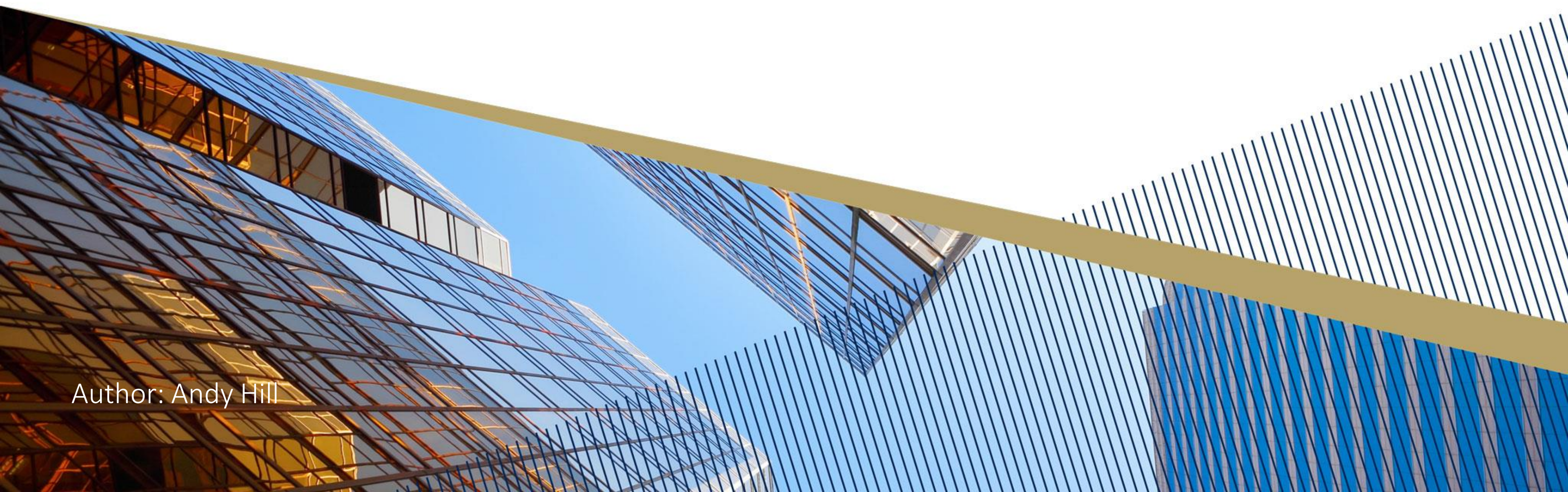
MiFID II/R
Systematic Internalisers for bond markets

Updated November 2016



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What is a systematic internaliser?

- MiFID I (2007) introduced the systematic internaliser (SI) regime for equity markets, where an SI for a particular instrument is ‘an investment firm which, on an organised, frequent and systematic basis, deals on own account by executing client orders outside a regulated market or an MTF’.

- Following implementation of MiFID I, a smaller number of firms became SIs than expected: the qualitative nature of the criteria that defined an SI made the assessment highly subjective, and many firms concluded that that they did not meet the criteria.

- MiFID II/R extends the SI regime to a broader range of financial instruments, including bonds.

- It applies to an investment firm which, on an organised, **frequent and systematic**, <u>and</u> **substantial** basis, deals on its own account by executing client orders outside a RM, MTF, or OTF.

- MiFID II/R further sets out quantitative thresholds for ‘frequent and systematic’ and ‘substantial’.

Trading thresholds for SIs: (i) frequent and systematic

- The frequent and systematic basis will be measured by the number of OTC trades in the financial instrument carried out by the investment firm executing client orders on its own account.

- For liquid bonds, this is where the number of trades during the last six months is equal to or larger than 2.5% of the total number of transactions in the relevant financial instruments in the EU executed on any venue or OTC during the same period. At a minimum, the firm shall deal on its own account in the instrument once a week.

- For illiquid bonds, this is where the firm has dealt on its own account OTC in the financial instrument on average once a week during the last six months.

Trading thresholds for SIs: (ii) substantial

- The substantial basis will be measured either by the size of the firm's OTC trading on own account in relation to the total trading of the firm in a specific instrument, or by the size of the firm's OTC trading on own account compared with the total trading in the EU in a specific financial instrument.
- The firm internalises on a substantial basis if the size of OTC trading on own account during the last six months is equal to or larger than:
  - 25% of the total nominal amount traded in that financial instrument executed by the investment firm on its own account or on behalf of clients, and carried out on any trading venue or OTC; or
  - 1% of the total nominal amount traded in that financial instrument executed in the EU and carried out on any EU trading venue or OTC.

Thresholds for bonds

Frequent and systematic basis threshold (liquid instruments)	Number of transactions executed by IF on own account OTC / Number of transactions in same financial instrument in the EU	2.5% And at least once a week
Frequent and systematic basis threshold (illiquid instruments)	Minimum trading frequency	At least once a week
Substantial basis threshold Criteria 1	Size of OTC trading by IF in a financial instrument on own account / Total volume in the same instrument executed by the IF	25%
Substantial basis threshold Criteria 2	Size of OTC trading by IF in a financial instrument on own account / Total volume in the same instrument in the EU	1%

Assessments for SIs

- The investment firm shall assess whether it meets both the ‘frequent and systematic’ and ‘substantial’ criteria on a quarterly basis, based on data from the last six months. These assessments shall be performed on the 15th calendar day of February, May, August, and November.
- Where an investment firm qualifies as an SI for a particular bond, it will become an SI for all other bonds of the same class[1] and issuer group.[2]
- MiFID II/R allows firms to choose to opt-in to be a systematic internaliser for a financial instrument, even where it does not meet all or any of the quantitative criteria, provided it complies with the requirements for SIs.

[1] sovereign; other public; convertible; covered; corporate
[2] defined as the same financial group of the issuer, including parent undertakings and subsidiary undertakings

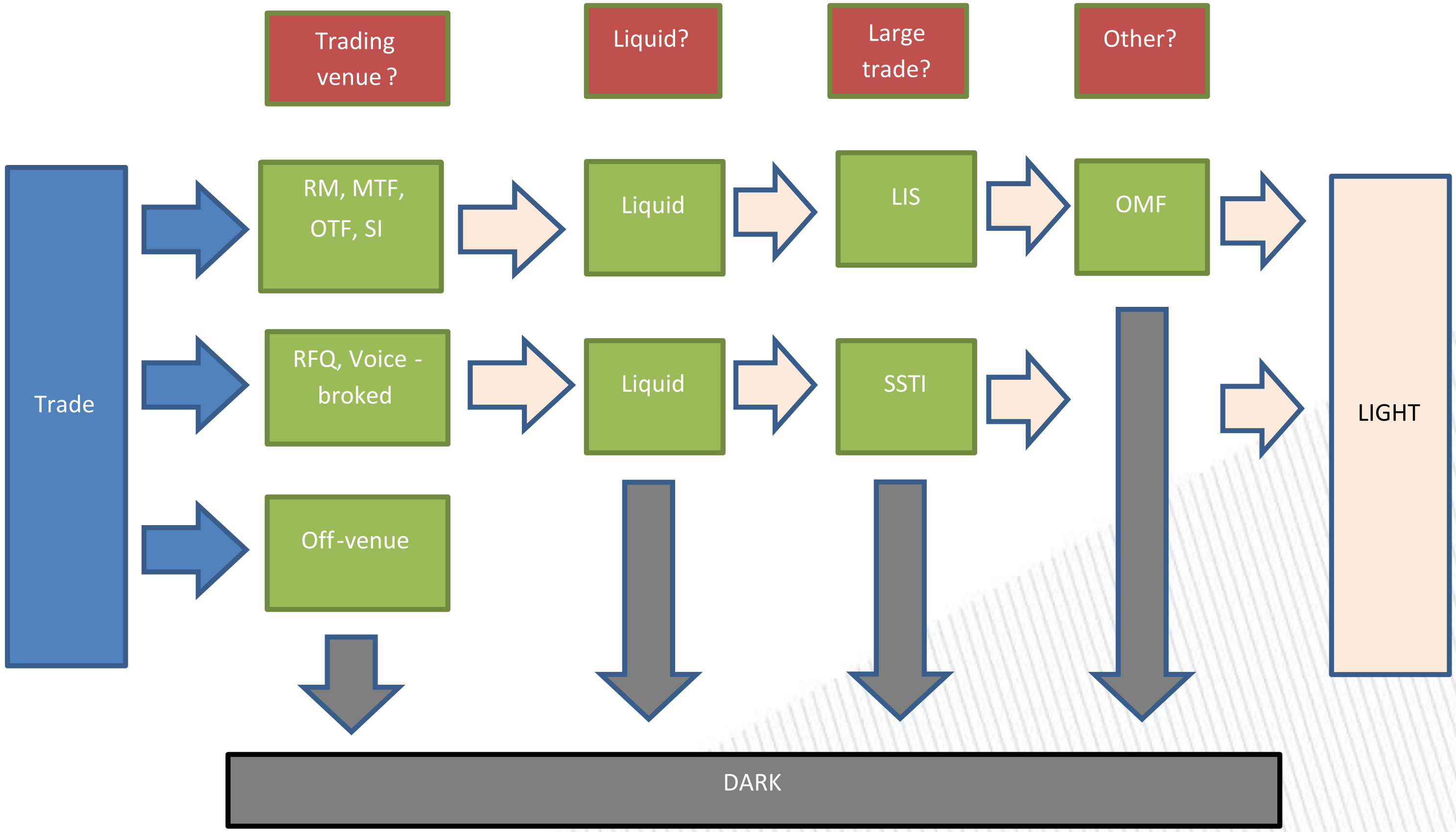
Reporting obligations for SIs

- The main purpose of the systematic internaliser regime is to ensure that the internalisation of order flow by investment firms does not undermine the efficiency of price formation on RMs, MTFs, and OTFs. Effectively, SIs are subject to the same pre-trade transparency requirements (including the same conditions for waivers).
- SIs are also subject to the same post-trade transparency requirements and waivers as RMs, MTFs, OTFs, and other investment firms.
- In the case of liquid bonds, SIs must make public firm quotes to all their clients when (a) they are requested for a quote by a client, or (b) they agree to provide a quote.
- However, SIs are able to 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 (e.g. a policy of 'one transaction per quote'). SIs are further able to update their quotes at any time, and can withdraw quotes under exceptional market conditions which would be contrary to prudent risk management.

Reporting obligations for SIs continued

- SIs can make their quotes public through arrangements with a trading venue or an Approved Publication Arrangement (APA), or through proprietary arrangements (i.e. on their own website).
- When using a trading venue or APA, the firm's identity will also be made available.
- Where an SI is using more than one arrangement the publication of quotes must occur simultaneously.
- The SI must also make available on its website homepage which publication arrangements it has in place and where its quotes can be accessed.
- In an OTC transaction involving an SI (including where the SI is the buyer), the SI is responsible for post-trade reporting. To ensure that the transaction is only reported once, the SI should inform the other party that they are reporting on their behalf.

Pre-trade transparency



SI regime timeline

- January 3 2018: MiFID II/R transparency regime is due to come into force. Investment firms can opt-in to the SI regime from this date.
- August 1 2018: ESMA will have published 6 months of data (from January 3 to June 30) to support firms' SI assessments.
- September 1 2018: Investment firms must have concluded their first assessment and, if necessary, begin complying with the SI regime and related reporting obligations.

Regulatory references

MiFIR	(EU) No 600/2014	May 15 2014
Delegated Regulation on organisational requirements and operating conditions for investment firms		April 25 2016
Delegated Regulation on definitions, transparency, portfolio compression and supervisory measures on product intervention and positions		May 18 2016
Delegated Regulation on regulatory technical standards on transparency requirements for trading venues and investment firms in respect of bonds, structured finance products, emission allowances and derivatives		July 14 2016
ESMA Questions and Answers on MiFID II and MiFIR transparency topics		November 4 2016

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