market users. (See paragraphs 162-163 for details of how the DMO collates and publishes the data).

150. All GEMMs are required to submit an electronic prices file, in the designated format and using designated channels, to the DMO on a daily basis. The file should contain that GEMM's mid-market price in all the gilts, including strips, in which they are designated market maker, excluding rump gilts. The prices should be taken as a 'snapshot' at exactly 4:15pm every afternoon – this timing is to coincide with euronext LIFFE's official settlement of the long gilt futures contract.

151. GEMMs then have until 4:50pm to format their files and transmit them to the DMO, where they are collated and published on the wire services at 5:00pm<sup>14</sup>, and later that evening on the DMO website.

152. Files are expected to contain accurate prices and a fully comprehensive list of gilts. As the DMO has little or no control over the quality of the input, GEMM traders should pay particular attention to these issues as inaccurate publications can lead to financial losses to individual GEMMs or other market participants, and reputational damage to the market as a whole. The DMO provides weekly feedback to every GEMM firm about the quality of their individual contributions. Dealers also need to ensure that their systems are kept up-to-date with any changes in the gilt portfolio – this means the timely addition of new gilts, including WI bonds, even where the forthcoming auction is a re-opening of an existing gilt, and the deletion of gilts as soon as they enter their final ex-dividend period prior to redemption.

## **Positions data**

153. GEMMs are also required to submit a daily file in confidence to the DMO, giving details of all the end-of-day positions held by the GEMM in UK government bonds, including rumps and strips, but not eurosterling, bulldog or other countries' government bonds. Under normal circumstances, the DMO will not look closely at individual holdings, but does use aggregated data to inform itself of overall market positions in individual gilts and sectors, which can serve as an 'early warning system' of any potential for market dislocation, and the likely success or otherwise of a forthcoming auction. The DMO does, of course, protect such data as 'highly confidential', but does reserve the right to share them with other market authorities in exceptional circumstances.

154. A GEMM's daily position file should also provide details of any trades that have failed on that day, or that are still outstanding as unsettled from a previous fail. Again, these data are only used as an early warning signal of any potential for systemic failure or dislocation in the market, and will be treated as highly confidential by the DMO.

<sup>14</sup> These timings may be brought forward on days when a relevant Exchange closes early (e.g. Christmas or New Year's Eve).

155. These files may be submitted to the DMO, in the designated format and using designated channels, any time between 5:00pm on the day and 8:00am the following morning.

### **Turnover data**

156. On a weekly basis, GEMMs are required to submit details of all transactions in gilts executed during the Monday-Friday period of the previous week. These files must be submitted in confidence by 8:00am on the Tuesday of the following week (or the second working day where there is a bank holiday), in the designated format and using designated channels. This file must be dated with the Friday of the week to which it relates, regardless of whether or not the Friday itself was a bank holiday (e.g. Good Friday).

157. GEMM turnover is to be reported in various maturity/instrument type, trade type (i.e. buy or sell) and counterparty type brackets – details of which can be found at Annex 4 of this document. Note that turnover volumes are to be reported by market value (i.e. nominal size x dirty price), not in purely nominal terms.

158. In order to maintain the accuracy and integrity of the data, it is essential that all GEMMs maintain their systems constantly, in terms of sifting the relevant data, counterparty classifications, stock lists and maturity banding, and valuations. This means that each GEMM's system must be able to collect and collate each week's turnover data, and correctly identify which trades are allocated to which band, counterparty type etc. The DMO, will of course be prepared to offer help and advice, but ultimately it is the responsibility of individual GEMMs to ensure that they are complying with the requirements.

### **Pre-auction data**

159. In the run-up to a gilt auction, conventional or index-linked, GEMMs are asked to provide details of transactions over a minimum size<sup>15</sup> executed in the WI period between the announcement of the final terms and conditions of each auction (usually on the Tuesday in the week preceding the auction date). These details should be submitted by fax to the DMO by 8:00am on the morning of an auction, on the forms provided.

160. The DMO requests these data in order that it may monitor whether any one or more institutions, GEMMs or investors, is/are building up a large position, long or short, which may affect the outcome of the auction itself, and/or the orderliness of the grey or secondary market in that particular gilt or in the market as a whole. Once again, the DMO will treat all such submissions as 'highly confidential'.

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<sup>15</sup> £10 million + (nominal) in conventional auctions, £5 million + (nominal) in index-linked.

## **DATA PROVISION BY THE DMO**

### **Intra-day benchmark prices**

161. Between the hours of 8:05am and 4:15pm, the DMO collates and publishes a composite page of indicative mid-prices in a selection of benchmark gilts. These prices represent the average of contributions from GEMMs to the wire services, after discarding the highest and lowest outlier quotes for each gilt. The DMO's composite page will therefore update every time a new GEMM contribution in any one gilt is sufficient to change the overall average price. Note that these reference prices do not constitute an offer from the DMO to buy or sell securities, nor are they in any way intended to be binding on GEMMs dealing with other market participants. Ownership of the input data remains with the contributing GEMMs, the output with the DMO, and no GEMM or third party may re-distribute them, in any format, on a chargeable basis. The composite prices are published to various wire services providers and are available to all subscribers to those services, without charge and without discrimination over access.

### **End-of-day GEMMA reference prices**

162. Upon receipt of the end-of-day price files detailed in paragraphs 149-152 above, DMO dealers run an automatic averaging program, which collates all the data received from individual GEMMs on a gilt-by-gilt basis. The program calculates first the median of all contributions received, then rejects any that are outside tolerated boundaries and finally re-calculates the arithmetic mean of the remainder<sup>16</sup>. Once this clean price is derived, dirty prices, yields etc can then be calculated. Rump gilt prices and spreads are determined by the DMO, but are based on GEMM-contributed prices in reference gilts.

163. The full set of prices is downloaded and published to the relevant wire services' pages at 5:00pm every evening, and later in the evening on to the DMO's web pages. The DMO also sends the prices to CrestCo, the Bank of England, the London Stock Exchange and certain newspapers in varying formats.

### **Weekly feedback on GEMMA contributions**

164. The DMO monitors the accuracy and integrity of the GEMMA reference prices, as inaccurate pricing can be reputationally damaging to the DMO, the GEMM community and the market as a whole. And given the widespread use of these prices for official mark-to-market by a wide range of traders, investors and others, including CrestCo, any aberrations can have a financial cost as well.

165. To this end, the DMO provides all GEMM firms with weekly feedback, normally on a Monday, on the quality of the price files they contributed in the preceding week. This feedback is in the shape of a graph and table which provide a daily record of - (a) the number of prices accepted, (b) the number of any prices rejected as outliers, and (c) any non-contributions. Where there are any instances of either (b) or (c) above, GEMMs are expected to investigate the cause and to take corrective action.

<sup>16</sup> For further details on the calculation of GEMMA reference prices and applicable tolerance levels, please see <http://www.dmo.gov.uk/documentview.aspx?docname=/giltsmarket/formulae/gemref.pdf>

## **Weekly turnover and market shares**

166. Turnover data submitted by the GEMMs to the DMO are collected and collated on a weekly basis. From the data received, the DMO will calculate total aggregate turnover volumes in the various maturity bands, types of gilt and on an overall basis, making a distinction between counterparties regarded as 'professional' and those regarded as 'customers'.

167. Since 1 January 2005, the DMO has defined GEMMs' 'professional' counterparties as the DMO itself, the Bank of England, any other recognised GEMM or IDB and any agency broker<sup>17</sup> acting as an agent for a third party, regardless of whether or not that agent is dealing as a matched principal or on a name-give-up basis. All other counterparties (i.e. those dealing directly with GEMMs for their own account) are regarded as 'customers'. Turnover generated on electronic dealing platforms counts as 'professional', where the trades are booked to a central counterparty, but as 'customer' business where resultant trades are booked directly with the end-investor. The DMO will also calculate individual GEMM's market shares in the various maturity bands, types of gilt and on an overall basis, again making a distinction between 'professional' and 'customer' counterparties, but without attaching a particular weight to either type. The DMO regards the provision of liquidity to the 'professional' sector of the market as equally 'useful' towards the transparency and fluid functioning of the gilt market, but would disapprove of any case of 'churning' or deliberate manipulation of turnover volumes.

168. Market share data are collated by the DMO on a weekly basis, normally on a Tuesday, assuming that all contributions have been received on a timely basis. Output from DMO systems is sanity-checked by DMO dealers before being released for publication to GEMMs. These checks may involve DMO dealers verifying any unusual numbers with the relevant GEMM traders. Any GEMM wishing to query or verify the output should contact the DMO immediately upon receipt of their file.

## **Quarterly turnover**

169. Weekly turnover files and data, submitted to the DMO by GEMM firms, are also used for the aggregation and production of quarterly turnover and market share data, which are published in detail to individual GEMM firms, and, on an aggregated basis, to the wider market on the DMO website. Note that by its very nature, these data cover only those transactions conducted by recognised GEMM firms, and are therefore not wholly comprehensive in terms of turnover in the entire gilt market. Nevertheless, it does represent a very significant proportion of transaction volume.

170. Each quarter is taken as a 13-week period, dated as closely as possible to the beginning of January, April, July and October to the end of March, June, September and December respectively. Dealers and other market participants can therefore expect publication of quarterly data in the first week or so of the following 3-month period.

171. Each GEMM firm will receive a package of charts detailing the following: overall week-by-week gilt market turnover, split between professional and customer

<sup>17</sup> Prior to this date, the DMO classified agencies as 'customer' counterparties in its data production.



counterparties and including a 13-week average; individual week-by-week turnover, with the same counterparty split and 13-week average; a breakdown of overall market turnover by maturity band/type of gilt, with the same counterparty split; individual turnover by maturity band/type of gilt and by counterparty type; and finally a chart measuring levels of concentration in the secondary market by use of Herfindahl indices.

172. Aggregated data – the equivalent of the first, third and fifth charts mentioned above – are published on the DMO website as soon as it is made available for public release, at <http://www.dmo.gov.uk/index.aspx?page=Gilts/Turnover>.

### **General data provision**

173. The DMO website ([www.dmo.gov.uk](http://www.dmo.gov.uk)) also includes a whole host of data and information on all aspects of the gilt-edged market, and forms the primary source of reference material from the DMO to the market – dealers, investors, analysts and all other interested parties. GEMM dealers are strongly recommended to familiarise themselves with the content and navigation of the DMO website, although DMO dealers and other personnel may always be contacted for assistance.

### **Ad hoc requests**

174. From time to time, the DMO is also requested, by GEMM firms and others, to provide 'tailor-made' turnover data, to suit a specific presentation, publication or piece of research etc.

175. In the interests of openness, transparency and freedom of information, the DMO is prepared to consider supplying the data requested on a case-by-case, provided that the following conditions are met:

- that the request is not unreasonable and not disproportionately labour-intensive to provide;
- that the subject matter or output is in no way commercially- or market-sensitive, in that it might reveal details of any individual institutions<sup>18</sup> market positions or transactions that they would otherwise wish to protect; and
- that the DMO is credited as the source of the data and that the data are not reproduced, in any format, other than for the purpose for which it was originally requested, without prior consent from the DMO.

176. Requests for such data should be addressed in the first instance to the DMO's Head of Gilt Dealing, Information Manager and/or Press Officer, whose contact details are provided in Annex 1 of this publication.

### **FREEDOM OF INFORMATION**

177. Please note that since 1 January 2005, the DMO is, as a 'public authority', subject to the provisions of the Freedom of Information Act 2000, under which any person may make a request seeking information held by the DMO. Upon receipt of such a request, the DMO must balance the legitimate interests of all parties involved against public expectations of accountability, openness and transparency.

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<sup>18</sup> This includes the DMO itself.

178. Legitimate business interests of primary dealers and other third parties may be protected by a series of exemptions within the Act, particularly those relating to the 'economy', 'commercial interests' and the 'in confidence' provision of information to the DMO. Whilst the decision to disclose or not rests solely with the DMO, every effort will be made to consult with the source prior to a decision being taken, where third party information is involved.

179. Further information on Freedom of Information may be obtained from the DMO's Head of Gilts Dealing or its Information Manager.

## **CHAPTER 6 - INFORMATION PROVISION**

### **PRICES**

180. As mentioned in the previous chapter, GEMMs are strongly encouraged to provide comprehensive and accurate, real-time price information to their client bases, either through proprietary dealer-to-customer platforms, via pages on the various wire services and/or by participation on multi-dealer electronic trading platforms. The DMO would expect to be treated as a GEMM's client in respect of being granted access to the provision of such prices, even if this is on a 'view-only' basis.

### **CONTACT DETAILS**

181. GEMM firms are expected to provide the DMO with a list of relevant personnel involved with the gilt market making operation. Generally speaking, this should include the names, telephone numbers and e-mail addresses of the following: all traders, senior salespeople, compliance officer, settlement and data reporting contacts. GEMM dealers should endeavour to ensure that these lists are kept up-to-date and that any changes in personnel (arrivals and departures) are notified to the DMO in a timely fashion. It is important that contact details are accurately maintained, particularly for business continuity planning purposes and access to BAS.

### **CONSULTATIONS**

182. Over the course of the financial year, the DMO will undertake a number of consultation processes with representatives of the GEMM community and others. These may take the form of physical meetings, written or oral requests for information or opinion.

#### **Annual consultation**

183. Early in the calendar year, all GEMM firms will usually receive an invitation to send a representative to attend, and contribute to, an annual meeting with the Economic Secretary to the Treasury (EST). The purpose of this meeting, normally held at HM Treasury in Westminster, is to inform the EST, HM Treasury and the DMO of market makers' advice vis-à-vis the setting of the financing remit for the forthcoming financial year. Topics under discussion are likely to include the likely scale of borrowing in the coming year, options and preferences for maturity band or instrument type splits, possible new lines of gilts or instrument design, as well as any relevant matters of wider government policy or current concern.

184. Summary minutes of this meeting, and a similar one held with representatives of end-investors, will be published as soon as practicable on the following day.

#### **Quarterly Consultations**

185. On a quarterly basis, the DMO will host a meeting with representatives from each of the GEMM firms, at which the options and preferences for funding operations over the forthcoming three months, as well as any other topical matters, will be discussed. GEMMs are invited, and expected, to send one representative each. They

are normally held on a Monday evening, towards the middle of March, May, August and November.

186. These meetings take the form of a roundtable discussion, led by the DMO, which will summarise the events and operations in the current quarter, before outlining the funding options for the coming quarter, within the bounds of the published remit and current policy. The DMO may also point out any portfolio preferences of its own, but these should not be seen as prescriptive. GEMM representatives are each asked to put forward their own 'house' views on the scheduling of auctions over the coming quarter, giving the reasons behind their choices. Attendees are also given the opportunity to raise questions or suggestions about any other aspect of gilt financing or the market in general. Issues concerning the index-linked sector of the market, including auction scheduling, are discussed only by those firms who are recognised as market makers in these gilts.

187. Again, summary minutes of these meetings, and similar ones held with representatives of end-investors, will be published as soon as practicable on the following day.

188. Decisions on the actual timetable and the identity of auction gilts for the forthcoming quarter are made by the DMO's Debt Management Committee in the light of feedback received from these meetings, and usually published on the last business day of the month in March, May, August and November.

#### **Ad hoc consultation exercises**

189. From time to time, the DMO may launch a formal consultation exercise on any issue pertinent to reform or innovation in the gilts market. Formal consultations usually consist of the publication of a paper outlining the DMO's proposals on the topic and the rationale behind them, and an invitation to comment to all market participants, with a deadline for response. Following receipt of these comments, the DMO may formulate definitive policy and publish a response document, or it may seek further clarification of views on contentious points. All GEMM firms are expected to participate with due consideration in such consultation exercises.

190. The DMO may also conduct less formal market soundings on some issues. These may range from a questionnaire posted on the DMO website to a simple e-mail or Bloomberg message to GEMM traders requesting information or opinions on a more minor matter. Again, all GEMMs are expected to respond to such requests. In addition, the DMO may seek information through a series of one-to-one meetings (eg. an agenda item at regular bilateral meetings with GEMMs) or it may target certain institutions or individuals, market makers, investors or others, known or believed to have a particular interest or expertise in the matter under debate.

#### **MARKET INTELLIGENCE**

191. Because of their situation at the heart of the gilt market, GEMM firms are in a strong position to gauge market sentiment and traded flows. The DMO is particularly appreciative of any intelligence that market makers can supply, in confidence if desired, on such matters. Such intelligence could encompass views or information on

investment trends, large individual trades, forthcoming government or corporate issuance, developments in other markets, potential future reforms or problems in the gilt market etc. GEMM firms may feed such information through contacts on the DMO's dealing desk, or by contact with other relevant DMO personnel.

## **RESEARCH**

192. Most GEMM firms support research operations whereby specialist analysts produce research on the sterling markets. Such research can range from analysis of macro-economic fundamentals down to specific relative value trade ideas or predictions about a forthcoming auction. Whilst it is recognised that the production of research is primarily for use as a 'marketing tool' for investment banks to reach out to their existing or potential client base, the DMO is grateful to primary dealers who produce such analysis as a means of promoting the gilt market to new investors or opportunities to existing ones, all of which helps to improve the liquidity and orderliness of the market. The DMO is also keen to receive relevant research itself.

193. Please note that, in the UK, the Financial Services Authority's PS04/6<sup>19</sup> publication imposes a duty on market participants to distinguish between those analysts that provide 'biased' information (i.e. those that work closely with traders and may or may not be producing material that reflects positions held by the firm) and those that are wholly independent from the trading desks, whose material may not be released to that firm's own trading staff prior to general release.

## **CONFERENCES AND PRESENTATIONS**

194. Throughout the year, various investment banks, market and media organisations etc. may host conferences, forums or seminars on subject matters relating to the UK economy, sterling and/or sovereign bond markets, or specific subsets of these markets. The DMO welcomes the staging of such events as a means of promoting the gilt market, reaching out to new investors or simply as a means of better informing existing participants. To this end, the DMO is prepared to consider requests to participate at these events itself, subject to resource availability, the perceived relevance to its own operations and not being seen to be favouring one or more individual institutions.

195. Similarly, the DMO is also prepared to consider requests to meet with or make presentations to GEMMs' customers, individuals or groups, existing or potential, again subject to considerations of resource, relevance and favouritism.

## **DMO ANNOUNCEMENTS TO THE MARKET**

196. In the interests of transparency and predictability, the DMO strives to release announcements at a set time of the day. Unless otherwise mentioned, announcements to all market participants are generally released at 3:30pm, and occasionally at 7:30am, simultaneously on recognised wire services and as soon as possible thereafter on the DMO website, although the DMO does reserve the right to make an announcement at any time, depending on the circumstances - for example, auction results or announcements made in the wake of the Chancellor's Budget speech or Pre-Budget Report.

<sup>19</sup> See [http://www.fsa.gov.uk/pubs/policy/ps06\\_04.pdf](http://www.fsa.gov.uk/pubs/policy/ps06_04.pdf)

197. The interest and redemption payments for all index-linked gilts with first issue dates before 2002 are fixed by the Bank of England. The Bank aims to announce details of these payments by 2:30pm on the day that the relevant value of the General Index of Retail Prices (RPI) is published. For index-linked gilts first issued from 2002 onwards, the DMO is responsible for fixing and announcing the interest and redemption payments. The DMO aims to announce details of these payments by 3:30pm on the day that the relevant RPI value is published. On days on which both the Bank and the DMO publish details of index-linked gilt interest or redemption payments the DMO announcement will also incorporate details of the payments published by the Bank. In every case, all fixings are published on the DMO website.

## **CHAPTER 7 - RELATIONSHIP MANAGEMENT**

198. It is, of course, in the interests of all concerned that a close and productive working relationship is maintained between the issuer and primary dealers. To this end, the DMO works hard to foster relations between the parties involved in the following respects:

### **DAILY CONTACT**

199. All GEMM firms are required to install and maintain a direct telephone line between its gilt trading desk and the DMO's dealers. This line is, of course, used for trading enquiries and as a back-up for the submission of auction bids, but may also be used for any other purposes necessitating dialogue between the respective dealing teams (e.g. dissemination of market intelligence, operational or policy information queries or requests).

200. The DMO's dealers may also be contacted via e-mail or Bloomberg messaging services, although GEMM traders should note that any dealing transactions between themselves and the DMO must be carried out, or at least confirmed, on a recorded telephone line. Other members of DMO staff may be contacted in the same way, or on an outside telephone number<sup>20</sup>.

### **REGULAR BILATERAL MEETINGS**

201. On a regular basis, usually once every nine months or so, the DMO will conduct a round of structured bilateral meetings with representatives of each GEMM firm. These meetings may be held at the DMO's offices, the GEMM's offices or at another venue, and are usually attended by the DMO's gilt dealers and possibly a member of the DMO Management Board on one side, and GEMM traders, including the head of the desk, and possibly a more senior manager on the other.

202. The agenda for each of these meetings is standard for all GEMM firms, although the focus and direction will vary according to individual views and circumstances. It is normal for the first half of the agenda to follow a set pattern of discussing GEMMs' corporate and staffing issues, individual auction participation and secondary market shares, while the second half of the agenda will discuss topical events, issues or proposals in the gilt market at the time. GEMMs may, of course, raise other matters under Any Other Business. The DMO may take minutes at such meetings for purposes of internal reporting, but, as they will inevitably be commercially sensitive, all records shall remain unpublished.

### **AD HOC CONTACT**

203. Meetings between GEMMs and the DMO are not restricted to the scheduled bilateral meetings detailed above. Either party may request a meeting at any time to discuss or present a particular concern, market development or innovative idea. Such meetings may involve gilt dealers on either or both sides, or other members of staff as appropriate.

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<sup>20</sup> Contact details for key DMO personnel are provided in Annex 1.

## **CHAPTER 8 - REGULATION AND EXCHANGE MEMBERSHIP**

204. UK gilts are listed securities, listed on the London Stock Exchange (LSE), and, as such, are treated as 'on-exchange' products, even though the vast majority of dealing takes place 'over-the-counter' (i.e. bilaterally over the telephone or via electronic trading platforms not operated or controlled by the LSE). It is a requirement of the DMO that all GEMM firms be members of a Recognised Investment Exchange (RIE), which in practice tends to be the LSE, and that they are regulated by a competent and recognised regulatory authority, in practice this means the UK's Financial Services Authority (FSA). GEMMs are expected to comply fully with these institutions' regulations.

### **SUPERVISORY REGULATION**

205. As most, if not all, GEMM firms will be based in London, they are expected to be regulated by the FSA, and to comply fully with their regulations and codes of conduct or best practice. Even if not directly regulated by the FSA, they are expected to have FSA approval for their operations in the gilt market through European Economic Area 'passport' arrangements with their home market regulator.

206. Monitoring of individual GEMM firm's operations in the gilt-edged market and elsewhere is the responsibility of the FSA, in terms of risks undertaken, balance sheet capabilities, trading behaviour etc. The DMO has a mandate to maintain the 'health' of the market as a whole, in order to maintain a liquid and orderly market in the interests of all investors and future funding costs. In pursuance of their twin objectives, the FSA and DMO may liaise with each other and exchange any relevant information, although this is only likely in an exceptional situation or where a firm is proposing to undertake new or increased trading activities (e.g. an application to be recognised as either type of GEMM). The FSA and the DMO may also liaise where either party is proposing a (significant) change to the existing market structure or rules.

### **EXCHANGE MEMBERSHIP**

207. Again, as most, if not all, GEMM firms will be based in London, they are expected to be(come) members of the LSE, and to abide by the rules and requirements of the Exchange as they pertain to the gilt market. GEMM applicants wishing to operate under the terms of any other RIE must first seek jurisdiction approval from the DMO.

208. The complete rules of the LSE are available on the exchange's website<sup>21</sup>, but GEMM firms should note that these currently dictate that all members of the Exchange must trade report immediately details of any transactions executed, even if transacted over-the-counter. The rules also prescribe the Exchange's own obligations on market makers with regard to reporting, making prices (and exceptions thereto), delivery of stock, registration and access to inter-dealer broker services.

<sup>21</sup> <http://www.londonstockexchange.com>



## **CHAPTER 9 - ENTRY AND EXIT PROCEDURES**

209. In the interests of promoting fair competition amongst investment banks and other securities firms, the DMO has no fixed notion of the number of primary dealer firms that it is prepared to recognise at any one time, nor does it operate a 'promotion and relegation' system for its primary dealers. In line with recommendations from the Office of Fair Trading and other EU legislation, barriers to entry as a Gilt-edged Market Maker are kept as low as is prudent, but there remain certain criteria and procedures that must be fulfilled before a (potential) applicant may be considered for recognition (see below). The DMO also recognises that market conditions or an individual firm's circumstances or priorities can change over time, which might lead to that firm requesting, or being requested by the DMO, to resign their status as a GEMM. In such cases, it is important to ensure that the (sudden) departure of one firm is not detrimental to other GEMMs or the wider market.

### **APPLICATION PROCESS**

210. It is recommended that any firm considering applying to become a GEMM first contacts the DMO, in order to discuss its plans and to obtain an 'official' application form – a copy of which is reproduced in Annex 5 of this document. At this stage, DMO dealers will offer guidance on the likely suitability of the application and how best the applicant should go about meeting the criteria requested. Once the official form has been completed and submitted, the DMO will request a formal meeting with the applicant firm, involving senior staff from both parties, at which the firm may expand in more detail on its strategies and commitment to the market, and the DMO may seek to clarify any outstanding points and future course of action.

### **ESSENTIAL CRITERIA FOR NEW GEMM APPLICANTS**

211. In order to ensure the ongoing integrity and functionality of the gilt market, any firm wishing to be recognised or endorsed as a GEMM (or IDB) must be able to demonstrate that, where applicable, it has all of the following:

- a viable business plan, including demonstrable market demand;
- sufficient balance sheet capabilities to support their intended activities;
- adequate staffing resources, including trading, sales, research, risk management, settlement and compliance professionals;
- relevant technological capabilities;
- approval from an RIE and their regulator to undertake such activity;
- a willingness to sign up to all of the DMO's requirements and expectations; and
- a long term commitment to the UK Government bond market.

212. Further details on any or all of the above may be obtained from DMO dealers.

### **PROCEDURES FOR GOING 'LIVE'**

213. Assuming that an applicant firm meets the criteria listed above, and is approved by the DMO, the exchange and the regulator, the DMO's Chief Executive or other Managing Board member, will write to the senior representative of the firm to inform him/her whether its application has been successful. At this stage, any approval is still

subject to the DMO receiving written confirmation of agreement from the regulator and from the exchange, signed acceptance of the terms and conditions of becoming a GEMM by the applicant (including any repo or other legal contracts), installation of the necessary technical requirements and agreement between the DMO and the applicant on a starting date.

214. Once all these procedures have been completed, the DMO, jointly with the exchange, will announce the fact to the wider market via its wire services pages and website. This announcement may be made some time in advance of the committed start date, or on the afternoon before, according to the applicant's preference. However, having made such an announcement, the DMO would not expect any firm to delay its start of operations.

## **PROBATION**

215. Depending on the nature of the applicant or application, the DMO may impose, and announce, a conditional period of 'probation' on the granting of GEMM status. The actual terms of a firm's probation shall remain confidential between the two parties, on the grounds of commercial interests, but, depending on the particular situation, are likely to involve the attainment of a minimum amount of market share, auction participation, client penetration or similar target, within a specified period of time. Such targets are unlikely to be any more onerous than those already imposed on existing market makers. At the end of the probation period, the DMO would announce whether the firm had been granted 'full-time' GEMM status or not, having first informed the firm itself of the outcome.

216. Existing GEMM firms may also have a period of 'probation' imposed on them, should their performance as a GEMM deteriorate, either overall or in a particular segment of the market. Were the DMO to judge that a firm was no longer meeting any or all of its obligations as a primary dealer, or failing to achieve a satisfactory market share, it is likely that senior representatives of the GEMM in question would be called in to discuss the shortcoming(s) with the DMO, and may be given a warning that the problems must be addressed within an agreed period of time. If, by the expiry of this deadline, the agreed objective has not been achieved, the firm will be asked to resign its status as a GEMM, either entirely, or in the relevant sector of the market. In these circumstances, and in order not to affect the firm's reputation and chances of succeeding in its objective, the DMO will not publicise the fact that such a probation order has been imposed.

## **EXIT PROCEDURES**

217. As well as failing to meet the required standards, there are, of course, other reasons why a firm may no longer wish to continue operating as a gilt-edged market maker (e.g. a change in business priorities, bank consolidation etc). In all cases, the DMO is concerned to ensure that a firm's departure is carried out in a way that does not cause undue disruption to other market participants.

218. Exiting firms should liaise early on with the DMO to inform of any intention to resign, and to discuss the orderly unwind of any positions held, agree the timing and date of resignation, and the content of any announcements made to the market, by

the DMO and/or by the firm involved. Such an announcement is likely to be made on the last day of a trading week, with the resignation effective from the close of business on the same day.

219. A firm that does resign its status will be asked to return any property belonging to the DMO (e.g. reporting systems) as soon as is practicable. In the interests of discouraging 'fair weather' trading, it is unlikely that the DMO would approve an application from the same firm to rejoin the GEMM community for some considerable period of time.

## **CHAPTER 10 - EMERGENCY ARRANGEMENTS**

220. The following chapter attempts to detail some of the arrangements that the DMO has made or will invoke in the event of a disruption to normal operations. Obviously, the nature and effect of such disruptions can vary enormously, from a regular fire drill to a terrorist attack, and as such it is impossible to prescribe a particular course of action for all possible scenarios. However, some background information and 'working assumptions' are outlined below.

### **BUSINESS CONTINUITY SITES**

221. In common with many other investment banks and other businesses, the DMO has a dedicated back-up site, which it may invoke in times of interruption to normal operations at its offices in Eastcheap Court. As far as possible, the DMO has arrangements in place to ensure minimal disruption in the event of invocation. However, there may on occasion be a risk of delay, depending on the nature of the circumstances, between the occurrence of an 'event' and the resumption of the full range of normal activities. Nevertheless, the DMO will keep stakeholders and counterparties apprised of its operational status via announcements on wire services pages and/or website.

222. The DMO also has reciprocal arrangements with the Bank of England, to cater for interim or short-term periods of disruption. In the event of DMO dealers being denied access to their offices for whatever reason, GEMMs might expect to be contacted by staff at the Bank or for announcements to be made on the Bank's wire services pages.

223. The DMO expects GEMM firms to have made similar arrangements for continuity of their own businesses, and would be willing to consider requests to participate in any testing exercises, subject to resource availability. GEMMs should also provide the DMO with emergency contact details, for use in the event of their operations being disrupted.

### **AUCTIONS**

224. The DMO, and the market, is particularly at risk if the occurrence of an emergency event were to coincide with the running of a scheduled gilt auction. Again, there is a wide range of potential interruption scenarios and it is not practical to prescribe a particular course of action for each case. However, the DMO is highly aware that the market's strong preference is likely to be that the auction should be conducted at the scheduled time on the scheduled date, and that the postponement or cancellation of an auction should only be considered in extreme circumstances. However, in the event of a situation where the DMO, or a significant number of GEMM firms, are incapacitated for whatever reason, the DMO's preferred option is likely to be to postpone the holding of the auction until later on the same day, or possibly very early the following morning, in order that the auction, and any WI trades previously executed, may still be settled on the same day as originally advertised. Please note, however, that the incapacity of a single GEMM firm is unlikely to cause the postponement or cancellation of an auction. In the event of an interruption of this nature, GEMMs should contact the DMO as soon as possible in order that special

arrangements for the submission of bids may be made. However, the DMO will not be able to offer any special facility to guarantee the allocation of stock, other than the usual non-competitive allocation.

## **SECONDARY MARKET DEALING**

225. In the event of the DMO being incapacitated for any period of time due to emergency circumstances, market makers should be aware that the DMO's provision of prices for near maturity and/or rump gilts is likely to be withdrawn temporarily, until such time as normal operations are resumed, either from its offices in Eastcheap Court, or from the recovery site.

226. It is also likely that, in such circumstances, the provision of real-time benchmark price indications on wire services pages will be suspended temporarily.

227. The DMO is also likely to exempt a GEMM firm from its market making obligations, on a temporary basis, should that firm suffer from a loss of key personnel or systems through circumstances beyond its control.

## **END-OF-DAY GEMMA REFERENCE PRICES**

228. In the event that one or more market makers are unable to contribute end-of-day price files, due to systems problems at either end, there is a facility whereby DMO dealers can input files into the database on behalf of the relevant GEMM(s), provided that the GEMM can transmit its file to the DMO by some other means (e.g. e-mail, courier, etc.). The same is true for daily positions or weekly turnover data, although the deadline for submission of these files is less urgent.

229. In the event that a database problem means that no GEMM, nor the DMO on their behalf, can input end-of-day price files, then the DMO reserves the right to use its own dealers' contingency price file to generate end-of-day GEMMA closes. As with the GEMM contributions, this file is a record of the DMO dealers' closing prices, taken as a snapshot at 4:15pm, and produced on a daily basis for just such a purpose, as well as internal records. However, time limitations and the current configuration of the contingency programme mean that it is unlikely that strips prices will be updated on any day where database access is denied.

## **WIDER MARKET RESILIENCE MEASURES**

230. As a Government agency with particular responsibilities in the financial markets, the DMO works closely with the UK's tripartite authorities (Bank of England, HM Treasury and the Financial Services Authority) in business continuity planning and testing, with the intention of strengthening the financial sector's resilience to maintain or restore operations in the event of disruption. In such circumstances, the tripartite authorities' main communication mechanism will be the UK Financial Sector Continuity website ([www.fsc.gov.uk](http://www.fsc.gov.uk)).

## CONCLUSION

231. It is hoped that this document serves as a valuable source of reference for traders and other personnel working for institutions recognised as Gilt-edged Market Makers by the DMO, as well as for other interested parties.

232. The content is believed to be wholly accurate in describing the situation in the UK gilt market as it stands at the time of publication in May 2007, but readers should be aware that markets are fluid, and that, as a result, conventions and regulations may change in time. Any major changes in policy regarding the operation of the gilt market and its primary dealers would be announced by the DMO via the usual channels, and revised chapters to this document issued in due course.

233. Any comments on the content with a view to enhancing future publications, or requests for further clarification on any matter, should be addressed to the DMO's Head of Gilt Dealing, whose contact details appear in Annex 1 of this document.