Secondary Markets



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MiFID II/R implementation in secondary markets

Following an intense period of preparation for market participants, MiFID II and MiFIR entered into force on 3 January 2018. Overall, the "go-live" of MiFID II/R appears to have been smoother than anticipated, without causing major market disruption.

In the first quarter of 2018, ICMA has held further regional roundtables in Copenhagen, London and Vienna, focused on MiFID II/R "post-implementation". Similar to previous workshops, the roundtables targeted trading and research-related market participants from the buy side and sell side who have been heavily involved in preparations for MiFID II/R. The objective was to share experiences, assess the initial impact on trading workflow and market structure, and identify remaining challenges post-MiFID.

From the roundtables and bilateral discussions with market participants it became apparent that a number of challenges remain, some of which were expected, whilst others only emerged after 3 January 2018.

Trading workflow

With respect to trading activity, participants in ICMA roundtables reported mixed experiences. Some commented that traded volumes in fixed income had been subdued, in the first weeks of January, before recovering to pre-MiFID II levels. This short-term decrease was largely considered to be a seasonal effect rather than a direct consequence of MiFID II/R. In contrast, other market participants, notably small and mid-sized firms observed a marked and prolonged decline in trading, stemming from remaining uncertainty and a lack of official guidance from their NCAs. It was also stated that some firms had stopped providing liquidity for certain derivative products.

In a similar vein, market participants reported that trading on regulated venues[1] had increased. Some small and mid-sized participants said they executed all transactions on platforms since 3 January, having previously transacted mainly OTC. A general shift from OTC trading towards venues was somewhat anticipated, in particular for relatively liquid instruments. However, it was pointed out that trading illiquid instruments remained predominantly OTC. Overall, most participants concurred that the market share of electronic trading had risen.

The shift towards venue-trading appears to be further reflected in the increase of "move-to-venue" trades, sometimes also referred to as "processed" or "negotiated" trades. This means that trades are negotiated bilaterally and then "consummated" or formalised on a trading venue via an RFQ-to-1 between the counterparties. Participants stated that the market was adjusting to the process of "move-to-venue" trades, which may vary between trading venues and their respective rulebooks.

Market structure

A concern that had been raised prior to the "go-live" of MiFID II/R relates to identifying Systematic Internalisers (SIs). According to trade reporting requirements, it is incumbent on SIs who transact with a non-SI to publish details of the transaction via an Approved Publication Arrangement (APA). It is therefore vital for market participants to understand which counterparties are SIs for which bonds. However, ESMA's SI register does not distinguish SIs on an ISIN-level, but rather by broad categories such as "bonds", "derivatives" or "shares". As a result, in the absence of a sufficiently detailed SI register, market participants identify SIs mostly on the basis of existing relationships.

1. ie regulated markets (such as stock-exchanges), multilateral trading facilities (MTFs) or the newly created category of organized trading facilities (OTFs; such as inter-dealer brokers).

Data

A further source of concern, which relates to data, only came to light after 3 January 2018. Increasing transparency in bond (and other non-equity) markets is one of the key objectives of MiFID II/R. Under trade reporting rules, operators of trading venues and SIs are required to make quotes and details of executed transactions publicly available, free of charge after 15 minutes, in a machine-readable format. The publication is subject to pre-trade waivers and post-trade deferrals. However, in the absence of common standards, the format in which data is published by APAs and SIs varies significantly. Further feedback from members is that there is less usable data available today than before MiFID II in many instances. The data is also not "publicly available" (which is not in the spirit of MiFID II). Often an instrument ID or transaction number is needed to access the data. If the data is accessed, it may only be for a short period of time. Finally, this public data is supposed to be downloadable (in machine-readable format). Again, in many instances this is not the case. As a result, it is challenging to source, aggregate and make use of the transparency data. This is compounded by the absence of a consolidated tape provider, or "golden source", of trading activity at EU level. As requested by member firms, ICMA will further explore the development of *minimum* common data standards, in collaboration with relevant stakeholders.

With respect to transparency requirements, market participants reported furthermore that there were significant discrepancies between the number of bonds deemed liquid and illiquid bonds for trade reporting purposes. ESMA published transparency calculations of bonds in December 2017 and January 2018, setting out which individual bonds are deemed liquid or illiquid. These assessments excluded new bond issuances post 3 January 2018. However, it appeared that some platform operators considered more instruments to be liquid than those published by ESMA (again, excluding new issues).

A common theme that was raised by market participants across the EU/EEA is the lack of harmonisation when it comes to the interpretation of certain MiFID II provisions. As a Directive, MiFID II sets out common objectives whilst granting EU Member States leeway in how to achieve these, taking into account national specificities. However, the undesired side effect, in particular on cross-border transactions within the EU, is that NCAs have diverging interpretations, leading to uncertainty. For example, participants reported that NCAs have different views on what constitutes research or a "minor non-monetary benefit" (MNMB); the scope of the definition of "investment firm" in relation to buy-side firms (significantly reducing transparency and research obligations under MiFID II); or how to determine whether derivatives are TOTV (traded on a trading venue) and therefore have transparency requirements.

Conclusion

Whilst it is too early to assess the wider impact of MiFID II/R, ICMA will hold further regional "post-implementation" Q&A roundtables across Europe. ICMA will continue to address issues raised in the Q&A roundtables in its relevant committees, councils and working groups as well as explore industry-led solutions.

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ESMA guidance on MiFID II/R

In the first quarter of 2018, the European Securities and Markets Authority (ESMA) issued further guidance in relation to MiFID II/R to address specific issues following 3 January 2018. The following briefing is designed to provide a non-exhaustive summary of selected guidance impacting market structure and fixed income trading, notably (i) Systematic internalisers (SIs) and riskless back-to-back transactions; (ii) ESMA's opinion regarding packages and the derivatives trading obligation under MiFIR; (iii) pre-arranged/negotiated transactions for non-equity instruments; (iv) ESMA's update regarding liquidity assessments of individual bonds for trade reporting; and (v) further ESMA Q&A updates in relation to research, post-sale reporting, information on costs and charges, and inducements, released on 23 March 2018.

MiFID II/R

Overview of selected ESMA guidance in the first quarter of 2018:

28 March: Q&As on transparency topics

28 March: Q&As on market structure topics

26 March: Lists of trading venues and CCPs benefiting from a transitional exemption from the access provisions

- Under MiFIR Article 36(5)
- Under MiFIR Article 54(2)

23 March: Q&As on investor protection topics

21 March: Opinion in relation to packages and the derivatives trading obligation

7 February: Q&As on transparency topics

19 January: Updated liquidity assessments for individual bonds by ISIN

(i) Systematic Internalisers (SIs) and riskless back-to-back transactions

On 28 March 2018, ESMA issued an additional clarification in regards to SIs, matched principal trading, and other types of riskless back-to-back transactions. ESMA originally published on 5 April 2017 [Section 5, Question 22] its interpretation of "arrangements operated by an SI [which] would be functionally similar to a trading venue", and hence are not permissible.

Amongst other criteria, this would be the case where "arrangements would extend beyond a bilateral interaction between the SI and a client, with a view to ensuring that the SI *de facto* does not undertake risk-facing transactions." ESMA further stated on 28 March the following: "The concept of *de facto* riskless back-to-back transactions is not confined to pairs of transactions in the same financial instrument. Other arrangements, for example where one leg is a securities transaction and the other is a derivative which references that security, could also be deemed as having the objective or consequence of carrying out *de facto* riskless back-to-back transactions."

However, ESMA's conclusion outlined in Question 22, Section 5, remains unchanged: "ESMA highlights that the above does not prevent SIs from hedging the positions arising from the execution of client orders as long as it does not lead to the SI *de facto* executing non risk-facing transactions and bringing together multiple third party buying and selling interests. ESMA is of the view that an SI would not be bringing together multiple third party buying and selling interests as foreseen in Recital 19 [of the Commission Delegated Regulation (EU) 2017/565] where hedging transactions would be executed on a trading venue."

MiFIR – Article 2(1)

Definitions

(49) "package order" means an order priced as a single unit:

(a) for the purpose of executing an exchange for physical; or

(b) in two or more financial instruments for the purpose of executing a package transaction;

(50) "package transaction" means:

(a) an exchange for physical; or

(b) a transaction involving the execution of two or more component transactions in financial instruments and which fulfils all of the following criteria:

(i) the transaction is executed between two or more counterparties;

(ii) each component of the transaction bears meaningful economic or financial risk related to all the other components;

(iii) the execution of each component is simultaneous and contingent upon the execution of all the other components.

(ii) ESMA opinion regarding packages and the derivatives trading obligation under MiFIR

On 21 March 2018, ESMA released an opinion providing further guidance on the treatment of packages under the MiFIR trading obligation for derivatives (DTO) introduced on 3 January 2018.

ESMA stated that "only components of a package are subject to the TO [trading obligation, as specified in Commission Delegated Regulation 2017/2417] but not the package as such (ie the other components of the package)."

In the opinion, ESMA proposed a "tailored approach ensuring that, only where it is feasible to trade components of a package that are subject to the TO on a trading venue without creating undue operational or execution risk, those components need to be concluded on a trading venue. This approach applies to the following categories of packages:

- All components of the package are subject to the TO;
- At least one component is subject to the TO and all other components are subject to the clearing obligation for derivatives (CO);
- At least one component is an IRS subject to the TO and all other components are government bonds denominated in the same currency ('spread overs')."

The opinion is subject to review by ESMA in the future.

(iii) Pre-arranged/negotiated transactions for non-equity instruments

On 7 February 2018, ESMA issued further guidance with respect to "pre-arranged" or "negotiated" transactions in non-equity instruments. This type of transaction is initiated bilaterally, and formalised subsequently on a trading venue. While MiFIR explicitly sets out provisions for "negotiated" transactions in equity instruments, there is no equivalent provision for fixed income instruments.

With respect to non-equity instruments, ESMA therefore clarified that "it is possible to formalise negotiated or pre-arranged transactions on a trading venue subject to meeting the conditions for the respective waivers from pre-trade transparency set out in Article 9(1) of MiFIR [Waivers for non-equity instruments]." A distinction is made between instruments that are not subject to the derivatives trading obligation (DTO) and those that are subject to the DTO.

With respect to "non-equity instruments that are not subject to the trading obligation for derivatives pre-arranged transactions are possible under:

(a) the LIS-waiver (first part of the sentence in Article 9(1)(a) of MiFIR),

(b) the waiver for instruments that do not have a liquid market (Article 9(1)(c) of MiFIR),

(c) the EFP [exchange for physical] waiver (Article 9(1)(d) of MiFIR) and

(d) the package order waiver (Article 9(1)(e) of MIFIR).

However, pre-arranged transactions may not be executed using the order management facility waiver (second part of Article 9(1)(a) of MiFIR) or the size-specific-to-the-instrument (SSTI)-waiver (Article 9(1)(b) of MiFIR).

Concerning derivatives subject to the trading obligation, pre-arranged transactions are only possible under: (a) the LIS-waiver (Article 9(1)(a) of MiFIR) and (b) the package order waiver (Article 9(1)(e) of MiFIR)." ESMA further stated that trading venues are responsible for ensuring that "pre-arranged" transactions comply with relevant regulations.

In addition, ESMA issued guidance with regard to orders held in an order management facility of a trading venue. Further information can be found here [Question 12 in section 5 of ESMA's Q&A document].

(iv) ESMA update regarding liquidity assessments of individual bonds for trade reporting

On 19 January 2018, ESMA issued an update of the liquidity assessments for bonds in relation to MiFID II/R transparency requirements. Previous calculations were published on 6 and 22 December 2017 respectively. According to ESMA, the update included "bond instruments (except ETCs and ETNs), traded for the first time on a trading venue between 1 November 2017 and 2 January 2018 (included)."

As a result, a total of 803 bonds were deemed liquid (+242 compared to the previous TTCs released on 22 December 2017). With respect to corporate bonds, the number of liquid instruments increased by 117 and totals 270. The list of individual ISINs is available on ESMA's website. This excludes new issues.

As a reminder, the transitional transparency calculations (TTC) for the liquidity assessments of bonds are applicable until 15 May 2018 and may be revised, if deemed necessary, by ESMA. It is stated that "the next version of the liquidity assessment for bonds will be published on 1 May 2018", applicable from 16 May 2018 to 15 August 2018. Subsequently, the liquidity assessments will be revised on a quarterly basis.

Latest updates of the FAQ document issued by ESMA are available on its website.

(v) Further ESMA Q&A updates released on 23 March 2018

On 23 March 2018, ESMA issued further Q&A updates in relation to MiFID II/R investor protection topics. With respect to research in the context of inducements, ESMA provided the following clarifications:

- *Macroeconomic analysis:* ESMA considers that "openly available" in the context of written material should mean that there are no conditions or barriers to accessing it, for example a necessary log-in or sign-up, or the submission of user information by a firm or a member of the public, in order to access material;
- *FICC research:* ESMA specifies that where FICC material is made openly available to all investment firms or the general public, it should be made so on the same basis as in Question 8 [macroeconomic analysis], ie there are no conditions or barriers to accessing it.

Other questions and answers include post-sale reporting in relation to retail client accounts; information on costs and charges, and the use of product costs as presented in the PRIIPs KID by investment firms; inducements and the provision of portfolio management services; and clarifications with respect to the term "ongoing relationship" within MiFID II/R and related legal texts.

Further information on the ESMA guidance mentioned above can be found on ICMA's MiFID II secondary markets website.

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