MiFID II/R: Systematic Internalisers
A 'Q&A' for bond markets
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Q1. What is a systematic internaliser?

A. A systematic internaliser (SI), under the EU MiFID regime, is an investment firm that deals on its own account by executing client orders outside a trading venue.

MiFID I

MiFID I, in 2007, introduced the definition for European equity markets, defining an SI as 'an investment firm which, on an organised, frequent and systematic basis, deals on own account by executing client orders outside a regulated market or an MTF'. The core requirement for SIs is to publish firm quotes in shares admitted to trading on a regulated market that are classified as 'liquid' under MiFID when dealing in sizes up to standard market size. Under MiFID I, there is no specific definition of 'frequent' or 'systematic', and investment firms can elect to become SIs at their own discretion. Following the introduction of the regime, very few firms became SIs.

MiFID II/R

MiFID II/R extends the SI regime to other financial instruments, including bonds, and broadens the definition to 'an investment firm which, on an organised, **frequent and systematic**, and **substantial** basis, deals on its own account by executing client orders outside a RM, MTF, or OTF. Furthermore, the regulation specifies quantifiable definitions for 'frequent and systematic', and 'substantial', based on trading volumes (see below).

Q2. Why does MiFID II/R introduce the SI regime for bonds?

A. The rationale for the SI regime is to move 'dark', off-venue trading, on to 'lit' venues by creating a level playing field and greater price transparency between OTC and venues. The key requirement of an SI, compared to a non-SI, is that it is subject to similar pre-trade transparency obligations as a RM, MTF, or OTF, as this is expected to aid price formation for investors.

Q3. How do I become a systematic internaliser?

A. MiFID II/R level 2 will set out clearly defined thresholds for becoming an SI, based on trading volumes in respect of 'frequent and systematic' and 'substantial'.[1]

[1] See: ESMA's final Technical Advice to the Commission on MiFID II and MiFIR (December 2014)

Proposed trading thresholds for SIs: ‘frequent and systematic’

- The frequent and systematic basis will be measured by the number of OTC (off venue) trades in the financial instrument carried out by the investment firm executing client orders on its own account.

- For liquid bonds, this is where the number of trades executed off venue during the last six months is equal to or larger than 2-3% of the total number of transactions in the relevant financial instruments in the EU executed on any venue or OTC during the same period. At a minimum, the firm shall deal on its own account in the instrument once a week.

- For illiquid bonds, this is where the firm has dealt on its own account OTC in the financial instrument on average once a week during the last six months.

Proposed trading thresholds for SIs: ‘substantial’

- The substantial basis will be measured either by the size of the firm’s OTC trading on own account in relation to the total trading of the firm in a specific instrument, or by the size of the firm’s OTC trading on own account compared with the total trading in the EU in a specific financial instrument.

- The firm internalises on a substantial basis if the size of OTC trading on own account during the last six months is equal to or larger than:
  - 25% of the total nominal amount traded in that financial instrument executed by the investment firm on its own account or on behalf of clients, and carried out on any trading venue or OTC; or
  - 0.5-1.5% of the total nominal amount traded in that financial instrument executed in the EU and carried out on any EU trading venue or OTC.

Firms will be required, on a quarterly basis, to assess whether they meet the criteria for both ‘frequent and systematic’ and ‘substantial’, and should they qualify they will register themselves as an SI with the relevant NCA, which in turn will notify ESMA (who will maintain a list of all SIs in the EU).

Q4. Is being an SI optional?

A. If an investment firm does not meet the quantitative criteria it may still be able to opt-in to become classified as an SI, so long as it complies with all the applicable requirements. However, there is no option to opt-out. If a firm wishes not to be an SI, then it must fail either the ‘frequent and systematic’ or the ‘substantial’ quarterly tests.

Q5. Do I become an SI on a specific instrument basis, or by market type or asset class?

A. Firms become SIs for bonds (either through meeting the trading threshold criteria or by opting-in) on an instrument-by-instrument basis.

Q6. How often are the SI criteria re-assessed?

A. Investment firms are required to assess whether they meet both the ‘frequent and systematic’ and ‘substantial’ criteria on a quarterly basis, based on data from the last six months. These assessments are to be performed on the first working day of January, April, July, and October.

For new (non-equity) instruments, the assessments are only to be considered once the data covers a minimum period of six weeks.

Q7. What are the reporting requirements of an SI?

A. SIs are subject to comparable pre-trade reporting requirements as RMs, MTFs, and OTFs. They are also subject to the same reporting waivers for illiquid markets, orders that are large in scale (LIS), orders that are equal to or larger than the relevant size specific to the instrument (SSTI), and orders held in a management system. For OTC quotes made by an investment firm in their capacity as an SI, the firm will be identifiable; whereas quotes provided on a venue will be averaged with those of all other quoting firms, and anonymized.

SIs are also subject to the same post-trade transparency requirements and waivers as RMs, MTFs, OTFs, and other investment firms.

Q8. What discretion do I have in my quoting and trading as an SI?

A. SIs for bonds are required to provide firm quotes to clients on request (in standard market size) for liquid bonds. However, SIs are able to limit the number of transactions a client may enter into, and the clients to whom the quotes are provided, so long as its commercial policy is set in a non-discriminatory way (e.g. a policy of ‘one transaction per quote’). Thus, SIs are able to manage their trading activity and the costs and risks associated with this.

Q9. Can I be an SI and operate an OTF?

A. No. MiFID II/R does not allow the operation of an OTF and systematic internalization within the same legal entity.

Q10. Are there any benefits to being an SI?

A. There are no obvious benefits from a market-making perspective. It could be possible that some investors, as part of their best execution policy, may require quotes from SIs for specific instruments when trading OTC. Alternatively, whether a bond has a certain number of registered SIs could be a component of an investor's internal liquidity scoring. However, given that being an SI is no guarantee of either competitive pricing or liquidity, these scenarios seem unlikely, and investors are unlikely to differentiate between SIs and non-SIs when requesting quotes.

Q11. Are there any advantages to not being an SI?

A. Investment firms who do not qualify as SIs are not subject to the same pre-trade transparency requirements as SIs. Furthermore, where non-SIs qualify for the post-trade transparency exemption, they only have to publish trade data on a quarterly basis, not monthly.

Q12. When will the SI regime come into force?

A. MiFID II/R is expected to come into force in January 2017.

Q13. Is the SI regime likely to have any positive outcomes for bond market pricing or liquidity?

A. The general view is that any impact will be limited. The criteria for becoming an SI are sufficiently high enough for many investment firms to avoid becoming an SI, and so it is likely that a significant proportion of bond trading will remain OTC, or exempt from pre-trade transparency obligations. Also, the pricing and trading discretion that SIs will need to retain as part of their commercial policy will mean that any pre-trade pricing transparency is not necessarily meaningful from a price formation perspective.

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