

MiFID II Costs & Charges: fixed income market-making
An ICMA briefing note
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Overview

MiFID II introduces an obligation for investment firms to provide clients with detailed ex ante and ex post information related to the costs and associated charges of providing investment services, including the execution of client orders. It would also seem that this is intended to apply to situations where investment firms are providing client execution as principal risk-takers (market-makers), which is characteristic of bond and repo markets. In these instances, where any costs and charges are implicitly embedded in the dealer's price, this is likely to be extremely challenging, particularly from an ex ante perspective. Nonetheless, investment firms will need to decide how best to comply with the requirement, while clients and regulators will need to appreciate the particular challenges with extrapolating 'embedded costs' from a market-maker's price.

Note that ICMA is not providing any legal advice in this commentary, nor suggesting how firms comply with the requirements. This document is only intended to make member firms aware of the new obligations with respect to costs and charges disclosure with respect to fixed income market-making (for bonds and repos).

Background

Article 24 of [MiFID II](#) requires MiFID firms to provide information on all related costs and associated charges with respect to the provision of MiFID services. The regulation states:

Appropriate information shall be provided in good time to clients or potential clients with regard to the investment firm and its services, the financial instruments and proposed investment strategies, execution venues and all costs and related charges.

Furthermore:

[T]he information on all costs and associated charges must include information relating to both investment and ancillary services, including the cost of advice, where relevant, the cost of the financial instrument recommended or marketed to the client and how the client may pay for it, also encompassing any third-party payments.

Also:

The information about all costs and charges, including costs and charges in connection with the investment service and the financial instrument, which are not caused by the occurrence of underlying market risk, shall be aggregated to allow the client to understand the overall cost as well as the cumulative effect on return of the investment, and where the client so requests, an itemised breakdown shall be provided. Where applicable, such information shall be provided to the client on a regular basis, at least annually, during the life of the investment.

During the legislative implementation of the Level 1 requirements it was clear early on from ESMA's [Technical Advice to the Commission](#) that the obligation to provide clients with ex ante and ex post

information on costs and charges are intended to apply to transactions in MiFID instruments where the MiFID firm acts as principal, and where any costs or charges (in the form of mark-ups or mark-downs) are 'embedded' in the price.

Annex 2.14.1 of the Technical Advice outlines the information that should be disclosed:

Cost items to be disclosed		Examples:
All costs related to transactions initiated in the course of the provision of an investment service	All costs and charges that are related to transactions performed by the investment firm or other parties.	Broker commissions, entry- and exit charges paid to the fund manager, platform fees, mark ups (embedded in the transaction price) , stamp duty, transactions tax and foreign exchange costs.

This advice was followed by the European Commission in its Level 2 [Delegated Regulation](#) which provides further details.

Recital (74) provides for the possibility of a limited application with respect to the level of detail of the disclosure for professional clients:

*In order to ensure that all categories of clients benefit from such increased transparency on costs and charges, investment firms should be allowed, in certain situations, when providing investment services to professional clients or eligible counterparties, **to agree with these clients to limit the detailed requirements set out in this Regulation.** This however should never lead to disapplying the obligations imposed on investment firms pursuant to Article 24(4) of Directive 2014/65/EU. In this respect, investment firms should inform professional clients about all costs and charges as set out in this Regulation, when the services of investment advice or portfolio management are provided or when, irrespective of the investment service provided, the financial instruments concerned embed a derivative.*

Recital (79) reaffirms the principle of disclosing imbedded costs in dealer prices:

The costs and charges disclosure is underpinned by the principle that every difference between the price of a position for the firm and the respective price for the client should be disclosed, including mark-ups and mark-downs.

Article 59 outlines the reporting obligations in respect of executing orders other than for portfolio management:

1. Investment firms having carried out an order on behalf of a client, other than for portfolio management, shall, in respect of that order:

(a) promptly provide the client, in a durable medium, with the essential information concerning the execution of that order;

(b) send a notice to the client in a durable medium confirming execution of the order as soon as possible and no later than the first business day following execution or, where the confirmation is

received by the investment firm from a third party, no later than the first business day following receipt of the confirmation from the third party.

4. The notice referred to in point (b) of paragraph 1 shall include such of the following information as is applicable and, where relevant, in accordance with the regulatory technical standards on reporting obligations adopted in accordance with Article 26 of Regulation (EU) No 600/2014:

(m) a total sum of the commissions and expenses charged and, where the client so requests, an itemised breakdown including, where relevant, **the amount of any mark-up or mark-down imposed where the transaction was executed by an investment firm when dealing on own account**, and the investment firm owes a duty of best execution to the client;

Applying this to market-making

ESMA does not provide a specific methodology for either ex ante or ex post disclosure of costs and charges, and is not expected to. It is therefore very much down to the individual investment firm to determine how best to comply with the obligations. Where firms are acting on an agent or riskless matched-principal basis, this is relatively straightforward. However, this creates particular challenges where a firm is acting as a market-maker or liquidity provider, by which they are providing a price and taking risk, and where any costs and charges are likely to be implicit in the price, rather than explicitly added-on.

Deconstructing embedded costs

Deconstructing the effective mark-up or mark-down in a price is challenging, and is also likely to vary on a transaction by transaction basis, although it would seem that the regulation expects firms at least to attempt provide an estimate. This could entail estimating the value of the various elements that (implicitly) form a bid-ask spread, which could include: cost of capital, expected return on capital, the volatility of the instrument, financing costs, hedging costs, estimated liquidity of the instrument, as well as idiosyncratic elements such as the trader's market view or risk appetite.¹ In the case of repo this can become even more complicated and variable, given that the capital and liquidity impacts of the trade are also counterparty specific.

Of course, this is near impossible to do with any degree of precision, particularly from an ex ante perspective. It also overlooks the fact that, in reality, dealers do not provide bid-ask spreads; rather they provide a bid or an offer in response to a client's intention to sell or buy securities.

No agreed or standardized methodology for disclosing embedded costs

There are likely to be as many approaches to disclosing embedded costs and charges as there are firms, and each will need to work with their compliance teams and, potentially, with their regulators, to establish a methodology that is both practical from a disclosure perspective, and justifiable with respect to the principles outlined in the regulation.

Possible methodologies could include referencing the price being given to the client to a fair-value estimate of the security, which in turn could be based on a screen price or 'last trade', or potentially

¹ These elements will very much depend on the product, trading scenario, and firm-specific factors

another benchmark. However, this needs to be viewed in context of the unreliability of screen quotes for certain fixed income markets, or the fact that quotes can be for specific sizes that may be larger or smaller than the size the dealer is pricing. In the case of repo quotes this becomes even more complicated since screen quotes are also likely to be for centrally cleared repos, which have very different capital and balance sheet management implications to non-cleared repos.

Other approaches could potentially involve attempting to isolate the various components that are implicitly embedded in a market-maker's price (as discussed), and assigning an average cost based on historical trade analysis. This could then be disclosed to clients based, say, on an asset class or sub-asset class basis.

However, it is important to stress that there is no standardized or recommended approach to disclosing costs and charges embedded in market-makers' cash bond or repo prices, and it would seem that this is very much something that firms will need to establish for themselves based on their individual business models, while keeping in mind the principles outlined in the regulation.

The provision for "Limited Application"

The regulation does provide that where firms are providing investment services to professional clients and eligible counterparties, they are able to agree a limited application of the detailed disclosure requirements. However, this would require investment firms to agree reduced disclosures with professional and eligible clients.

This option is not available where the relevant financial instruments embed a derivative or, specifically for professional clients, the service being provided is investment advice or portfolio management.

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