ICMA
International Capital Market Association

MiFID II/R and the bond markets: the second year

An analysis of the impacts of MiFID II/R implementation in 2019, its challenges and potential solutions

December 2019

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Executive Summary

Following ICMA's first report on MiFID II/R and the bond markets: the first year in 2018, it is evident from market participants' feedback that implementation of MiFID II and MiFIR in the European bond markets continues to face a number of challenges in 2019 and has not fully achieved its objectives.

In fixed income primary markets, the impacts of MiFID II/R at year-end 2019 are effectively the same as at the end 2018. Requirements in terms of allocation justification recording and disclosure of underwriting fees do not seem to have generated tangible benefits or interest whilst placing a greater administrative burden on underwriters. However, the product governance and Packaged Retail and Insurance-Based Investment Products (PRIIPs) regimes continue to have significant problematic features that have led to unintended consequences lowering retail investors' participation as well as raising concerns over the fundamental practicability of compliance.

From a secondary market perspective, electronic trading has further increased across IG, HY, SSA and EM bonds in 2019 while interest in reporting on the quality of transaction execution ("best execution") appears to remain minimal. 15 months after the Systematic Internaliser (SI) regime has been introduced, major challenges still persist in identifying whether a counterparty is a SI. However, one of the greatest shortcomings is the continued lack of post-trade transparency in fixed income markets. Survey results suggest that data quality, accessibility of data published through Approved Publication Arrangements (APAs) and usability of data published after deferral periods are key obstacles to creating greater transparency.

A single, centralised consolidated tape provider (CTP) for bonds in Europe seems to be the preferred solution for aggregating and disseminating post-trade data, according to survey results. Furthermore, market participants reported that a more streamlined approach such as direct reporting of post-trade data to a CTP would be preferable. However, cost is an important consideration and changing regulatory reporting obligations would likely increase costs, at least in the short term. Brexit and the risk of fragmentation is unsurprisingly expected to have a negative impact on an EU27 CT, and the preferred option would be to combine post-trade data from both the EU27 and the UK in a CT post-Brexit. Overall, the extraterritorial impacts of MiFID II/R on market participants seem rather limited but non-EEA branches of EU firms appear to be impacted adversely while non-EEA trading activity seems to have shifted to non-EU trading venues.

In terms of FICC research unbundling, it is evident that research rules have been implemented differently, both within Europe and globally. In the UK, firms have adopted the profit and loss (P&L) approach, European based firms have mostly chosen the research payment account (RPA) model, in the US costs remain bundled, while APAC sees a diverse range of practices. Eventually, performance will determine where assets are allocated, and this, in turn, will determine which system will prevail. Also, regulators have started to review the impact of the investment research rules' implementation in light of its potentially negative impact on SME research. At the same time, the new rules have given rise to research management systems (RMS), which are an increasingly important tool in institutional investment management.

In summary, implementation of MiFID II/R continues to be a process and ICMA will continue to work with its diverse membership and engage with EU authorities and national competent authorities to help achieve the desired regulatory outcomes while maintaining resilient and efficient markets.

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Introduction

The second Markets in Financial Instruments Directive (MiFID II) and Regulation (MiFIR) has been in application for nearly two years now. In December 2018, ICMA published its first report MiFID II/R and the bond markets: the first year - *An analysis of the impacts and challenges of MiFID II/R implementation since January 2018* which revealed that European bond markets and liquidity had not been impacted noticeably in the first 12 months by the new regime.

However, it also became clear that key objectives of the directive and regulation, notably greater transparency, had not yet been achieved. At the same time, a number of challenges in relation to post-trade data, the systematic internaliser regime and best execution reporting needed to be addressed. It would seem that MiFID II/R was a process rather than an event and more time would be required to assess fully the impact on European bond markets.

The purpose of this year's report is therefore to take stock of the impact of MiFID II/R on fixed income markets in 2019, encompassing bond issuance, secondary market trading and research unbundling, and identify remaining challenges, and propose potential solutions.

This report is intended to provide an overview of the second year of MiFID II/R, drawing on discussions and feedback from ICMA's diverse sell-side and buy-side members and trading venues active in the European bond markets. It is hoped that this will prove useful to market participants and regulators alike as the MiFID II/R implementation process continues into 2020 and beyond.

I. Primary markets

Introduction

In fixed income primary markets, the impacts of MiFID II/R at year-end 2019 are effectively the same as at the end of 2018. As a result, the key findings of ICMA's 2018 report remain valid.

Fixed income primary markets have continued in 2019 to be affected by MiFID, as many underwriters participating in new issue syndicates are MiFID authorised entities. These new measures include allocation justification recording (in relation to underwriting & placing), the inducements and costs & charges regimes, and product governance.

The primary markets community has also continued in 2019 to experience the Packaged Retail and Insurance-Based Investment Products (PRIIPs) regime, to the extent that certain bonds are potentially 'packaged' and are being made available to retail investors in the EEA.

Allocation justification recording

Concept – MiFID firms providing a MiFID placing service to issuers are required to keep an 'audit trail', non-public written record of the justification for each investor allocation made. The rationale for this is to identify potential conflicts of interests, as underwriters look to balance the interests of their issuer clients with the interests of their buy side relationships.

Practical experience – The underwriting community reached broad consensus on allocation recording principles, with the underwriter responsible for billing and delivery generally circulating an initial draft record that other syndicate members can then adopt (modifying it as relevant for their internal needs). The experience so far has mainly just resulted in added administration for underwriters, and it does not seem this measure has meaningful benefits for issuers or investors.

Inducements and costs & charges

Concept – Firms providing MiFID services (eg order reception/transmission to any investor 'client') must disclose to their client in advance any fee/commission or non-monetary benefit received from a 'third party' in relation to the client service. Firms must also inter alia disclose ex ante and annually ex post the costs and charges relating to the services and financial instruments concerned (also "encompassing any third-party payments").

Practical experience – Agreement on whether these rules apply to the disclosure of underwriting fees has varied in practice depending on guidance from some national regulatory sources, the type of fees involved and how individual underwriters and/or how individual transactions are organised. Moreover, the prevailing view is that investors have little or no interest in the level of bond underwriting fees as these are very rarely a material factor in making an investment decision regarding bonds.

Product governance and PRIIPs

PRIIPs concept – Any person 'manufacturing' a 'packaged' product, before it is 'made available' to retail investors in the EEA, must publish a key information document (KID) of no more than three pages and then regularly review it, and if needed, publish a revised KID. Any person advising on, or selling, such a product must provide retail investors in the EEA with the KID in good time before those retail investors are bound by any contract or offer.

Product governance (PG) concept – MiFID II persons that "create, develop, issue and/or design financial instruments, including when advising corporate issuers on the launch of new financial instruments" are 'manufacturers' for PG purposes. Collaboration between manufacturers must be documented in an agreement. MiFID II persons that "offer or sell", or "offer or recommend", financial instruments are 'distributors' for PG purposes (with no connection to the manufacturer being explicitly required). Manufacturers must identify, and communicate to distributors, a compatible target market of investors and periodically review that target market. Distributors must identify their own target markets (by either adopting the manufacturer's target market or refining it). These requirements are all applicable on a 'proportionate' basis.

Practical experience of PRIIPs and PG – The PRIIPs regime is designed to enhance protection of retail investors participating in the structured products markets, while the PG regime imposes a type of suitability obligation on different market participants with respect to all products and investors. In this regard, the two regimes have significant problematic features that have led to unintended consequences and as well as raising concerns over the fundamental practicability of compliance.

Under PRIIPs, certain authorities have taken the position that the inclusion of a term or condition that deviates only slightly from what is regarded as a 'plain vanilla' bond will bring that security into scope as a 'packaged' product, requiring a KID to be produced. An example would be the inclusion of a 'make whole' provision. (The markets are still digesting the potential implications of a 24 October 2019 Supervisory Statement on PRIIPs scope by the European Supervisory Authorities – ESMA, EIOPA and EBA.) The fact that this and other terms can be to the benefit of investors but bring a bond within PRIIPs, combined with the fact that equities are not subject to the PRIIPs regime yet present greater risks to the retail investor, has led many to question the efficacy and rationality of the PRIIPs regime. Under PRIIPs, a KID must not only be accurate but may also be interpreted to require the inclusion of all material information. The imposition of this requirement with attendant issuer liability for both a three-page KID and a full 100+ page prospectus has not only created perplexity but more significantly led many issuers to refuse to produce a KID and instead restrict placement of newly issued bonds to non-retail investors in the EEA.

The PG regime has had similar consequences. It has effectively created an investor suitability obligation, not just at the point of sale (the approach taken in the past by regulation), but also imposing this obligation on issuers, underwriters, and secondary market sellers over the entire lifetime of the instrument. The practical burden of compliance with PG has caused many EU-originated issues to curtail altogether placement of bonds to retail investors.

Conclusion

The impact of MiFID II/R and also PRIIPS on European primary bond markets in 2019 remains unchanged. While the objective of these primary market aspects of MiFID II and PRIIPs is enhanced investor/consumer protection, it seems the outcome has mainly been an increase in administrative burdens and a reduction in retail access to the bond markets. ICMA will continue to engage EU authorities and national competent authorities to better achieve desired regulatory outcomes while maintaining resilient and efficient markets.

II. Secondary markets

19 member firms responded to the survey, of which 18 are MiFID regulated. 7 classify themselves as buy-side, 9 as sell-side (including 8 systematic internalisers for bonds), and 3 as regulated trading venues or 'execution as a service' providers.

Market liquidity

ICE Liquidity Indicators™ tracks the corporate bond market and is prepared exclusively for ICMA and employs statistical methods to measure liquidity dynamics[1] at the security level that are then aggregated at the portfolio level.

Prior to the go-live of MiFID II/R at the end of Q4 2017, corporate bond market liquidity appeared to drop followed by a sharp decline in Q1 2018, which largely correlates with the US led sell-off in global credit markets. But IG liquidity remained relatively rangebound throughout 2018 followed by another drop at year-end. In Q1 2019, IG liquidity levels rebounded swiftly, and continued to improve steadily throughout 2019. However, EUR and GBP, but also USD HY liquidity, shows a fairly steep decline throughout 2018 followed by a marked drop at year-end. Liquidity levels recovered at the beginning of 2019 and reached slightly higher levels at the end of 2019 with the exception of USD HY.

While it is difficult to attribute causality, there is a confluence of factors impacting market liquidity, including regulation such as MiFID II/R, the economic uncertainty arising from Brexit, monetary policy and "portfolio rebalancing" effects, and global geopolitical tensions, amongst others. The topic of market liquidity will be further discussed in depth in ICMA's forthcoming 3rd study into the state and evolution of the European IG corporate bond secondary market, which is expected to be published in Q1 2020.

Figure 1: ICE Liquidity Indicators™

Source: ICE Data Services

1 ICE Data Services incorporates a combination of publicly available data sets from trade repositories as well as proprietary and non-public sources of market colour and transactional data across global markets, along with evaluated pricing information and reference data to support statistical calibrations.

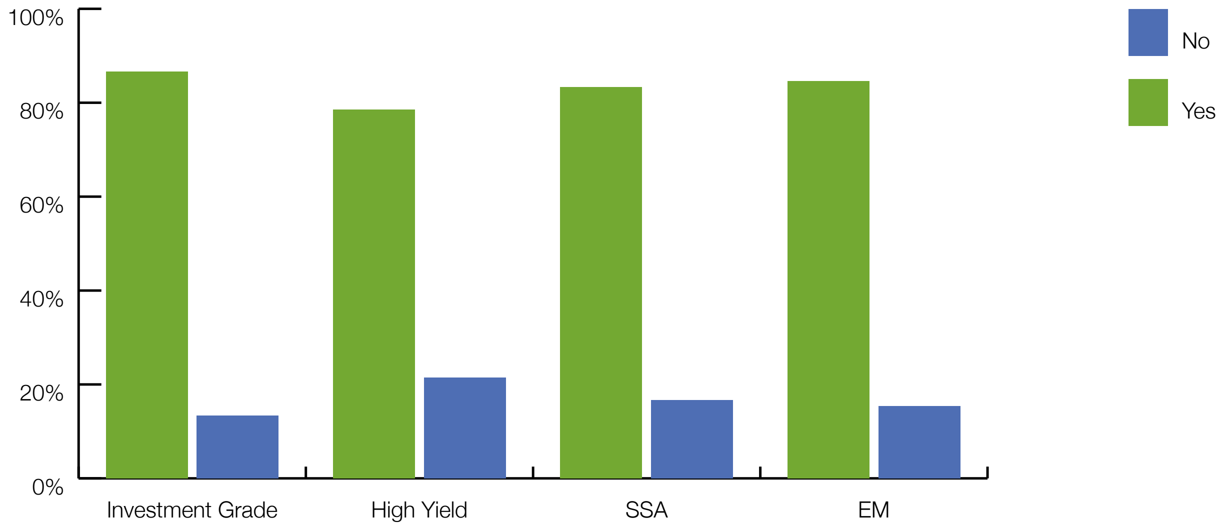
Electronic trading

Electronic trading in fixed income continues to rise in the second year of the implementation of MiFID II/R. While it is difficult to attribute causality, greater efficiency and post-trade reporting obligations under MiFID II/R are arguably two of the factors influencing the shift towards electronic trading venues. However, to which degree each factor or other factors are at play remains difficult to determine.

Around 80% of buy-side and sell-side participants indicated that they executed a larger share of trades electronically in IG, HY, SSA and EM bonds in 2019 compared to 2018. In terms of percentage, a majority of respondents reported an increase of up to 20% across those four sub-asset classes, in particular for EM bonds. Electronic trading of HY bonds appears to have increased between 20% and 40% according to over 40% of participants.

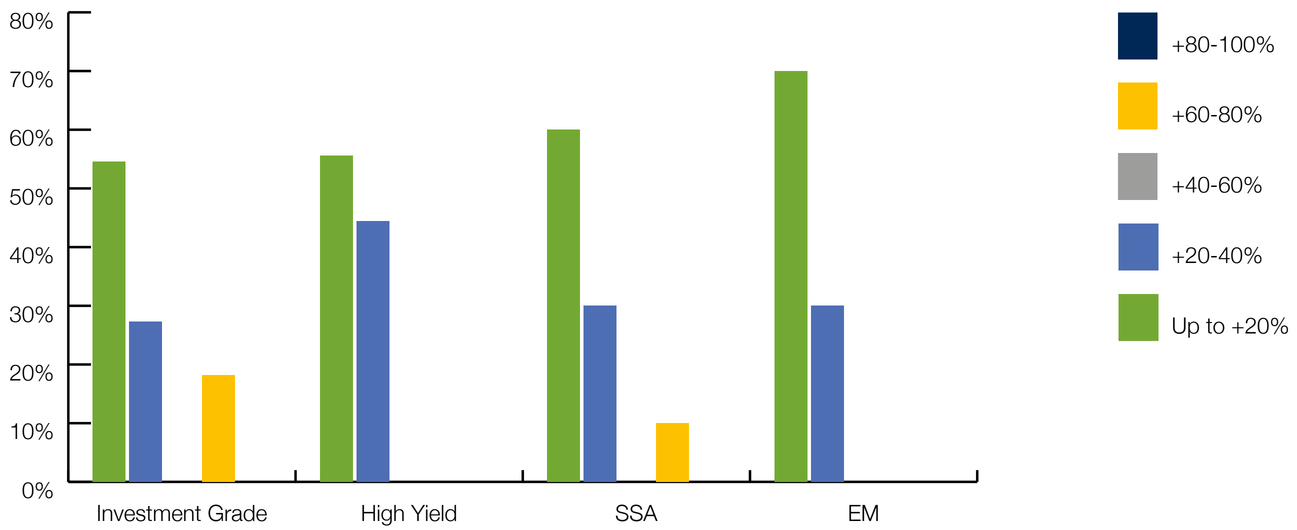
Q: Do you execute a larger share of your tradeflow electronically in 2019 compared to 2018?

Figure 2: Increase in electronic trading



Q: How would you quantify the increase of electronic trading in comparison to OTC trading (year-on-year)?

Figure 3: Quantifying the increase in electronic trading



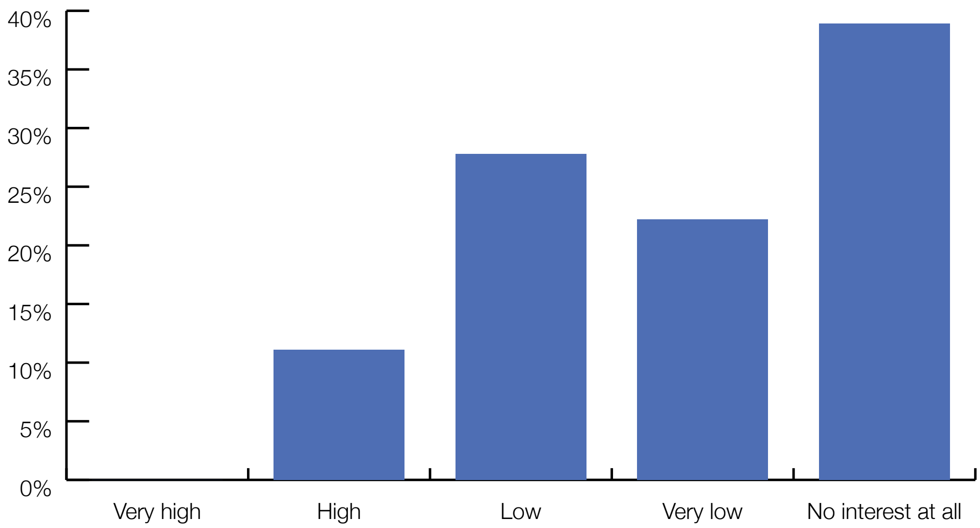
Best execution

Evidencing best execution is a key requirement under MiFID II/R for investment firms, systematic internalisers (SIs) and trading venues. Accordingly, data on the quality of transaction execution has to be made publicly available on a regular basis.

While markets participants questioned the value of those reports and some of the data that has to be reported in the past, overall interest in viewing the best execution reports (RTS 27 and RTS 28) remains low or very low according to 50% of respondents. The share of firms indicating that there had been "no interest at all" has in fact increased (by around 10 percentage points) compared to 2018.

Q: How would you describe interest in viewing the RTS 27/RTS 28 reports published by your firm?

Figure 4: Interest in viewing the RTS 27/RTS 28 reports



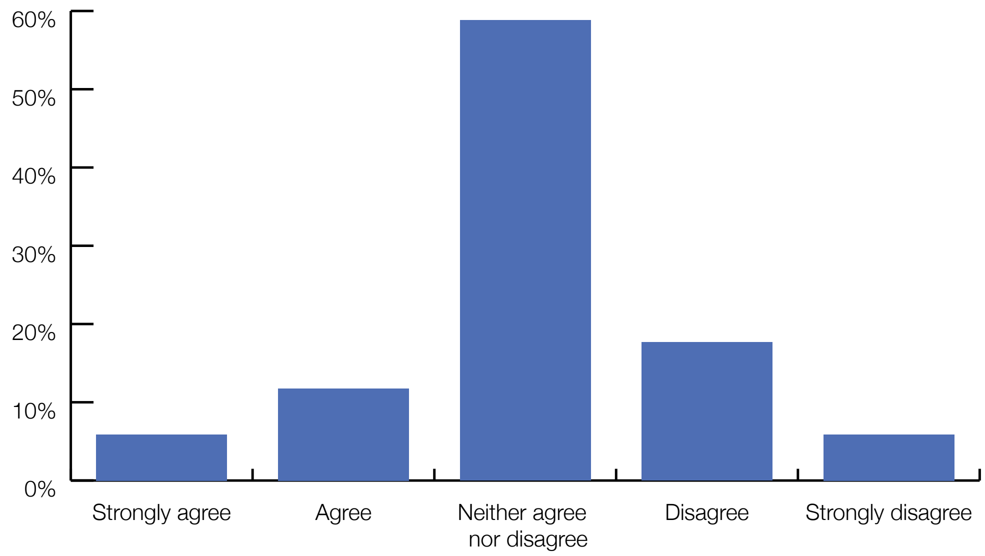
Market structure: the SI regime

MiFID II/R introduced two new categories of regulated entities ie Systematic Internalisers (SIs) and Organised Trading Facilities (OTFs) in an attempt to distinguish different types of business and liquidity provision models. The objective being to create a more 'level playing field' between multilateral trading and OTC trading which continues to be prevalent in fixed income markets. Around 25% of respondents disagree or strongly disagree that the 'playing field' is more even, but nearly 60% do not seem concerned and neither agree nor disagree.

However, in the absence of a central database or 'golden source' of SIs for bonds, identifying whether a counterparty is an SI or not remains challenging according to over 50% of participants in 2019, compared to over 60% in 2018. Considering that post-trade reporting obligations of OTC transactions depend on the regulatory status of trading parties (ie SI or non-SI), survey responses highlight the continuing difficulties of the SI regime which took effect from September 2018.

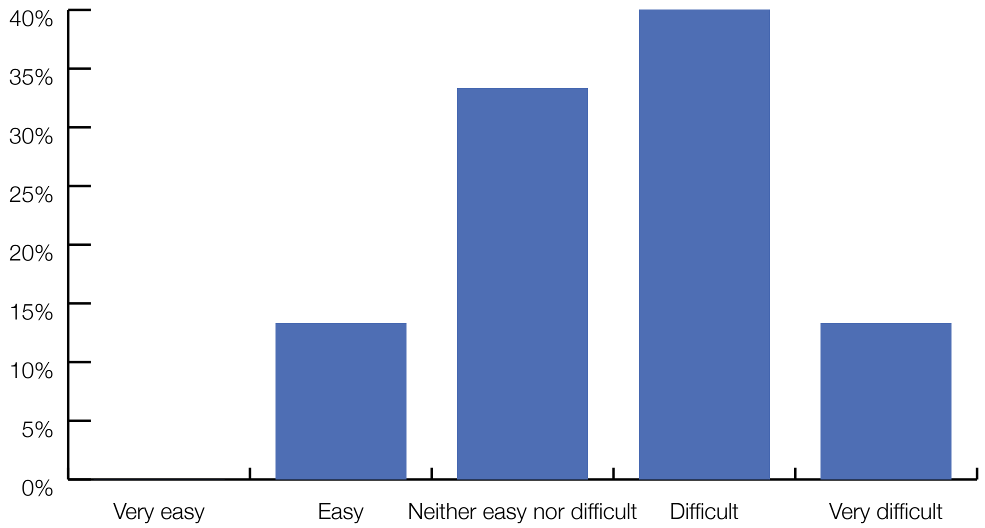
Q: One of the main objectives of MiFID II/R is to create a more 'level playing field' between trading venues on the one hand and market makers and other liquidity providers on the other. Do you agree that it is achieving this objective?

Figure 5: A level playing field between trading venues and market-makers



Q: How would you describe the ease of identifying whether your counterparty is a Systematic Internaliser (SI)?

Figure 6: Ease of identifying SIs



Transparency

Greater transparency in bond markets was one of the key objectives of MiFID II/R. Last year's report found that price discovery had not improved according to over 70% of respondents, which is echoed by 60% of participants in this year's survey. That said, nearly a third of respondents stated that price discovery has 'improved somewhat' in 2019. More importantly, however, it appears that post-trade transparency has not improved substantially either, according to around 80% of respondents in both 2019 and 2018.

Survey responses suggest that accessing post-trade data published by Approved Publication Arrangements (APAs) remains either difficult or very difficult – two years after MiFID II/R took effect. These findings are very much in line with last year's report and hint at a broader issue in accessing and consuming APA data. In terms of usability of post-trade data, 50% of participants consider only up to 10% of the data to be of satisfactory quality, while less than a third believe 10% to 20% of data published by APAs to be useful. In other words, a vast majority of post-trade transparency data is deemed unusable.

However, the survey responses show that nearly 50% of participants are hopeful that APA post-trade data will improve over the next few years, while the other half does not expect any improvements. Data quality appears to be a key issue, resulting on the one hand from the data that is submitted to APAs, diverging interpretations of reporting fields and possibly misinterpretation. On the other, the lack of standardisation in the way data is published by APAs and machine readability poses a challenge to aggregating the data and drawing meaningful conclusions.

One of the key features of the MiFID II/R transparency regime is that national regulators ("national competent authorities") across the EU have discretion in granting deferred publication of transactions in bonds based on thresholds (ie size-specific-to-the-instrument, SSTI, and large-in-scale, LIS) or the liquidity status of a bond. As a result, the timing of public post-trade reporting varies significantly within the EU.

The survey responses suggest a positive correlation between the timing of data being published and its usefulness. According to over 70% of respondents, post-trade data made available after the shortest deferral of 48-hours is deemed useful while data published after a four-week deferral (which tends to be the norm in most EU jurisdictions) is either considered to be not useful at all or of limited use (approx. 40% and 30% respectively). A potential two-week deferral as a compromise would be expected to produce data of limited use according to the majority of respondents. However, as some respondents pointed out, deferrals are needed to protect liquidity providers, notably for less liquid instruments and large sizes.

It is also worth bearing in mind that transparency under MiFID II/R has been phased in gradually based on thresholds and has not yet reached its full transparency levels. While 50% of respondents do not expect data usability to increase as a result, nearly 45% do expect improvements in data usability as more data on bond transactions becomes available in real-time.

However, in light of data quality issues and fragmentation of APA data, it seems less surprising that most participants do not use a third-party aggregator to make use of the MiFID II post-trade transparency data. As one respondent pointed out, "the current [data aggregator] vendors do not offer value in terms of data usefulness".

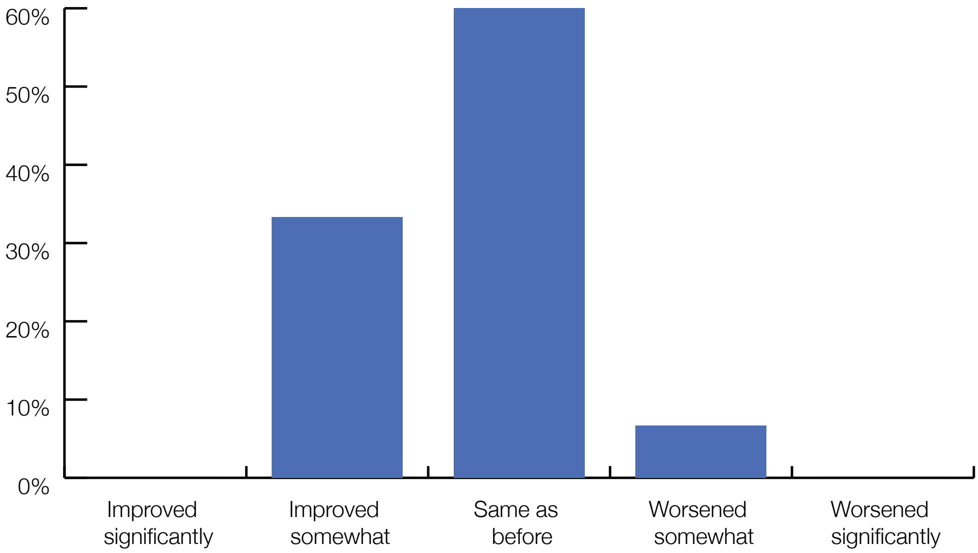
With respect to the current post-trade transparency regime, over 50% of respondents indicated they would prefer the same level of transparency in a forthcoming review of MiFID II/R. In contrast, more transparency would be the preferred outcome of nearly 40% of participants.

ICMA's MiFID II Data Workstream

Improving post-trade data has been a focus of ICMA's MiFID II Data Workstream throughout 2019. The workstream brings together data experts from ICMA member firms, representing trading venues and market data providers, as well as buy-side and sell-side members. The task force identified challenges and engaged with ESMA to propose practical solutions in five key areas of ESMA's FIRDS (Financial Instruments Reference Data System) and FITRS (Financial Instruments Transparency System) databases. See further details in ICMA Quarterly Report Issue 53, Second Quarter 2019, "MiFID II/R: improving post-trade data quality" by Liz Callaghan, p. 37.

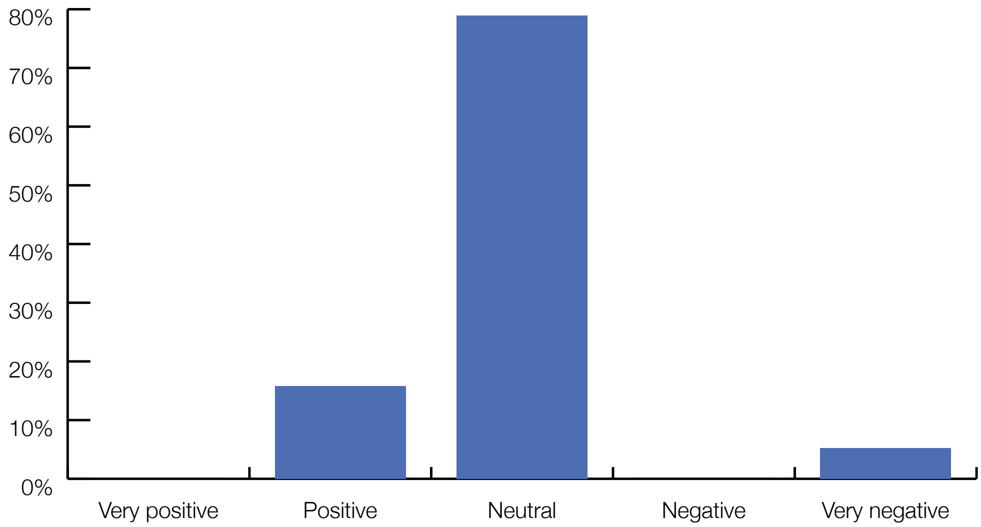
Q: How would you describe price discovery in fixed income markets in 2019 compared to 2018?

Figure 7: Price discovery in fixed income markets in 2019 compared to 2018



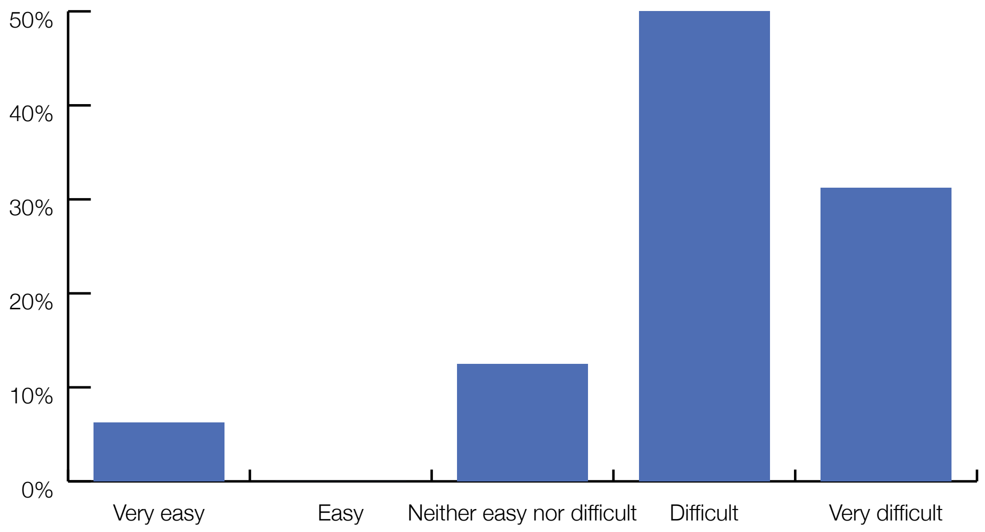
Q: How would you describe post-trade transparency in fixed income markets in 2019 compared to 2018?

Figure 8: Post-trade transparency in fixed income markets in 2019 compared to 2018



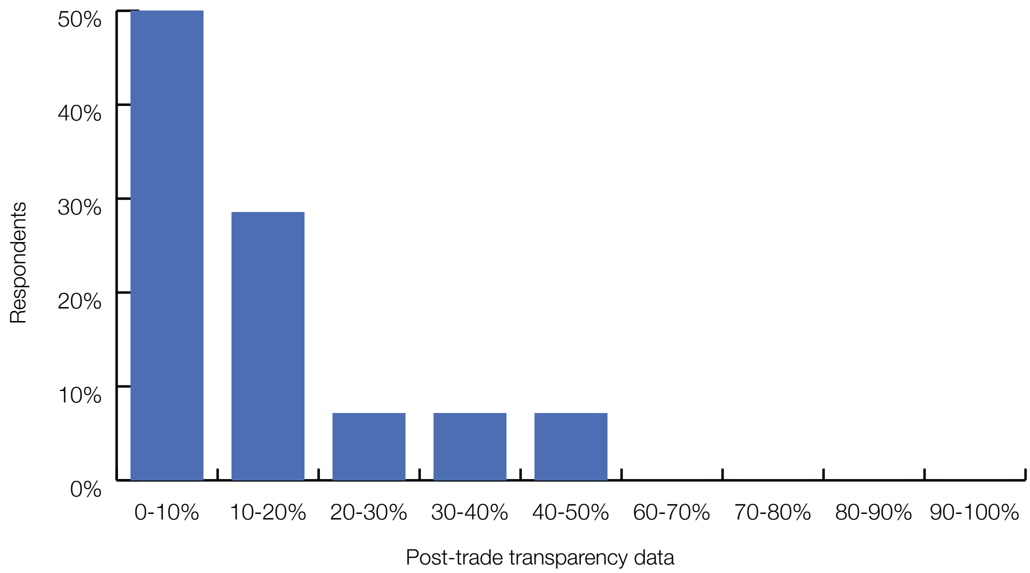
Q: How would you describe access to publicly available APA data (both data published in near-real time and after a deferral period)?

Figure 9: Access to publicly available APA data



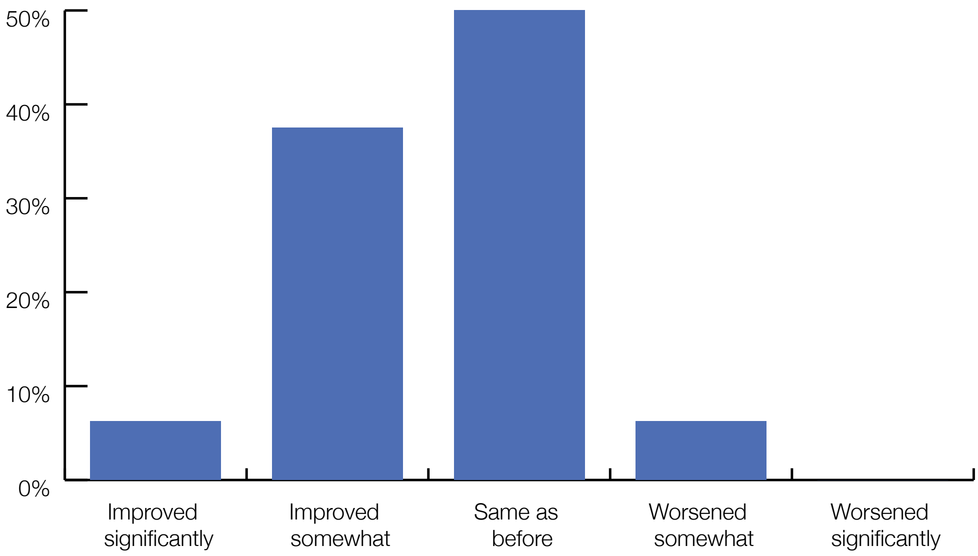
Q: In your opinion, what percentage of the publicly available post-trade transparency data under MiFID II/R is usable (ie of sufficient quality and easily accessible)?

Figure 10: Percentage of usable publicly available post-trade transparency data



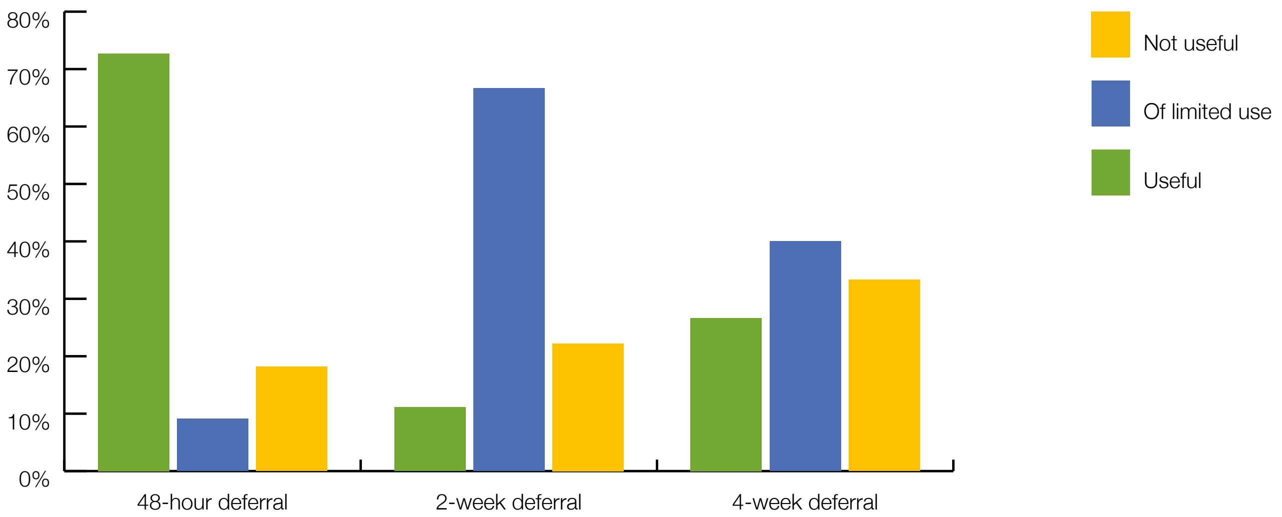
Q: How do you expect the usability of post-trade transparency data to change as lower transparency thresholds are phased in over the next few years?

Figure 11: Expected change in usability of post-trade transparency data



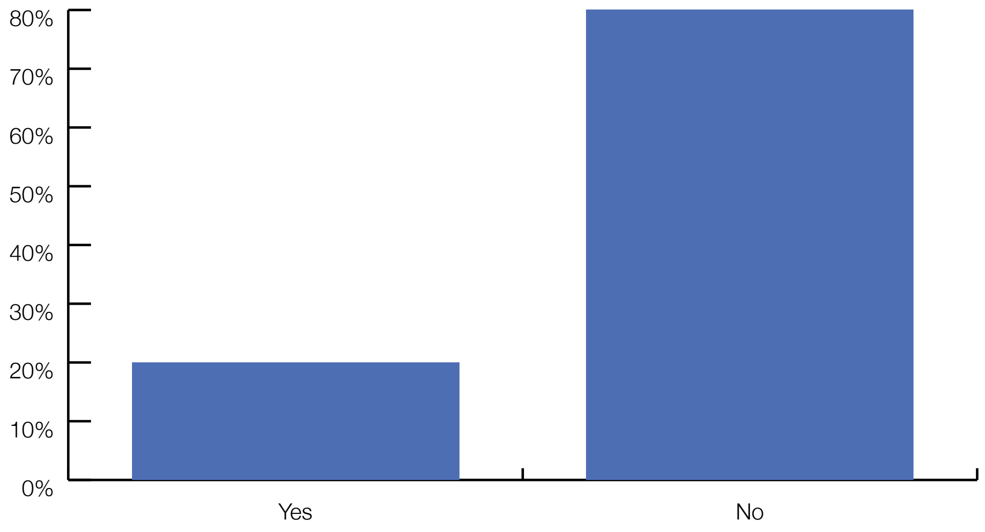
Q: How would you describe the usefulness of post-trade data published following a deferral period?

Figure 12: Usefulness of post-trade data published following a deferral period



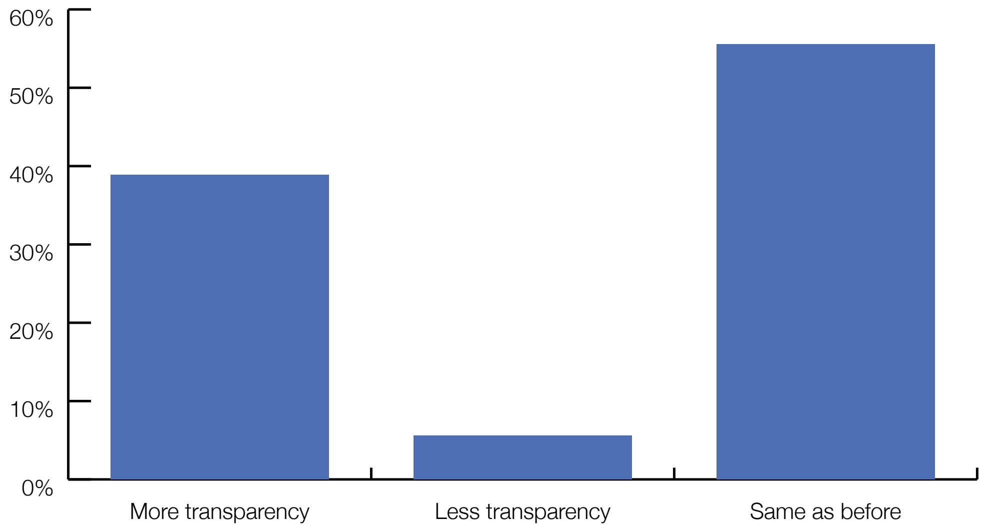
Q: Are you using third-party data aggregators to make use of the MiFID II post-trade transparency data?

Figure 13: Use of third-party data aggregators



Q: In a forthcoming review of the MiFID II/R post-trade transparency regime, which of the following outcomes would you prefer?

Figure 14: Preferred outcomes from a review of the MiFID II/R post-trade transparency regime



A consolidated tape (CT) for bonds in Europe

Considering the lack of progress in creating greater transparency in the European bond markets, a recurring question is the need for a consolidated tape provider (CTP) for bonds. An overwhelming majority (over 80%) of respondents considers a CTP to be beneficial for the industry and ensure a level playing field between market participants in terms of market overview and accessibility of transparency data. Importantly, over 90% of respondents are in agreement that there should be one single, centralised, CTP rather than multiple CTPs.

However, respondents appear to be divided by 60% versus 40% as to whether the development of a CT for bonds should be concurrent with the development of an equities CT, understanding that the implementation of a CT for bonds may take longer than for equity instruments. Should a CT for bonds emerge, an important question that arises is the extent to which existing reporting obligations and mechanisms should be amended. The survey responses suggest that a majority (approx. 60%) of respondents would be in favour of direct reporting from trading venues, SIs and OTC counterparties to a CTP provided the MiFID II/R legal framework is amended accordingly. However, whether direct reporting should be phased-in or not is a question that divides respondents in the middle. It is worth bearing in mind that changes to the reporting obligations would prove to be costly and disruptive to the existing reporting processes. As one participant noted, the "costs of [MiFID II/R] implementation were already high, change would require additional investment in building connections and integration of systems".

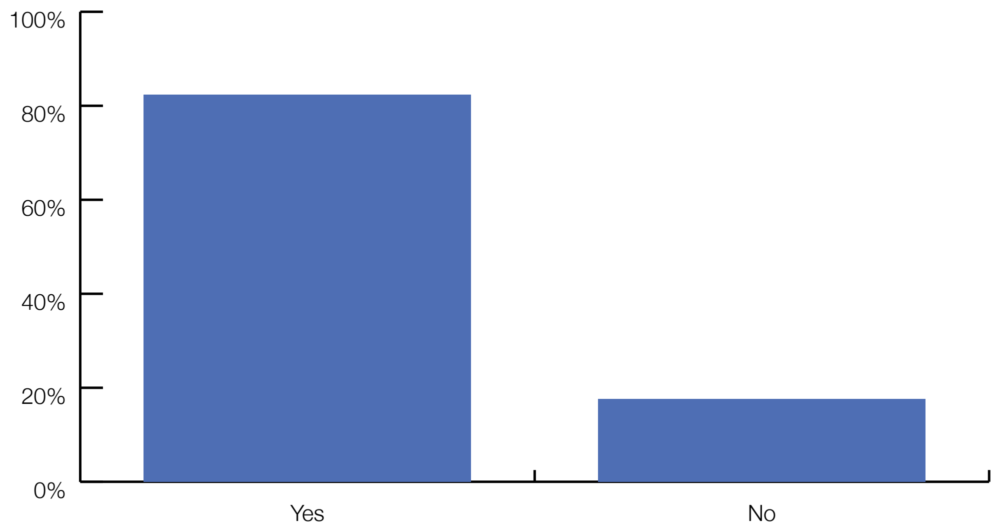
Brexit and the risk of fragmentation of post-trade data is unsurprisingly expected to have a negative impact on an EU27 CT for bonds. Still, 40% believe its impact will be neutral. However, an overwhelming majority would see merits in combining UK and EU27 data in a CT for bonds. Whether this can be achieved will depend to which extent UK and EU27 transparency regimes will remain aligned. Another concern is duplicate reporting which may pose a greater obstacle to consolidating EU27 and UK data than anticipated.

ICMA's Consolidated Tape (CT) Taskforce

To respond to the ESMA consultation on cost of market data and consolidated tape launched in July 2019, ICMA's MiFID II Data workstream set up a Consolidated Tape (CT) Taskforce bringing together buy-side, sell-side, trading venues and market data providers from ICMA's diverse membership. Whilst the consultation primarily focused on equities, the ICMA CT Taskforce (Taskforce) responded solely in relation to cash bonds. The consultation response is available on ICMA's website. Furthermore, the ICMA CT Taskforce believed it was important to put forward a presentation on how a consolidated tape would clearly benefit cash bond markets in Europe. A draft discussion paper covering the workings of a CT for bonds, drawing on observations of TRACE, has been prepared for the European Commission.

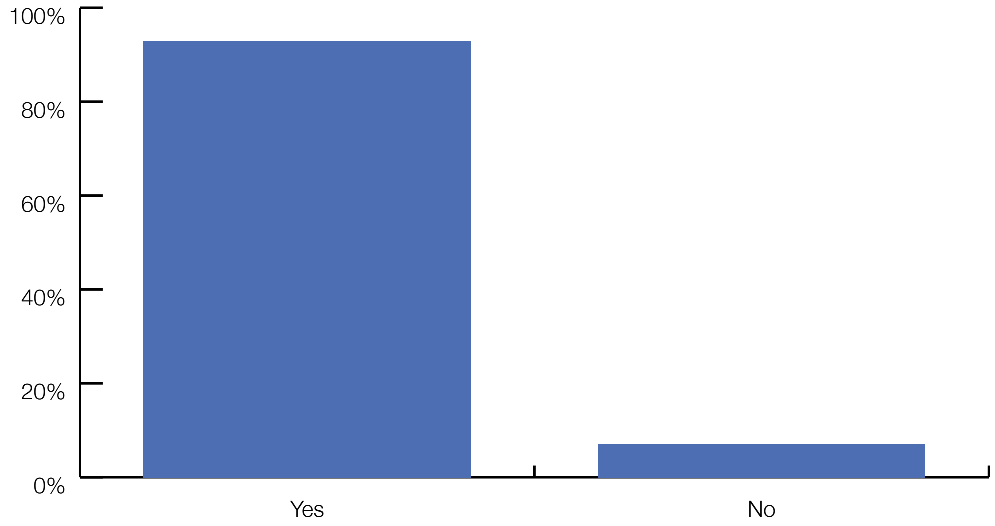
Q: Do you consider that a consolidated tape provider (CTP) would be beneficial for the industry and ensure a level playing field between market participants in terms of market overview and accessibility of transparency data?

Figure 15: Need for a CTP for bonds in Europe



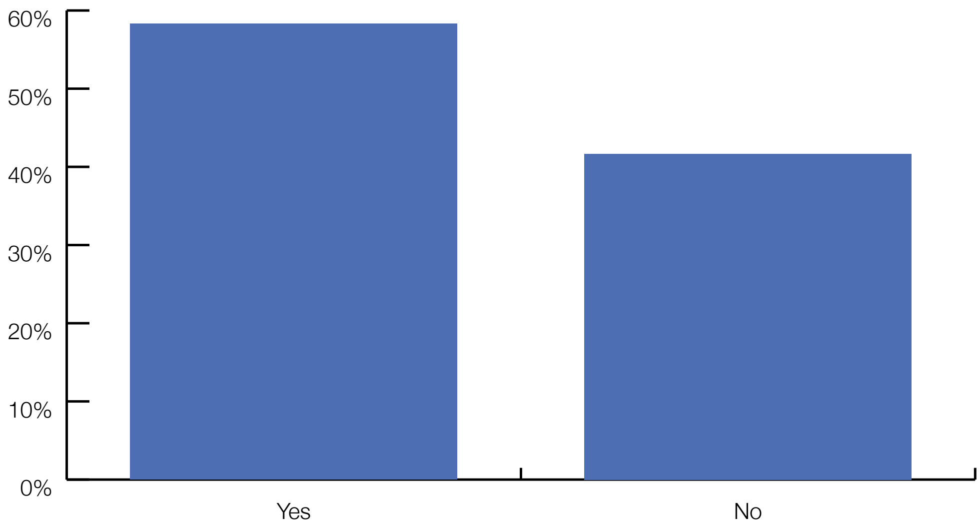
Q: If you answered 'Yes' to the previous question, do you agree that there should be one single, centralised, consolidated tape provider (rather than multiple CTPs)?

Figure 16: A single, centralised, consolidated tape provider (rather than multiple CTPs)



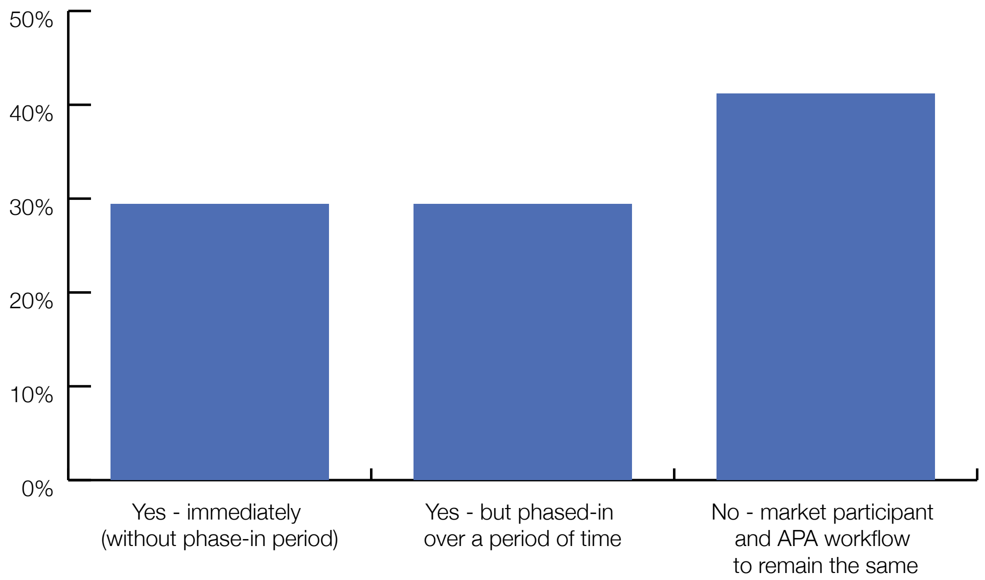
Q: If you answered 'Yes' to the previous question, do you agree that the development of a consolidated tape (CT) for bonds should be concurrent with the development of an equities CT (understanding that the implementation of a CT for bonds may take longer than for equities)?

Figure 17: Concurrent development of a CTP for equities and for bonds



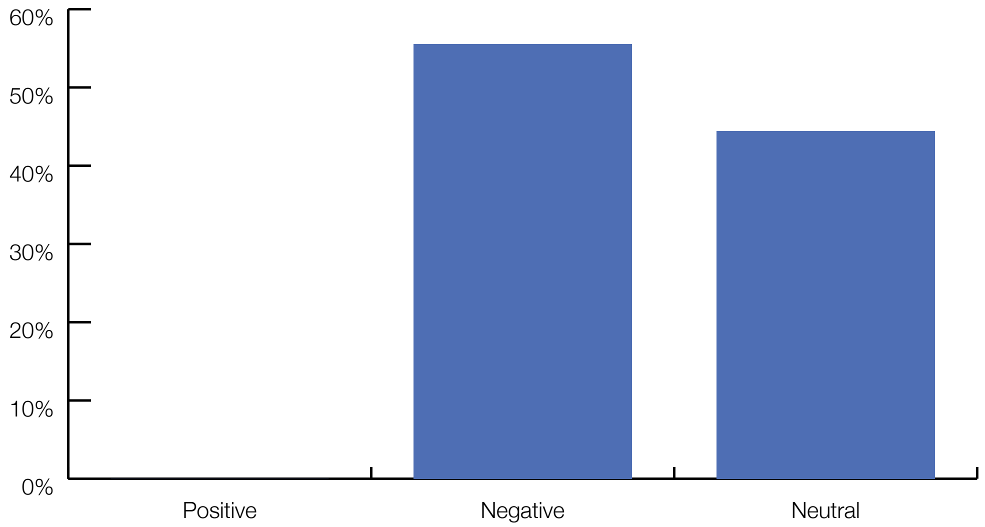
Q: Should a bond consolidated tape emerge, would you be in favour of direct reporting from trading venues, SIs and OTC to a consolidated tape (instead of reporting via APAs provided MiFID II/R is amended accordingly)?

Figure 18: Direct reporting from trading venues, SIs and OTC counterparties to a CTP



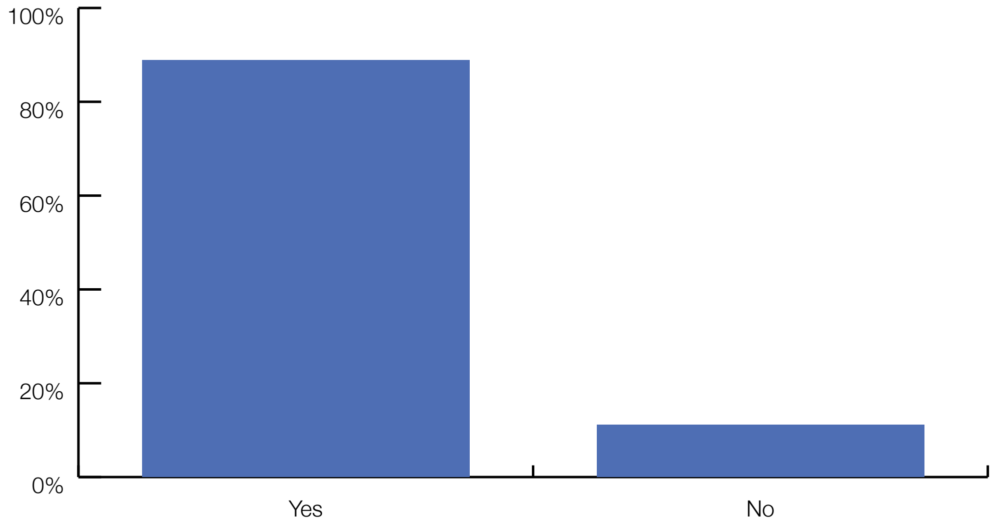
Q: In your view, what will be the impact of Brexit on MiFID II/R post-trade transparency data and a EU27 consolidated tape?

Figure 19: Impact of Brexit



Q: In your opinion, would a 'virtual' consolidated tape combining post-trade transparency data from both the UK and the EU27 be desirable?

Figure 20: A 'virtual' UK/EU27 consolidated tape for bonds

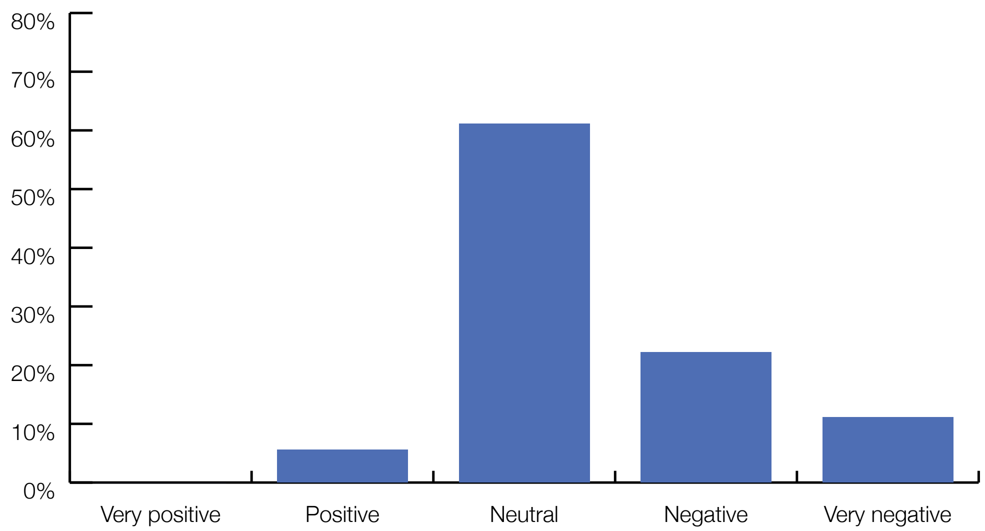


Extraterritorial impacts

As far as the extraterritorial impacts of MiFID II/R are concerned, 60% of respondents described the overall impact of MiFID II/R on their firm when transacting with non-EU counterparties as neutral two years after MiFID II/R entered into force. However, a third of respondents pointed out that the impact has been negative or very negative. As one respondent noted, "non-EU counterparties generally prefer now to engage with us outside of the EU". Others stated that MiFID II/R "puts non-EEA branches of EEA firms in a worse position in comparison to non-EEA firms or subsidiaries of EEA firms" (for example, in terms of transaction reporting requirements of personal data or legal entity identifiers (LEIs) of non-EEA counterparties or clients, transparency reporting obligations, or derivatives trading obligations).

Q: In your opinion, how would you describe the overall impact of MiFID II/R on your firm when transacting with non-EU counterparties two years after MiFID II/R entered into force?

Figure 21: Overall impact of MiFID II/R when transacting with non-EU counterparties



Anecdotal comments by survey participants

Main benefits of MiFID II/R

- “So far very few benefits have been achieved. Arguably [MiFID II/R} has helped with the move to more electronic trading.”
- “No direct benefits but it pushes digitalisation of the OTC flow.”
- “More transparency” (eg for clients, in terms of pricing, fee schedules)
- “All-to-all trading more prevalent and therefore a more viable pool of liquidity”
- “Encouraged better post trade oversight of trading outcomes”
- “Better process of price formation”
- “A start has been established”
- “More streamlined trading on regulated trading venues.”
- “Very limited if any”
- “None”

Main drawbacks of MiFID II/R

- “The cost and complexity of the various reporting requirements.”
- “Increased complexity/friction in the front office.”
- “Dry liquidity on the market”
- “Lack of level playing field between OTC and trading venues.”
- “Increased cost and operational risk.”
- “Too much ‘blind’ RFQ-to-all trading done to satisfy misinterpretation of ‘best ex’ causing severe price movements in illiquid markets”
- “Far too much collation and publication of data and commentary that’s not used and was not asked for. OMS’s have not kept up with need to capture all data points to help explain trading decisions, therefore traders have to manually record too much information. Platforms and exchanges view this as a reason to sell us data (often our own data) at silly prices.”
- “Unbundling Fixed Income “
- “Lack of clear NCA leadership. Non compliance. No penalties or sanction. Defensive behaviour of market participants and data vendors over issues like non-discriminatory venue access and data accessibility.”
- “No improvements to post-trade transparency.”
- “Significantly increased duties for no tangible benefit.”
- “The amount of data we are expected to have access to is overwhelming and inefficient to mine.”

III. MiFID II/R Research unbundling

From 3 January 2018, MiFID II/R required asset managers to pay for research separately from execution services, and either charge clients for research costs transparently or absorb it in their own profit and loss (P&L) account.

Across regions these research rules have been implemented differently, largely: UK firms have adopted the P&L approach, European based firms have largely chosen the research payment account (RPA) model, in the US costs remain bundled, while APAC sees a diverse range – cherry picking best practices.

Impact on SME research

Industry participants have voiced concerns at the negative impact of the new rules on research coverage of small and medium-sized enterprises (SMEs) and how this unintended consequence goes against the European Commission's CMU plan, to improve access to market-based finance for SMEs.

This led ICMA's Asset Management and Investors Council (AMIC) to conduct a survey after less than one year of implementation (November 2018) which among other things showed that 43% of the buy-side firms who responded noticed a decrease in the availability and breadth of SME research.

In 2019, given that the European Commission (EC) has tasked a consultant (Risk Control) to undertake a larger scale analysis of the impact of the MiFID II/R rules on investment research and their impact on SMEs' coverage, AMIC has decided not to re-run its survey. The publication of the results of the EC survey have unfortunately been postponed to 2020 and therefore cannot be commented upon in this report. We note however, in line with our 2018 study, that many surveys conducted in 2019 are indicating that the unbundling model has failed so far to create a market for SME research:

- Citigate Dewe Rogerson's 11th Annual IR survey[2] has found that 52% of UK companies reported a year-on-year decline in the number of sell-side analysts covering them and 38% reported a fall in the quality of that research. For European companies excluding the UK, the figures were 39% and 20%, respectively;
- A CFA institute survey found that since the introduction of MiFID II/R, research quality in respect of SMEs has decreased by 26%, according to the buy-side, and 44% according to the sell-side. Similarly, research coverage seems to have dropped by 47% and 53%, respectively. While 39% of market participants agreed that the industry has become more competitive, 25% believe it is now less competitive. Finally, asked whether they believe the MiFID II/R reforms have delivered better outcomes for end investors, 59% of participants said no.[3]

These studies are expected to give reasonable arguments for the EC to consider adjustments to the unbundling rules in the context of the upcoming 2020 MiFID review. This could include for instance an exemption for fund managers focusing on SMEs.

Regulators' views on research unbundling

In parallel, we have observed in 2019 that national regulators in the EU have also started to review the implementation and consequences of the new rules. The French Autorité des Marchés Financiers (AMF) announced, on 11 July 2019, that it had launched a study on the impact of the new rules governing research funding introduced by MiFID II/R, quoting changes to the market economy of research and in particular the issue of low SME coverage by analysts. Likewise, the German Ministry of Finance (BMF) has put itself forward as a key initiator of regulatory change in Europe, with the publication, on 27 August 2019, of two position papers on recommended amendments to MiFID II/R. In respect of the investment research rules, they acknowledge that reactions are divided with regard to the impact of the new rules on research fees and advocate for a thorough review to be conducted on the impact that these rules have had on the costs and availability of research relating to SMEs. It is stated that any amendments to the legislation should ensure that appropriate incentives for providing an adequate amount of research on SMEs are in place.

In contrast, on 19 September 2019, the UK FCA issued the results of a multi-firm review of the unbundling reforms concluding that the new rules have steered the market towards the intended outcomes and benefit consumers. They find that, due to most firms having absorbed the research costs themselves, the saving directly benefits investors. Most importantly, their findings suggest that most buy-side firms can still access the research they need, *with no evidence of material reduction in coverage of SMEs*. The FCA noted in its survey results that research valuation and pricing are still evolving and a market for separately priced research is still emerging – which explains the wide range

2 Citigate Dewe Rogerson's 11th Annual IR survey, 7 November 2019
3 CFA Institute report on MiFID II: One Year On – Assessing the Market for Investment Research, February 2019

of sell-side research pricing levels. They also found a material reduction, of around 20% - 30%, in the budgets firms set for externally produced equity research, which is in line with the findings of the *AMIC Survey on FICC Research Unbundling 2018*, issued in November last year. The FCA noted several reasons behind this reduction: a more targeted approach by buy-side, with fewer and more focused analyst meetings; high competition, which drove down the costs for written material; and most firms making the effort to better understand how they use their research, to improve cost discipline. Other observations made in the review findings include that too low pricing by sell-side research providers may have an adverse impact on competition, under-charging for corporate access could be problematic and that the sell-side should not just be "price-takers". The FCA indicated that there will be further thematic work on the topic over the next two years.

Looking beyond the EU, on 9 July 2019, the US House of Representatives passed a Bill, known as the *Improving Investment Research for Small and Emerging Issuers Act*, requiring the Securities and Exchange Commission (SEC) to study the provision of investment research into small issuers, including emerging growth companies. Among the issues the study will consider are: demand for research by institutional and retail investors; the availability of research in terms of number and types of providers; the volume of research over time; competition in the research market; costs of such research, as well as conflicts of interest in the production and distribution process. In addition, the study will consider the effects of concentration and consolidation on fund managers, including the size of fund managers and how this relates to the demand for research, and will also examine the impact of different payment mechanisms on research. It is difficult to not see the connection between this study and the MiFID II/R rules in the EU. However, while industry participants in the US acknowledged that some form of research unbundling was likely to be adopted in the US by asset managers, as it was slowly becoming a best practice, many are confident that regulators are unlikely to mandate unbundling in the US as they did in the EU.

The prevailing industry view seems to be that there will be no tweaking from UK regulators on MiFID II/R, regardless of Brexit. Europe may look to make small amendments, but these will be difficult to achieve, while the US has adopted a wait-and-see approach. The asset owners' attitude to this is key and they are the ones who will define the direction of travel.

The impact of technology on the market for investment research

Looking at the practical aspects of the investment research rules' implementation has led to the rise of research management systems (RMS), which are an increasingly important tool in institutional investment management. While relatively few currently use a formal RMS system, this is starting to change as more firms are beginning to realize the benefits that a modern approach can offer. Similarly, asset owners and allocators are increasingly seeking out the benefits of RMS technology, to assist them in conducting due diligence on the asset managers in their pre-allocation universe.

The use of technologies such as artificial intelligence (AI) and machine learning (ML) in research analysis is still being tested, but the human overlay to interpret and contextualise data remains important. Face-to-face contact with analysts continues to be considered the essential element of the research process.

For research providers, other data sources such as alternative data, environmental, social and governance (ESG) and big data are seen as the key areas where product innovation provides the best opportunities, where they can provide an overlay analysis of data sets which allows clients to generate more value from the data. This innovation has only been accelerated by MiFID II/R, as it is encouraging a focus on what is valuable and what is less valuable. However, challenges for new innovative products remain, the biggest one of which is proving return on investment for clients, which is still unknown in most cases.

Conclusion

Following ICMA's first report on MiFID II/R and the bond markets: the first year in 2018, it is evident from market participants' feedback that implementation of MiFID II and MiFIR in the European bond markets continues to face a number of challenges in 2019 and has not fully achieved its objectives.

In fixed income primary markets, the impacts of MiFID II/R at year-end 2019 are effectively the same as at year-end 2018. Requirements in terms of allocation justification recording and disclosure of underwriting fees do not seem to have generated tangible benefits or interest whilst placing a greater administrative burden on dealers. However, the product governance and Packaged Retail and Insurance-Based Investment Products (PRIIPs) regimes continue to have significant problematic features that have led to unintended consequences lowering retail investors' participation as well as raising concerns over the fundamental practicability of compliance.

From a secondary market perspective, electronic trading has further increased across IG, HY, SSA and EM bonds in 2019 while interest in reporting on the quality of transaction execution ("best execution") appears to remain minimal. 15 months after the Systematic Internaliser (SI) regime has been introduced, major challenges still persist in identifying whether a counterparty is a SI. However, one of the greatest shortcomings is the continued lack of post-trade transparency in fixed income markets. Survey results suggest that data quality, accessibility of data published through Approved Publication Arrangements (APAs) and usability of data published after deferral periods are key obstacles to creating greater transparency.

A single, centralised consolidated tape provider (CTP) for bonds in Europe seems to be the preferred solution for aggregating and disseminating post-trade data, according to survey results. Furthermore, market participants reported that a more streamlined approach such as direct reporting of post-trade data to a CTP would be preferable. However, cost is an important consideration and changing regulatory reporting obligations would likely increase costs, at least in the short term. Brexit and the risk of fragmentation is unsurprisingly expected to have a negative impact on an EU27 CT, and the preferred option would be to combine post-trade data from both the EU27 and the UK in a CT post-Brexit. Overall, the extraterritorial impacts of MiFID II/R on market participants seem rather limited but non-EEA branches of EU firms appear to be impacted adversely while non-EEA trading activity seems to have shifted to non-EU trading venues.

In terms of FICC research unbundling, it is evident that research rules have been implemented differently, both within Europe and globally. In the UK, firms have adopted the profit and loss (P&L) approach, European based firms have mostly chosen the research payment account (RPA) model, in the US costs remain bundled, while APAC sees a diverse range of practices. Eventually, performance will determine where assets are allocated, and this, in turn, will determine which system will prevail. Also, regulators have started to review the impact of the investment research rules' implementation in light of its potentially negative impact on SME research. At the same time, the new rules have given rise to research management systems (RMS), which are an increasingly important tool in institutional investment management.

In summary, implementation of MiFID II/R continues to be a process and it is hoped that this report will prove useful to market participants and regulators alike as implementation continues into 2020 and in light of a forthcoming review of MiFID II/R. ICMA will continue to work with its diverse membership and engage with EU authorities and national competent authorities to help achieve the desired regulatory outcomes while maintaining resilient and efficient markets.

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