MiFID II implementation: the Systematic Internaliser regime

by Elizabeth Brooks Callaghan

What is a Systematic Internaliser?

A Systematic Internaliser (SI) is an original MiFID term, used in equities in MiFID I (2007). It has an increased scope in MiFID II: an investment firm which, on an organised, frequent and systematic, and substantial basis, deals on its own account (principal trading) by executing client orders outside trading venues: Regulated Market (RM), Multilateral Trading Facility (MTF), or Organized Trading Facility (OTF). MiFID II will set out clearly defined thresholds for becoming an SI, based on trading volumes in respect of "frequent and systematic" and "substantial". Large global or regional banks are the most likely candidates to take part in the SI regime.

Why the Systematic Internaliser regime?

The purpose of the new expanded Systematic Internaliser regime (expanded to non-equities in MiFID II) is to capture over-the-counter (OTC) trading activity, increase transparency and ensure that the internalisation of order flow by investment firms does not undermine the efficiency of price formation on trading venues. The perception is that in MiFID I bond trading frequently experienced a "natural arbitrage" (pre-trade transparency could be circumvented by trading off-venue). The idea in MiFID II is to bring about transparency in bond trading by creating transparency obligations on a quote-by-quote basis. – bringing light into the previously un-lit OTC trading practice.

What is a Systematic Internaliser obligated to do?

SI obligations are different for liquid and illiquid/large-in-scale trades. In the case of liquid bonds, SIs must make public firm quotes (pre-trade transparency) to all their clients when (a) they are requested for a quote by a client, or (b) they agree to provide a quote. There is flexibility within pre-trade transparency, however; SIs can 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 (eg a policy of "one transaction per quote").

The mechanism for a bank making OTC/SI quotes public is through arrangements with a trading venue or an Approved Publication Arrangement (APA), or through proprietary arrangements (ie on its own website). Where a bank that is an SI is using more than one arrangement, the publication of quotes must occur simultaneously.

There are also post-trade obligations for SI trading activities. In an OTC transaction involving an SI (including where the SI is the buyer), the SI is responsible for post-trade reporting. To ensure the transaction is only reported once, the SI is required to inform the other party that it is reporting on the other party's behalf.

Regarding illiquid or large-in-scale trades, waivers are in place for both pre- and post-trade transparency. This is not only the case for SIs but for trading venues as well.

It is important to note that the obligation for pre-trade and post-trade transparency for OTC trading is a complete change compared with OTC trading practices today. In Europe today, there is no transparency for OTC trading in either the pre-trade or the post-trade space.

What are the practicalities of implementing the Systematic Internaliser regime?

The practicalities of implementing this SI regime are proving a challenge. For the Systematic Internaliser regime to function, a buy side (asset or fund manager) will need to see which bank is an SI for which individual bond. Ideally, there should be a central source of who is and who is not an SI, per bond and per legal entity. The logical consolidated "golden" source for this information should be within the European Securities and Markets

Authority (ESMA). However, ESMA has refused to produce this centralized database of information. Instead, it will be up to the industry. APAs, where most of the pre-trade quotes and post-trade reports are sent, are attempting to develop industry solutions. Unfortunately, there are several APAs across Europe. This will fragment this SI identification data and will most likely cause early growing pains for the new SI regime in bonds. The SI regime comes into force in September 2018 (eight months after the MiFID II effective date).

What are the pros and cons of a bank becoming an SI?

Banks are required to measure their OTC trading activity for SI thresholds and trading volumes that cause them to qualify as an SI. Some banks will monitor their activity to make sure they are not an SI, while other banks will opt in as an SI. Banks can opt in for the SI regime as early as 3 January 2018. So, what are the pros and cons of a bank opting in for the SI regime?

Pros

- The SI regime assists Tier 1 and Tier 2 buy sides with post-trade reporting obligation (the SI always has the obligation to report, regardless a buyer or a seller – in effect delegated reporting).
- The SI regime is a good marketing tool. The buy-side will know who is a specialist in a specific bond.
  - If you want to be known as a specialist in a particular bond but trade across several legal entities, the SI calibrations will be fragmented. Therefore, the bank will not qualify as an SI. Instead, the bank can opt in to the SI regime.
  - At the beginning of MiFID II, a smaller number of trades are expected to meet threshold requirements for real-time reporting. Opting in for liquid bonds is likely for banks as it is not too risky and provides clients with a useful quoting regime.

Cons

- SI quotes must compete with non-SI quotes for buy-side best execution purposes. This may be written in buy-side best execution policies. Banks may go to a lot of effort and expense for little reward.
- Identification and scope are not clear. Fragmented identification of bonds (mentioned earlier), and the fact that the product scope is not clear (ESMA has yet to provide guidance), will prove a challenge. It is not yet known if non-European instruments such as US Treasuries or Japanese Government bonds are in scope, for example.
- Owing to the fragmented APA market structure, a bank may end up as the only SI for a bond on an APA. Most buy sides use OTC for larger less liquid or large block trades, where a bilateral discussion is needed. This could create information leakage as to which buy sides are trading what (based on holdings data) through reverse engineering. This is because a "SINT" label identifies an SI trade. ("SINT" is a four-letter market identifier code in post-trade transparency indicating an SI transaction.)
- If a bank opts in before September 2018, it will have to do so for *all* bonds. Otherwise, it cannot truly help the Tier 2 and Tier 3 buy sides and prevent them from the need and expense to report.
- It is the buy side's responsibility to identify SIs. It is not clear how buy sides will be notified by the sell side. SI notification will be particularly challenging for voice and instant message trades.

Once a firm is an SI, what are the key differences between Trading Venues, SIs and OTC?

	Trading Venue Obligation	SI Obligation	OTC/ Non-SI Obligation
Pre-trade Transparency applies	✓ (non-firm)	✓(firm)	×
Post-trade Transparency applies	✓	✓	✓
Best Execution Data provided	✓	✓	✓
Reference Data provided	✓	✓	×
Post-trade Reporting obligation	✓	✓	Only if selling

What is the way forward for the Systematic Internaliser regime?

The SI regime – and the concept of bringing transparency to the over-the-counter market in bond trading – is one of the most complicated and nuanced MiFID II rules. It remains to be seen how successful this regime will be. There is a view that it will most likely be used for bonds where banks are specialists or primary dealers. However, beyond that it is unknown how the regime will roll out. In equities in 2007, when the SI regime was first introduced, only nine banks became SIs and very few trades took place on the back of an SI quote. This is one to watch as there is much interest in this regime in the bond market from both the buy side and the sell side, as well as from the regulators.

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