ICMA

ICMA: MiFID II SI Regime Workshops

A summary report

April 2017

Introduction

In February and March 2017, ICMA facilitated two member workshops on the MiFID II/R Systematic Internaliser regime for fixed income markets. Participants were primarily senior trading (in many cases heads of desk) or market structure experts, representing a broad range of both sell-side and buy-side member firms.[1] The objective of the workshops was to allow market participants to identify and discuss practical considerations related to the implementation of the Systematic Internaliser regime in the European fixed income markets, and how this is likely to impact market behaviour and structure. An ancillary output of the workshops would also be to identify aspects of the regulation that could warrant further clarification or guidance from ESMA through the Level 3 process.

This report summarizes the discussions and key points arising from the two workshops and is intended to provide a helpful resource for ICMA members who are likely to be impacted, directly or indirectly, by the Systematic Internaliser regime.

Background: what is the Systematic Internaliser regime with respect to fixed income?

The MiFID II Systematic Internaliser regime aims to move 'dark', off-venue trading in fixed income onto 'lit' venues by creating a level playing field and greater price transparency between OTC and venues. It does this by applying similar pre-trade transparency obligations to certain investment firms as for trading venues (regulated markets - RMs, multilateral trading facilities - MTFs, and organised trading facilities - OTFs). Investment firms that deal on their own account by executing client orders outside a RM, MTF, or OTF on both a 'frequent and systematic' and 'substantial' basis will be classified as a 'Systematic Internaliser' (SI) and so subject to the same pre-trade transparency obligations[2] (including waivers) as trading venues.

MiFID I, in 2007, introduced the SI concept 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. MiFID II/R extends the SI regime to

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[1] Participants were mostly members of the ICMA MiFID II Working Group, a work-stream of the Secondary Market Practices Committee.

[2] SIs can make their quotes public through arrangements with a trading venue or an Approved Publication Arrangement (APA), or through proprietary arrangements (i.e. on their own website).

other financial instruments, including bonds, and broadens the definition of 'frequent and systematic' to include 'substantial', based on quantifiable trading volumes.

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, and ESMA will publish market data to facilitate firms' assessments by the first calendar day of February, May, August, and November. These assessments are to be completed, and firms to comply with the SI regime, by the fifteenth calendar day of February, May, August, and November.[3] Alternatively, investment firms can 'opt-in' to be an SI, starting from January 2018.

With respect to fixed income, investment firms become SIs for bonds (either through meeting the trading threshold criteria or by opting-in) on the basis of the class of bond[4] and the financial group of the issuer. For the purposes of MiFID II, 'group' is defined as a parent undertaking and all its subsidiary undertakings. So, for example, an investment firm that qualifies (or opts-in) as an SI for a single specific bond issued by an entity within the VW group will de fact become an SI, and be subject to SI reporting obligations, for all bonds issued by VW entities. Importantly this applies to all bonds issued by the group of issuer of the same class of bonds, regardless of currency of issue.

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'). SIs are further able to update their quotes at any time, and can withdraw quotes under exceptional market conditions which would be contrary to prudent risk management.

As well as being subject to same pre-trade transparency obligations as trading venues, an SI is responsible for post-trade reporting (including where the SI is the buyer).[5]

There are a number of uncertainties around the SI regime with respect to fixed income markets, including which firms will meet the SI thresholds for various bonds, whether firms will opt-in to the regime for certain bond classes, credits, or market segments, whether firms will engineer their trading activity to avoid SI status, and whether buy-side firms will have a preference for dealing with SI firms (say, to benefit from delegated post-trade reporting) or not.

[3] The first assessment period will be by September 1 2018, based on data from January 3 2018 to June 30 2018

[4] Classes of bonds under MiFID II are: (i) sovereign; (ii) other public; (iii) convertible; (iv) covered; (v) corporate.

[5] To ensure that the transaction is only reported once, the SI should inform the other party that they are reporting on their behalf.

Workshop I
February 3rd 2017
ICMA, London

Agenda

- APAs in the pre-trade and post-trade space (from buy-side and sell-side perspectives)
- Practicalities of the SI regime: the sell-side perspective
- Practical implementation of the SI regime: the buy-side perspective
- SI topics for further discussion

APAs in the pre-trade and post-trade space

There is a difference between an Approved Publication Arrangement (APA), and an Approved Reporting Mechanism (ARM). An APA refers to pre- and post-trade reporting requirements of quotes and executed trades that are made available to the public. In return, an ARM is concerned with transaction reporting of executed trades made available to regulators only.

The wording of reporting requirements for 'derivative trade data' under EMIR may be a potential source of confusion as this falls under transaction reporting. However, 'trade data' suggests it could be linked to an APA. The purpose of an APA is to help investors make informed investment decisions while the data provided via an ARM are used by regulators for market supervision purposes.

The concept of 'systematic internaliser' (SI) was first introduced under MiFID I in the equities space. Many investments firms opted out, and only half a dozen decided to register. As a result, it was (and still is) difficult to identify SI quotes on an electronic trading venue. Extending the SI regime to the fixed income space aims at aligning reporting requirements for trades executed over-the-counter (OTC) with trades done on multilateral venues.

Whether an investment firm is classed as SI is determined on the basis of quantitative criteria ('frequent and systematic', and 'substantial') which set out specific thresholds. Illiquid instruments are exempt, according to in-place waivers. The SI assessment will be made quarterly based on previous 6 months' data.

Under MiFID II, investments firms who meet the SI criteria will be required to publish firm quotes from September 1st 2017. It is, however, possible for investment firms to opt in to the SI regime from January 3rd 2017. The pre-trade reporting requirement does not apply prior to September 1st. Importantly, investment firms are not obliged to publish their quotes via an APA, but may wish to do so without intermediation on their website in machine-readable format.

When determining whether to register as an SI, buy-side firms should consider the implications, notably in terms of post trade obligations. Some may consider only transacting with SIs. However, this may prove difficult from a best execution perspective, for instance when a non-SI is providing the best quote, or if certain illiquid instruments are only quoted by non-SIs.

In terms of publishing quotes, the view was that each firm's legal department should interpret the provision on which price to quote.

In regard to waivers for illiquid instruments, the suggested understanding is that an investment firm does not have to apply for it if the trading venue has already applied, which is also thought to be the stance of the FCA.

Regarding post-trade reporting, it is mandatory for investment firms to publish trade reports via an APA – unlike pre-trade reporting. An APA can also help determine whether the obligation to report real-time or a deferred publication for illiquid instruments (T+2) is applicable.

The importance of being aware of the impact on buy-side firms once MiFID II takes effect was discussed. It was stressed that the buy-side cannot give up the obligation to trade report. It is possible to collaborate with the sell-side, and have a sell-side SI report the trade, but this does not remove the regulatory obligation on the buy-side.

The question was raised whether an additional legal agreement was needed between the buy and sell-side, and whether the sell-side trade reporting on behalf of the buy-side would be classed as 'outsourced service' under MiFID. In case of a reporting fail, buy-side firms would either need an internal back-up solution or report via another APA which would result in sharing their flow with another counterparty. The FCA's stance apparently is that investment firms must be able to demonstrate that a back-up plan is in place. This is not applicable to 3rd country counterparties.

Duplicate reporting was highlighted as a challenge that needs to be addressed. It was pointed out that it will be difficult to identify duplicate trades as: (i) only one party is trade reporting; and (ii) there is no single 'ID' associated to a specific trade (unlike for transaction reporting). One of the few possibilities would be to reconcile trades based on timestamps or cross check who submitted the report. In practical terms, an investment firm would initially receive an electronic confirmation upon submission. In case of issues or inconsistencies, the APA's support team would then reach out to the investment firm.

Practicalities of the SI regime: the sell-side perspective

What are the aims of the SI Regime?

The objective is to capture OTC activity, and increase transparency. Under MiFID I, the trade reporting obligation could be circumvented by trading off-exchange. To remove this 'natural arbitrage', the idea is to bring transparency on a quote by quote basis.

Timeline for implementation and the reasons for delay to Sept 2018

The data used for calculating the relevant thresholds for SIs are based on APA data. The delay was caused by demanding requirements in terms of IT infrastructure that ESMA was facing.

Qualifying to be an SI

- *Opting in/Opting out (procedural)*
- *SI Registrations: Can a firm be an SI without registering as an SI with its regulator?*

Due to the lack of granularity in available trade data, it is currently difficult to anticipate which firms will qualify as SI, even more so with respect non-European products such as US Treasuries and Japanese Government Bonds. It was stressed that while it is possible to opt-in to the SI regime after January 3rd 2018, there is no opting-out from September 1st 2018.

For investments firms wishing to opt-in, it is important to be aware of post trade reporting, and for them to be prepared for pre-trade obligations. However, an issue may arise where only one SI and one APA are registered during the opt-in period. In this scenario, it may become clear to market participants whose trades are reported, notably in illiquid instruments. Whether to register as an SI, and which APA to use, may be a 'herd' decision. Another concern was raised by investment firms that have different legal entities across multiple jurisdictions. In this scenario, it is unclear as to which legal entity should register as SI.

Generally, it was expected that opting-in for liquid instruments will be less contentious while potential issues will arise around illiquid instruments. The reason being that the trading landscape remains unknown and the Size-specific-to-instrument (SSTI) and Large-in-scale (LIS) thresholds are yet to be determined. ESMA estimations do not provide sufficient clarity, and a small number of trades is expected to meet the requirements for (real-time) trade reporting.

Communicating that a market participant has opted-in was identified as a challenge. Buy-side firms pointed out that it will be complex to keep track of who is an SI and who isn't, by class of instruments, and by counterparty. It is not foreseen that a 'golden source' or database of SIs will be available. However, one sell-side firm mentioned that according to the AMF, a central SI database may be created at a 'later stage'. In absence of a central solution, there is a risk of fragmentation across regions. Most participants believed that to address this issue, the industry should provide a solution in the interim. At the same time, advocacy efforts should continue.

In addition, the question was raised how the buy-side would be notified by a sell-side firm having registered as SI. It was stated that it is the buy-side's responsibility to identify SIs. In practical terms, it is possible to indicate in a FIX message if a trade is executed electronically as SI or not. This can be a service provided by the sell-side. However, this solution is not applicable to trades done by voice or 'chat' (i.e. instant messaging facilities).

It was suggested that an alternative for voice trades could be to create an 'OTC-ticket' that captures all trade details discussed on the phone or via chat: apparently, one provider of an MTF already offers a similar solution. A further suggestion was that Order Management System (OMS) providers may also be able to provide a solution for pre-trade reporting purposes.

This led to the question whether a trade agreed by voice OTC, which is subsequently booked on a multilateral trading venue, would be classed as a single transaction or two separate transactions. In the case of an illiquid instruments, participants discussed whether the pre-trade waiver of the venue would be applicable, or whether the transaction would have to be reported separately off-venue. As participants indicated, this scenario would not be applicable for non-venue instruments such as swaptions, or inflation.

SI regime and firm quotes

- *Most view a SI flagged quote as 'Tradeable'. Is it in reality? If not, why not?*
- *In equities, there is 'price improvement' in the SI Regime. Can you 'price improve' a fixed income SI quote?*

ESMA released an updated Q&A on January 31st 2017 clarifying that it is possible to improve a price in justified cases:

> *'The systematic internaliser regime for non-equity instruments is predicated around a protocol whereby the systematic internaliser provides a quote or quotes to a client on request. However, nothing prevents the systematic internaliser, especially in the most liquid instruments, to stream prices to clients. Where those prices are firm, i.e. executable by clients up to the displayed size (provided the size is less than the size specific to the instrument), the systematic internaliser would be deemed to have complied with the quoting obligation under Article 18(1) of MiFIR. The systematic internaliser can, in justified cases, execute orders at a better price than the streaming quote. '*

However, the consensus was that the Q&A raises even more questions. Combining the notion of 'executable' and 'price improvement' seemed incompatible to some participants. Others noted that the clarifications made sense for bonds, but were problematic for non-standard swaps (broken dates) where dealers do not provide continuous streams.

Practical implementation of the SI regime: the buy-side perspective

How will the buy-side utilize the SI Regime? And what is the connection between the SI regime and best execution policy?

How the buy-side will utilize the SI regime in conjunction with Best Execution Policy will depend on various factors such as (i) operational capabilities; (ii) breadth of activities; and (iii) size of firm. Reporting solutions will have to be adapted to each firm's requirements. In terms of best execution, broker restrictions may prove to be potential obstacles.

SI topics for further discussion

It was agreed that a second workshop should be held to discuss some of the issues raised in more depth, as well as to address a number of topics that had not been covered in the workshop.

Workshop II
March 27th 2017
Nomura, London

Agenda

- Negotiated trade flow
- Identification of SIs (per bond and per legal entity)
- What is permissible as an SI?

Negotiated trade flow

Bloomberg and Tradeweb were respectively given the floor to discuss with participants on the possibility of allowing trading venues to facilitate the execution of trades that are negotiated bilaterally by the trading parties.

Next steps

The conclusion of the discussion flagged two key points. Firstly, there is no negotiated trade waiver under MiFID II for fixed income that would allow counterparties to negotiate a trade 'off-venue' and then process that trade through an MTF, nor is there any trading protocol available to support this. Secondly, the only apparent work-around seems to rely on the transacting parties modifying their language or terminology to suggest that the agreed transaction is not 'done' until it is executed on an agreed venue. Many felt that this solution is unsatisfactory, and, in practice, unworkable.

It was agreed that ICMA would work with a number of members to articulate a clean solution that it can present to the trading platform community for their consideration, noting that this could also require discussions between the interested platforms and their regulators.

A meeting between interested members of the ICMA's MiFID II Working Group and ICMA's Platform Working Group will be organized to discuss the optimal solution and to agree a plan for MTFs potentially to create rules for block trades that can be negotiated away from venue but formalised for execution on venue, with the benefit of pre- and post- trade (SSTI and LIS) waivers. At a later date, the interested MTFs will be asked individually to present solutions to MiFID II Working Group.

Identification of SIs (per bond and per legal entity)

It was noted at the previous workshop that there is a need for market participants to be able to readily identify the relevant SIs on an instrument-by-instrument basis. However, there is no 'golden source' for this information, as ESMA will not able to provide details.

Tradeweb discussed options:

1) Some NCAs may publish or store the SI lists electronically, so there is the possibility that APAs could source this information directly from the NCAs. However, this is highly unlikely to be viable for all 28 NCAs.

2) Self-declaration by banks as SIs seemed to be the best option, as there is willingness to assist. It was suggested that at the very least, firms ideally should inform the largest APAs if and when they opt-in as SIs.

3) Work with other service providers which are running SI determination services themselves, such as Reuters.

However, it was agreed that without ESMA's support, there is not going to be one golden source. In the meantime, Tradeweb is collaborating with other providers to put together an SI list that can be shared throughout the industry.

What is permissible as an SI?

There is a growing debate about SI best execution and multilateral facilities and how this is different between equities and fixed income. For equities, banks acting as intermediaries regularly access external points of liquidity such as exchanges and MTFs, as well as crossing-networks that involve other market-makers.

MiFID II is clear in its intent to remove this scenario, and there is language in the regulation that prevents a firm acting in a multilateral capacity from operating without being registered as a multilateral platform (either an MTF or OTF). Discussions with market participants seems to suggest that this should not impact the existing business model for fixed income, as market-makers are likely to be registered as SIs, while buy-side firms currently approach multiple market-makers directly for quotes. In this model, there is very little reliance on interacting with other SIs.

However, the differentiating factor between an SI and an OTF could depend on the distinction between 'risky' and 'riskless' trading, rather than on whether a firm is interconnecting with other SIs. To the extent that firms are operating as a riskless principal broker, they should be classified as an OTF, rather than an SI. Whereas principal intermediaries taking risk would be classified as an SI in the event that they met the threshold (or opted-in). What becomes less clear is where firms operate a principal hybrid model, combining both risky and riskless principal trading, and it was noted that there is lack of clarity in the regulation as to the boundary conditions of being a multilateral system. This is further complicated by the fact that there are consequences for firms operating hybrid models, since the regulation does not allow SIs and OTFs to interact within the same legal entity.

One participant suggested that the regulation appeared to penalize principal trading firms that relied on the competence of their salesforce to match client interest and reduce market risk. However, others felt that firms that did act mainly in a riskless principal capacity were more appropriately categorized as MTFs.

It was expected that ESMA would provide Level 3 guidance on the assessment criteria for an OTF in the near future, possibly with quantifiable thresholds for risky and riskless activity. In the meantime, it was suggested that firms scrutinize their arrangements and take legal advice if needed. However, it was felt that firms interconnecting with other SIs was not in itself prohibited, and that it did not appear to be necessary to inform clients before doing so.

For further information on the points raised in this report, or any questions related to ICMA's work with respect to MiFID II and fixed income markets, please contact:

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