MiFID II/R implementation: road tests and safety nets

With MiFID II/R's deadline looming, many firms are concerned that they may not have the optimal solution implemented on day one that meets both regulatory obligations and their firm's trading objectives. With this in mind, ICMA has some suggestions for road-testing new regimes and safety nets for new trading workflows to allay fears and assist in preparations for the MiFID II/R implementation date of 3 January 2018. These are based on the many interactive discussions in ICMA's MiFID II/R Working Group meetings.

SI regime "road testing"

The systematic internaliser (SI) regime[56] comes into effect in September 2018 (although investment firms may elect to "opt in" to the regime from 3 January 2018). Many thought it might have been quite useful in January to start "opting in" and "opting out" as much as firms wanted, in order to test the new SI regime in a live environment. However, this was deemed impractical as SIs would need to connect to their local regulator's data base to send reference data. Negative consequences could arise regarding the quality of the reference trade data, created from opting in and opting out. Therefore, opting in and opting out before September 2018 is clearly not the answer. Nevertheless, some sort of "road-testing" is needed.

The suggestion is therefore to create a "virtual" SI regime under which sell sides create various scenarios with clients and trade as if they were an SI (without opting into the regime) before September 2018. Firms must make clear to their clients that this is a road test and that they do not in fact have SI status. Some of the road-testing scenarios follow:

How to inform clients if you are an SI for a particular instrument, per legal entity and per currency:

- Individual approved publication arrangements (APAs)[57] are starting to collect the data. (As there will be no centralised database for SIs in order to replicate a centralised SI database, APAs will need to share the data they collect with all the other APAs.) While these databases are incomplete in the beginning, any of the identifier codes based on SIs, per instrument and per currency, will be useful to test. In this way firms can be ready for when this data is more fully available through the APAs.

How to provide firm pre-trade SI quotes publicly:

- A utility for publishing is the ideal, but some firms may end up posting spreadhseets (in the form of an "xls" file) on a website (this is still in machine readable format). That "xls" file on the website has to be tested with clients as if live.
- SI quotes will have an identifier. If a client wants to trade with an SI based on that quote, the client must identify that quote by its identifier. This procedure needs to be tested.
- OTC SI quotes that are subsequently executed on venue (usually via a "request for quote to one"– more on this further below). The SI quoting obligation is removed when the trade is executed on the venue, as venue obligations supersedes the SI. This needs to be reviewed and scenario-tested.

How to publish SI trades with SI flags:

- This is new. A pre-trade quote identifier will need to straight-through process (STP) to a post-trade flag. This is fine if you have an electronic trading system or an order management system (OMS)/execution management system (EMS) with FIX protocol.[58] However, it will be very challenging for local brokers who are used to voice trading and do not have systems that can handle SI trades that carry post-trade SI flags that MiFID II requires. A system

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56. The systematic internaliser regime imposes pre- and post-trade transparency requirements for OTC quotes and transactions on investment firms which, on an organised, frequent, systematic, and substantial basis, deal on their own account by executing client orders outside of regulated market, Multilateral Trading Facility, or Organised Trading Facility without operating a multilateral system.

57. Approved publication arrangements (APAs) are entities authorised under the provisions established in MIFID II to provide the service of publishing trade reports on behalf of investment firms.

58. A Financial Information eXchange (FIX) protocol is an electronic communications protocol that facilitates international real-time exchange of information related to securities transactions and markets.

needs to be created to attach flags to the trade reports. Testing of this process is then required.

Final note: Some firms have not yet decided whether they will or will not be an SI. It would be useful to road-test (while not live) the SI regime fully and test the STP of the SI process, including legal entity identifiers (LEIs), IT systems (will they be ready in time?) and APAs. Not to mention the take-up of firm quotes, are clients actually trading as a direct result of SI quotes? By testing the full end- to-end SI process, firms will have the data to make a more informed decision as to whether or not they should become an SI, come September 2018.

"Safety net" for large or illiquid trades

Many say that market structure is all about providing "tools in the toolbox" for buy-side and sell-side traders to execute in a more streamlined and efficient manner. MiFID II/R is speeding up the progress of automation in fixed income markets. Come 3 January 2018, it also increases the likelihood of major growth in platform execution on MTFs and the new category of OTFs for liquid bonds. However, based on the discussions in ICMA's MiFID II Working Group, there is concern regarding trading workflow and market structure when it comes to large or illiquid trades in light of the new MiFID II/R rules.

The anxiety surrounding the new MiFID II/R-based trading workflow refers to buy sides not wanting the impact of information leakage that is caused by putting a large or illiquid trade (ie an order or trade in securities considered to be illiquid) out to multiple counterparties. If this information is prematurely released, the market can trade (or re-price) against the counterparties involved. An example is a large block trade in a jurisdiction with a very short timeframe for post-trade deferral. This causes market impact for the buy side and does not give the sell side enough time to trade out of its positions. The counterparties involved will prefer to trade report in a jurisdiction that protects them from the negative effects of premature trade reporting exposure.

In the MiFID II Working Group, several participants have mentioned that what is needed is the use of an existing "safety-net" that allows for large or illiquid trades to be negotiated off-venue and executed on-venue (this is through the existing "Request for Quote to One" or "RFQ to 1" protocol). The possible addition to this existing RFQ to 1 protocol is a trade flag for buy-side best execution purposes to demonstrate that this order/trade did not go out to multiple counterparties for price formation, in order to protect the trade performance.

Other benefits to this "off-venue/on-venue" trade protocol, apart from reduction in market impact for large or illiquid trades, are: (i) confidence in trade reporting accuracy, as the platform reports; (ii) the agreed quote is captured electronically, instead of on the phone; and (iii) straight-through processing migrates voice trading to electronic and creates an audit trail.

However, it is important to stress that this will use the existing RFQ to 1 protocol, with the possible addition of a flag for best execution purposes. Since this protocol only applies to large or illiquid trades, platforms that execute using this protocol must have the necessary waivers for large or illiquid trades. Everyone agrees that the platforms will have to benefit from a jurisdiction that has a four-week supplementary deferral regime in place.

ICMA is currently hosting discussions with market structure providers and the bond trading community to further develop and define this protocol in order to provide market participants with a "safety-net" for large or illiquid trades, come January 2018.

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