MiFID II/R
Systematic Internalisers for bond markets

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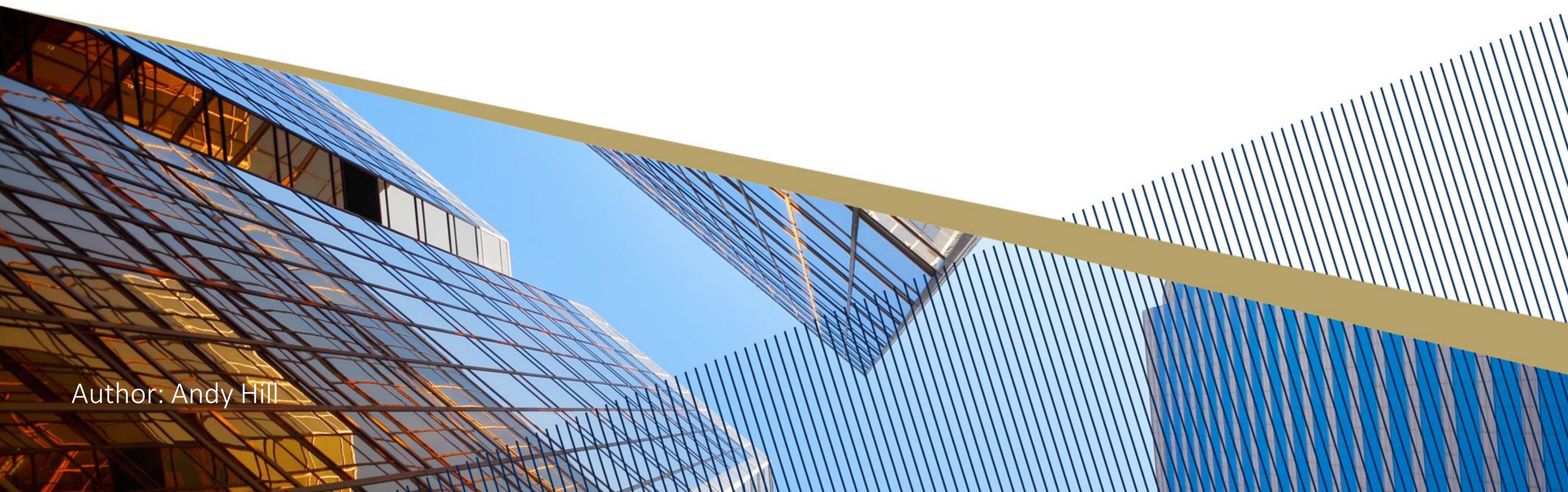

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What is a systematic internaliser?

- 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 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**, <u>and</u> **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'.

Proposed trading thresholds for SIs: (i) frequent and systematic

- The frequent and systematic basis will be measured by the number of OTC 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 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.

Source: ESMA's Technical Advice to the Commission on MiFID II and MiFIR – Final Report, December 19 2014
http://www.esma.europa.eu/system/files/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf

Proposed trading thresholds for SIs: (ii) 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.

Source: ESMA's Technical Advice to the Commission on MiFID II and MiFIR – Final Report, December 19 2014
http://www.esma.europa.eu/system/files/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf

Proposed thresholds for bonds

		Bonds
Frequent and systematic basis threshold (liquid instruments)	Number of transactions executed by the investment firm on own account OTC / total number of transaction in the same financial instrument in the EU	2 to 3% and at least once a week
Frequent and systematic basis threshold (illiquid instruments)	Minimum trading frequency	at least once a week
Substantial basis threshold Criteria 1	Size of OTC trading by investment firm in a financial instrument on own account / total volume in the same financial instrument executed by the investment firm	25%
Substantial basis threshold Criteria 2	Size of OTC trading by investment firm in a financial instrument on own account / total volume in the same financial instrument in the European Union	0.5 to 1.5%

Proposed assessments for SIs

- 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 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.

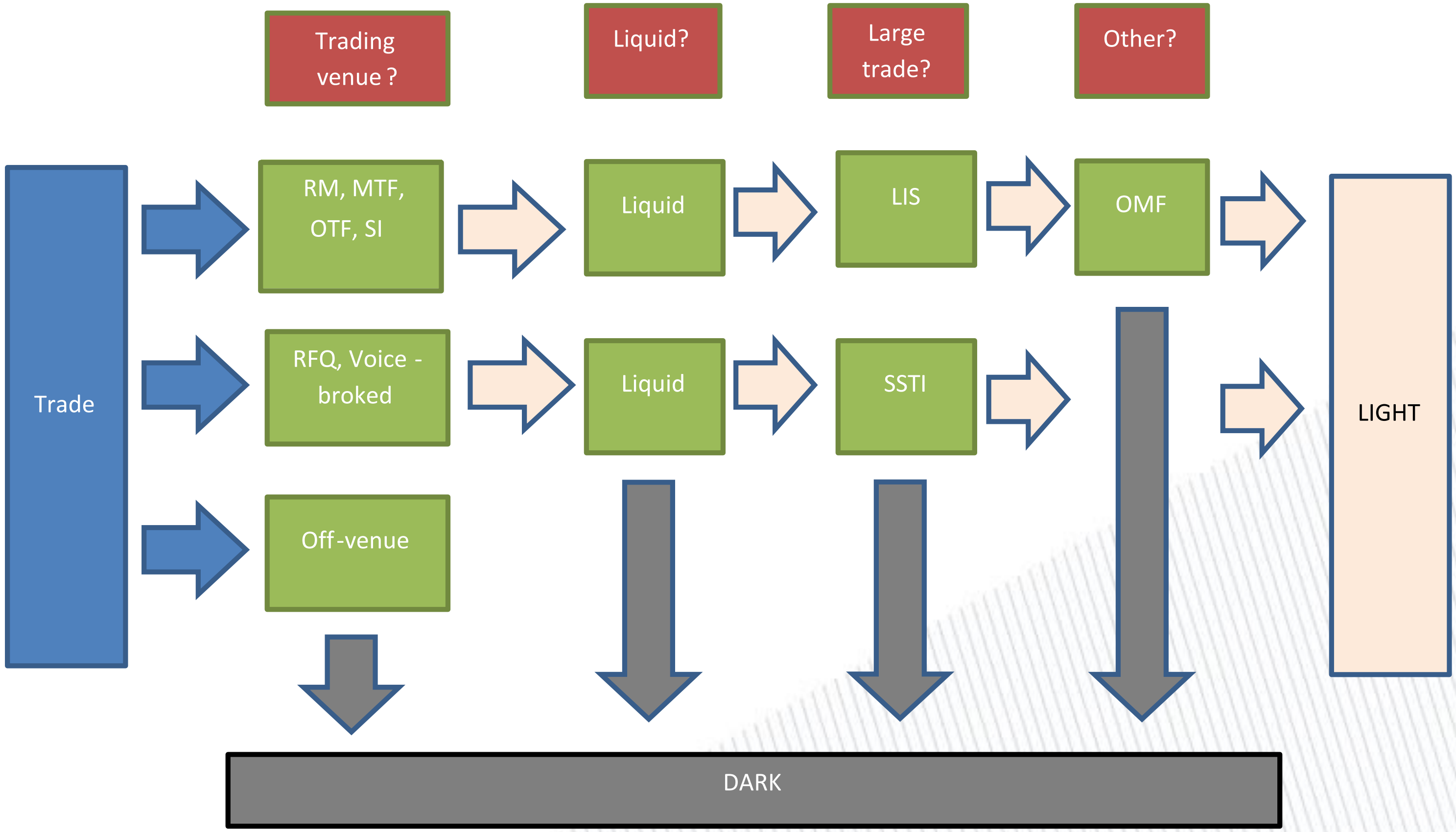
Requirements for SIs

- 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. 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.

Requirements for SIs (cont.)

- In the case of illiquid bonds, SIs must disclose firm quotes to their clients on request only where they agree to provide a quote.
- 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 their quotes, on the basis of their commercial policy and in an objective, non-discriminatory way (thus SIs retain control over their trading activity).

Pre-trade transparency



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