MiFID II/R

Draft Regulatory Technical Standards on transparency requirements in respect of bonds

A briefing note: January 2016
Overview

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- The new market structure paradigm
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Key objectives of MiFID II/R

- Move more OTC trading onto trading venues through a trading obligation for certain equities and derivatives and establishing a new type of trading venue for non-equites: the Organized Trading Facility (OTF). Systematic Internalisers will also become more important for bond trading.

- **Increase transparency by expanding pre- and post-trade transparency requirements to non-equity instruments.**

- Promote orderly markets by introducing specific provisions for algorithmic and high-frequency trading.

- Improve oversight and transparency of commodity derivative markets to reduce systemic risk and speculative trading.

- Promote competition in trading and clearing markets by requiring trading venues and CCPs to provide non-discriminatory and transparent access to one another.
Objective of transparency requirements for non-equities

- Aims to ensure that investors are adequately informed as to the true level of actual and potential transactions.

- Applies to transactions on regulated markets, multilateral trading facilities, organized trading facilities, via systematic internalisers, as well as outside of those facilities.

- A high degree of transparency is essential to ensure a level playing field between trading venues so that the price discovery mechanism for various instruments is not impaired by fragmented liquidity, and investors are not thereby penalized.

- However, the regulation recognizes that there may be circumstances where exemptions from pre-trade transparency obligations, or deferral from post-trade transparency obligations, may be necessary.
The new market structure paradigm

- **Regulated Market (RM)**
  A multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments.

- **Multilateral Trading Facility (MTF)**
  A multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments.

- **Organized Trading Facility (OTF)**
  A multilateral system which is not an RM or an MTF and in which multiple third-party buying and selling interests in bonds, structured finance products, and derivatives. Unlike RMs and MTFs, operators of OTFs will have discretion as to how to execute orders, subject to pre-trade transparency and best execution obligations.

- **Systematic Internaliser (SI)**
  An investment firm that deals on its own account by executing client orders outside a trading venue.

  - RMs and MTFs are not allowed to execute client orders against proprietary capital, or to engage in matched principal trading.
  - OTFs may deal on own account other than matched principal trading only with regard to illiquid sovereign debt instruments.
  - MTFs, OTFs, and SIs cannot exist within the same legal entity, nor connect to enable orders or quotes to interact.
Draft transparency requirements: pre-trade

- Applies to RMIs, MTFs, and OTFs

- Operators must make publicly available, on a continuous basis during trading hours, actionable indications of interest (IOIs); i.e. current bid and offer prices, and depth of trading interest.

- This includes Request For Quote (RFQ) systems and voice trading systems

- Waivers:
  - Pre-trade transparency requirements can be waived for:
    - Financial instruments for which there is not a liquid market
    - Orders that are large in scale (LIS) compared to normal market size
    - Orders on RFQ or voice trading systems that are equal to or larger that the relevant size specific to the instrument (SSTI)
    - Orders held in an order management system
Pre-trade transparency

- Trading venue?
  - RM, MTF, OTF
  - OTC (SI)
  - OTC (non-SI)

- Liquid?
  - Y
  - Liquid

- Large trade?
  - SSTI (for RFQ) or LIS

- Other?
  - OMF

Flow:
- Trade ➔ RM, MTF, OTF ➔ Liquid ➔ SSTI (for RFQ) or LIS ➔ OMF ➔ LIGHT
- OTC (SI) ➔ Liquid ➔ SSTI ➔ Y
- OTC (non-SI) ➔ Y ➔ Y ➔ Y

DARK ➔ LIGHT

Y ➔ Y ➔ Y
Draft transparency requirements: post-trade

- Applies to RMIs, MTFs, OTFs, and investment firms.

- Investment firms trading outside a trading venue and market operators and investment firms operating a trading venue, must make publicly available trade details, including price and quantity.

- Post-trade information must be available as close to real time as possible (within 15 minutes of execution up until Jan 2020 and within 5 minutes thereafter).

- There are no waivers for post-trade reporting, but reporting can be deferred for up to 48 hours in the case where:
  - The transaction is in a security for which there is not a liquid market
  - The size of the transaction is equal to or exceeds the relevant large is scale size (LIS)

- Under certain circumstances, a supplementary deferral regime grants relevant NCAs the authority to aggregate the trade details of several transactions, or omit publishing the size of an individual transaction, for an extended deferral period of 4 weeks.

- Where a class of instrument suffers a significant reduction in liquidity, the relevant NCA can temporarily suspend transparency requirements for that class (for up to 3 months).
Post-trade transparency
Draft liquidity assessment

- Underlying pre- and post-trade reporting obligations is whether or not a security is deemed ‘liquid’.

- MiFID II/R sets out a definition for ‘liquid’ securities, including bonds.

- Level 1 defines a liquid market as “a market for financial instruments or class of instruments for which there are ready and willing buyers and sellers, taking into consideration the average frequency and size of transactions, the number and type of market participants, and the market spread”. This implies an instrument-by-instrument approach (IBIA) to calibrate liquidity based on a number of factors.

- For bonds, Level 2 proposes an initial ‘static’ determination based on a class of financial instrument approach (COFIA), which is defined purely by issuance size relative to a variety of sub-classes of bonds.

- Once a full quarter of trading data is available for a bond, the liquidity determination will be based on a dynamic instrument IBIA methodology, applying a quarterly assessment of quantitative liquidity criteria.
Initial static liquidity assessment (COFIA) – new bonds

- The initial static COFIA approach for new bonds is based purely on issuance size relative to the class of instrument.

- This COFIA approach will be applied for up to 5.5 months following issuance.

<table>
<thead>
<tr>
<th>Bond Type</th>
<th>Issuance size</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sovereign Bond</strong></td>
<td>smaller than € 1,000,000,000</td>
</tr>
<tr>
<td><strong>Other Public Bond</strong></td>
<td>smaller than € 500,000,000</td>
</tr>
<tr>
<td><strong>Convertible Bond</strong></td>
<td>smaller than € 500,000,000</td>
</tr>
<tr>
<td><strong>Covered Bond</strong></td>
<td>smaller than € 200,000,000</td>
</tr>
<tr>
<td><strong>Corporate Bond</strong></td>
<td>smaller than € 500,000,000</td>
</tr>
<tr>
<td><strong>Bond Type</strong></td>
<td></td>
</tr>
<tr>
<td>Other Bond</td>
<td>A bond that does not belong to any of the above bond types is considered not to have a liquid market</td>
</tr>
</tbody>
</table>
Subsequent dynamic liquidity assessment (IBIA) – ‘seasoned’ bonds

- Following a full quarter of trading data for an individual bond, the liquidity determination will be based on a periodic (quarterly) quantitative assessment.

- The key quantitative determinants for each individual bond are: (i) average daily notional amount traded; (ii) average daily number of trades; (iii) and the percentage of days traded over the assessment period.

Bonds (all bond types except ETCs and ETNs) - classes not having a liquid market

<table>
<thead>
<tr>
<th>Asset class - Bonds (all bond types except ETCs and ETNs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Each individual financial instrument shall be determined not to have a liquid market as per Articles 6 and 8(1)(b) if it does not meet one or all of the following thresholds of the quantitative liquidity criteria on a cumulative basis</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Average daily notional amount</td>
</tr>
<tr>
<td>[quantitative liquidity criteria 1]</td>
</tr>
<tr>
<td>EUR 100,000</td>
</tr>
<tr>
<td>Average daily number of trades</td>
</tr>
<tr>
<td>[quantitative liquidity criteria 2]</td>
</tr>
<tr>
<td>2</td>
</tr>
<tr>
<td>Percentage of days traded over the period considered</td>
</tr>
<tr>
<td>[quantitative liquidity criteria 3]</td>
</tr>
<tr>
<td>80%</td>
</tr>
</tbody>
</table>
Draft waivers and deferrals

Large in scale (LIS)

Pre-trade: for RMs, MTFs, OTFs, and SIs
An order is considered large in scale compared with standard market size if its equal to or larger than a determination of standard market size for the class of instrument. The threshold is calculated based on a percentile threshold of the distribution of trade sizes for the class of instrument.

For most bonds the proposed LIS pre-trade threshold is the 70th percentile.

Post-trade: for RMs, MTFs, OTFs, SIs, and other investment firms
A transaction is considered large in scale compared with standard market size if its equal to or larger than a determination of standard market size for the class of instrument. The threshold is calculated based on a percentile threshold of the distribution of trade sizes for the class of instrument.

For most bonds the proposed LIS post-trade threshold is the 90th percentile.
Waivers and deferrals

Size specific to the instrument (SSTI)

Pre-trade: RMs, MTFs, OTFs, and SIs (for RFQ and voice trading systems)
An actionable IOI is considered above the size specific to the financial instrument if its equal to or larger than a determination of the minimum size of an actionable IOI for the class of instrument. The threshold is calculated based on a percentile threshold of the distribution of trade sizes for the class of instrument.

For most bonds the proposed SSTI threshold is the 60th percentile (40th for covered bonds).

Post-trade: RMs, MTFs, OTFs, SIs, and other investment firms
A transaction is considered above the size specific to the financial instrument if its equal to or larger than a determination of the minimum size of transaction for the class of instrument. The threshold is calculated based on a percentile threshold of the distribution of trade sizes for the class of instrument.

For most bonds the proposed SSTI threshold is the 80th percentile.
Waivers and deferrals

<table>
<thead>
<tr>
<th>Bond Type</th>
<th>Transactions to be considered for the calculation of the thresholds per bond type</th>
<th>Percentiles to be applied for the calculation of the pre-trade and post-trade SSTI and LIS thresholds for each bond type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sovereign Bond</td>
<td>transactions executed on Sovereign Bonds following the exclusion of transactions as specified in Article 13(10)</td>
<td>SSTI pre-trade</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Trade - percentile</td>
</tr>
<tr>
<td>Other Public Bond</td>
<td>transactions executed on Other Public Bonds following the exclusion of transactions as specified in Article 13(10)</td>
<td>60</td>
</tr>
<tr>
<td>Convertible Bond</td>
<td>transactions executed on Convertible Bonds following the exclusion of transactions as specified in Article 13(10)</td>
<td>60</td>
</tr>
<tr>
<td>Covered Bond</td>
<td>transactions executed on Covered Bonds following the exclusion of transactions as specified in Article 13(10)</td>
<td>40</td>
</tr>
<tr>
<td>Corporate Bond</td>
<td>transactions executed on Corporate Bonds following the exclusion of transactions as specified in Article 13(10)</td>
<td>60</td>
</tr>
<tr>
<td>Other Bonds</td>
<td>transactions executed on Other Bonds following the exclusion of transactions as specified in Article 13(10)</td>
<td>60</td>
</tr>
</tbody>
</table>

* Article 13(10) excludes all transactions \( \leq \) EUR 100,000 from the calculation
Systematic internalisers

MiFID I (2007) introduced the systematic internaliser (SI) regime for equity markets, where an SI for a particular instrument is ‘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’.

Following implementation of MiFID I, a smaller number of firms became SIs than expected: the qualitative nature of the criteria that defined an SI made the assessment highly subjective, and many firms concluded that they did not meet the criteria.

MiFID II/R extends the SI regime to a broader range of financial instruments, including bonds.

It applies 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.

MiFID II/R further sets out quantitative thresholds for ‘frequent and systematic’ and ‘substantial’, which are applied on an instrument by instrument basis*.

* There is a suggestion that this has been changed in the draft delegated acts to be applied on a class of instrument basis; i.e. if a firm qualifies as an SI in a particular instrument, it will be classified as an SI for all instruments in that entire class of instrument.
Systematic internalisers: proposed determination

Frequent and systematic test

- For **liquid bonds**, this is where the number of trades during the last six months is equal to or larger than 2.5% 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 should 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.

Substantial test

- 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
  - **1% of the total nominal amount traded** in that financial instrument executed in the EU and carried out on any EU trading venue or OTC.
Systematic internalisers: determination

- The investment firm shall assess whether it meets both the ‘frequent and systematic’ and ‘substantial’ criteria on a quarterly basis, based on data from the last six months. These assessments shall be performed on a quarterly basis, on the first working day of January, April, July, and October.

- For new instruments, the assessments shall only be considered once the data covers a minimum period of six weeks.

- MiFID II/R allows firms to choose to opt-in to be a systematic internaliser for a financial instrument, even where it does not meet all or any of the quantitative criteria, provided it complies with the requirements for SIs.
Systematic internalisers: requirements

- The main purpose of the systematic internaliser regime is to ensure that the internalisation of order flow by investment firms does not undermine the efficiency of price formation on RMs, MTFs, and OTFs. In other words, the objective of the SI regime is to extend transparency obligations into the OTC space. Effectively, SIs are subject to the same pre-trade transparency requirements (including the same conditions for waivers).

- The investment firm will be identified in the case of an SI quote, whereas on a venue quotes will be averaged across all 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.

- In the case of liquid bonds, SIs must make public firm quotes to all their clients when (a) they are requested for a quote by a client, or (b) they agree to provide a quote.

- In the case of illiquid bonds, SIs must disclose firm quotes to their clients on request only where they agree to provide a quote.
Systematic internalisers: requirements

- SIs may update their quotes at any time, and may also withdraw quotes under exceptional circumstances.

- Notwithstanding, SIs are allowed to decide which clients have access to, and can execute on, their quotes, on the basis of their commercial policy and in an objective, non-discriminatory way (thus SIs retain control over their trading activity).
Key market concerns

- Market-makers will be reluctant to provide liquidity in securities that are defined as ‘liquid’ under the regulation, but would otherwise be considered as ‘illiquid’ by the broader market. This would be detrimental to bond market liquidity, resulting in wider bid-ask spreads and fewer executionable prices. While the dynamic IBIA methodology is intended to minimize such ‘false positives’, bonds will still be subject to the static COFIA determination methodology for the first few months post issuance. However, by most determinations, corporate bonds, for instance, would only be considered ‘liquid’ for the first few days post issuance.

- The static COFIA determination methodology could influence issuer behaviour, particularly for corporate bonds. Issuers may choose to time issuance to minimize the period for which COFIA applies (i.e. 2.5 months). Similarly, they may elect to issue in smaller sizes to remain below the COFIA liquidity determination threshold.

- The determination of LIS and SSTI thresholds does not take into account transactions below EUR 100k. This skews the thresholds to higher than what might be considered appropriate values.
Key market concerns

- The percentiles chosen to determine SSTI and LIS thresholds appear to be arbitrary, rather than based on any market analysis.

- The proposed post-trade reporting deferral of 48 hours is generally considered inappropriate for transactions in illiquid securities, and will expose market-makers in these instruments to unwarranted market risk. Even the possibility of a 4 week deferral period may not be appropriate for some transactions.

- The application of deferrals may not be consistent across all jurisdictions, which could impact liquidity and pricing depending on a client’s location.

- The data to be used by the NCA’s in determining the initial liquidity and waiver/deferral thresholds will be based on trade data. Post implementation, these will be calibrated on transaction data (i.e. post-allocation at the client and sub-client level), which will have a different profile due to the exclusion of ≤€100k transactions.

- If the SI regime is applied at the class of instrument level, investment firms will be in scope of pre-trade transparency obligations for securities that they transact neither on a frequent or systematic basis.
MiFID II/R timeline

2015-16
- Q3: ESMA final technical standards
- Q3 2015/ Q1 2016: implementing measures finalized

2017?
- Q1: MiFID II/R originally scheduled to take effect

2018?
- Q1: Expected date for MiFID II/R to take effect
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