MiFID II/R: Systematic Internalisers
An ICMA 'FAQ' for bond markets
Updated November 2016

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 Q3).

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 investment firms become a systematic internaliser?

A. MiFID II/R sets out clearly defined thresholds for becoming an SI, based on trading volumes in respect of 'frequent and systematic' and 'substantial'.

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 2.5% of the total number of transactions in the relevant bonds executed on any venue or OTC, in the EU, 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.

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
  - 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.

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 firms become an SI on a specific bond basis, by class of bond, or by issuing entity?

A. Firms become SIs for bonds (either through meeting the trading threshold criteria or by opting-in) on the basis of the class of bond[1] 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 all bonds issued by the group of issuer of the same class of bonds, regardless of currency of issue.

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. ESMA will publish market data to facilitate firms' assessments by the first calendar day 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.

The first assessment period will be by September 1 2018, based on data from January 3 2018 to June 30 2018 (see Q11).

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.

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

Furthermore, in an OTC transaction involving an SI (including where the SI is the buyer), the SI is responsible for post-trade reporting. To ensure that the transaction is only reported once, the SI should inform the other party that they are reporting on their behalf.

Q8. What discretion do firms have in 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

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

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.

Q9. How do SIs make their quotes public?

A. 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). In the case of using a trading venue or APA their quotes must be machine-readable, and where using proprietary arrangements the quotes must be published in human-readable form. When using a trading venue or APA, the firm's identity will also be made available. Where an SI is using more than one arrangement the publication of quotes must occur simultaneously. The SI must also make available on its website homepage which publication arrangements it has in place and where its quotes can be accessed.

Q10. Can an investment firm 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.

Q11. When will the SI regime come into force?

A. The MiFID II/R transparency regime is due to come into force in January 2018, however the systematic internaliser regime cannot be applied until there is 6 months of data available. Accordingly, ESMA will publish the necessary data (covering January 3 2018 to June 30 2018) by August 1 2018. Investment firms will then have to perform their first assessment and, where necessary, comply with SI obligations (including notifying their relevant NCA) by September 1 2018.

However, firms may choose to opt-in to the SI regime from January 3 2018.

Q12. What are the potential challenges with the SI regime?

A. Investment firms will need to monitor their trading activity closely in order to assess (on a quarterly basis) whether they qualify as an SI in a particular security, and so become an SI in all bonds of the same class and issuer group. In the event that they do become an SI for a particular class and issuer group of bonds, they will need to ensure that they meet all their pre- and post-trade reporting obligations for these securities.

Further reading and references

REGULATION (EU) No 600/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012

Commission Delegated Regulation supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, EC, 25.4.2016

Commission Delegated Regulation supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions, EC, 18.5.2016

Commission Delegated Regulation supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on transparency requirements for trading venues and investment firms in respect of bonds, structured finance products, emission allowances and derivatives, EC, 14.7.2016

Questions and Answers on MiFID II and MiFIR transparency topics, ESMA, 4 November 2016

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