MiFID II/R implementation in secondary markets

Introduction

On the whole, MiFID II (the Directive) concerns the framework of trading venues and structure in which instruments are traded. Each EU member jurisdiction can adapt the Directive depending on the structure of the market in the EU Member State in question, when it transposes MiFID II (the Directive) into its national law. MiFIR (the Regulation), on the other hand, concentrates on regulating trading venues and structuring their operations. MiFIR is an EU Regulation, which applies directly – and compliance is mandatory – in all EU Member States. MiFID II covers "who" the different market structures are and "what" they trade, while MiFIR covers "how" they trade.

Regarding trading, the most important obligations are MiFIR's pre- and post-trade transparency regulations and best execution obligations.

Transparency

ICMA fully supports the principle of greater pre- and post-trade price transparency in Europe's fixed income markets, which can help to facilitate price discovery, and so greater market efficiency and liquidity. However, ICMA also recognizes that such transparency can create risks for both liquidity providers and liquidity takers, particularly with respect to less liquid securities or larger than standard-sized transactions. In order to have a well-functioning EU bond market, transparency calibrations and participant obligations need to be appropriately tuned, with liquidity and size of trade logically influencing the level of information published.

MiFID II/R liquidity assessments are dependent on three characteristics: (i) whether the bond is liquid or not (ie whether there is continuous buying and selling interest); (ii) whether there is no undue risk to liquidity providers (below size specific to the instrument (SSTI); and lastly (iii) whether the trade is large in scale (LIS) versus a normal market size trade and could potentially damage the transacting parties.

The liquidity assessments will impact whether there is transparency or not under MiFID II/R. If it is proved that the liquidity profile for a bond or a trade will impact the market negatively, then waivers or deferrals will be put in place and transparency obligations will be delayed or prevented altogether. If there is not a negative impact on liquidity in the market, then transparency obligations will go forward.

Key objectives of bond transparency obligations under MiFID II are to:

- move bond trading practices (currently over the counter (OTC) onto trading venues, such as Organised Trading Facilities (OTFs), Multilateral Trading Facilities (MTFs) and Systematic Internalisers (SIs);
- create a price discovery mechanism in bond markets, by expanding pre- and post-trade transparency requirements to fixed income instruments; and
- increase available reference data for bonds (so that market participants are informed as to the true level of potential transactions).

Pre-trade transparency obligations

- Requirements apply to Regulated Markets (RMs), MTFs, OTFs and SIs.
- Operators must make publicly available, on a continuous basis during trading hours, actionable indications of interest (IOIs): ie current bid and offer prices, and depth of trading interest, including: request for quote (RFQ) systems and voice trading systems.
- Systematic Internalisers (SIs), where they make quotes public, will trade at quote with all clients of the SI, subject to commercial policy (eg transparency limits and size thresholds.)

Pre-trade transparency requirements can be waived for:

- financial instruments for which there is not a liquid market;

- orders that are large in scale (LIS) compared to normal market size;
- orders on RFQ or voice trading systems that are equal to or larger than the relevant size specific to the instrument (SSTI).

Post-trade transparency obligations

- Requirements apply to RMs, MTFs, OTFs, and investment firms trading OTC.
- Investment firms trading outside a trading venue and market operators and investment firms operating a trading venue must make publicly available trade details, including price and quantity.
- Post-trade information must be available as close to real time as possible (15 minutes from execution, up until January 2020, and within 5 minutes thereafter).
- There are no permanent waivers for post-trade reporting, but reporting can be deferred for up to 48 hours in the case where:
  - the transaction is in a security for which there is not a liquid market; or
  - the size of the transaction is equal to or exceeds the relevant large in scale size (LIS).
- National competent authorities can decide that reporting can be further deferred (including aggregation and omission of size), for an extended deferral period of up to four weeks, usually referred to as a "Supplementary Deferral Regime".

Who reports post-trade, publicly, when?

- If executing on a venue – Venue reports (ie the relevant trading platform).
- If executing with an SI – SI reports (eg the market maker).
- If executing via OTC – the selling counterparty reports (whether sell-side or buy-side).

Note: If executing with a non-EU entity, the transaction is considered to be an OTC transaction – the EU entity reports, regardless of whether they are a seller or a buyer.

Best execution

MiFID II/R's best execution requirements (extended from MiFID) are playing a significant role in MiFID II/R. Through MiFID II/R's best execution policy, firms are required to "evidence" best execution and to provide the "best possible result for the client".

Best execution (RTS 27) – reporting criteria for execution venues:

- There is a requirement to provide the public with relevant data on execution quality to help them determine the best way to execute client orders.
- Execution venues including Regulated Markets, MTFs, SIs, OTFs, market makers or other liquidity providers must publish required data in a machine-readable electronic format, quarterly.
- The data should be segregated according to trading systems, trading modes and trading platforms.

Best execution (RTS 28) – quality of execution and top five venues for the buy-side:

- Investment firms (including buy-side firms) should evaluate the quality of their execution practices by identifying and publishing the top five execution venues, in terms of trading volumes where those firms executed client orders in the preceding year.
- Information published should be split between retail client flow and professional client flow.
- In a separate report, investment firms should summarise and make public the top five execution venues where they executed securities financing transactions (including repos).
- Investment firms must publish, for each class of financial instruments, a summary of the analysis and conclusions based on the quality of execution on the execution venues.

New bond market structure emerging from MiFID II

The new trading landscape extends many of the obligations relating to equities under MiFID into fixed income (eg MTFs and SIs). However, the OTF trading venue is new to all asset classes. MiFID II/R has now created a much more prescriptive rules-based market structure in which to trade.

In the new market structure, it is important to distinguish between MTFs, OTFs and SIs:

- *Multilateral Trading Facility (MTF):* A multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments.
- *Organized Trading Facility (OTF):* A multilateral system which is not an RM or an MTF and which brings together multiple third-party buying and selling interests in bonds (also including: structured finance products, and derivatives). Unlike RMs and MTFs, operators of OTFs will have *discretion* as to how to execute orders, subject to pre-trade transparency and best execution obligations.
- *Systematic Internaliser (SI) regime:* An investment firm that deals on its own account by executing client orders outside a trading venue. Its purpose 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 (in short, SIs extend transparency obligations into the OTC space).

There are several points to note about the new market structure:

- RMs and MTFs are not allowed to execute client orders against proprietary capital, or to engage in matched principal trading.
- OTFs may deal on own account, other than matched

principal trading, only with regard to illiquid sovereign debt instruments

- OTFs and SIs cannot exist within the same legal entity, nor connect to enable orders or quotes to interact.

Implementation planning

The January 2018 MiFID II/R implementation date is approaching and market participants are immersed in preparations for MiFID II/R. With this in mind, ICMA will be holding MiFID II/R implementation workshops across Europe. These workshops will assist buy-side and sell-side bond traders in assessing whether they are on the same track as their counterparts in other regions. The workshops will also facilitate discussions on local implementation challenges and interpretations as well as the sharing of information. These workshops are for bond trading participants who are heavily focused on transparency, best execution and the research obligations of MiFID II/R, as well as the newly emerging market structure trends, such as innovative protocols and platforms. Panels will feature international and local experts from the buy side and sell side.

ICMA's MiFID II/R Workshops will be interactive as they will assume an audience with a working knowledge of cash bond trading and MiFID II/R related obligations. Registration for these events can be found on ICMA's event page: https://www.icmagroup.org/events/ . The MiFID II/R Implementation Workshop schedule began in London on 4 July and it is planned to continue in the autumn in Stockholm, Brussels, Frankfurt, Milan, Madrid and Paris.

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Practical challenges of implementing MiFID II/R in secondary markets

Trading workflow and regional interpretations

It is becoming increasingly evident, and not without some concern, that MiFID II/R is likely to have a dramatic impact on the way trading is currently conducted in the European fixed income markets, influencing not only the way in which firms work their orders and execute their trades, but also where they will choose to trade and with whom. This becomes even more complex given the scope within MiFID II/R for the various jurisdictions to use their individual discretion in how they interpret and apply the rules. Two examples of potential challenges are provided below.

Differing post-trade deferral regimes across regulatory judications in the EU: Under MiFID II/R transparency rules, EU Member States have discretion with respect to the application of the post-trade deferral regime. With respect to large trades, or those in non-liquid securities, each jurisdiction can decide what trade information should be made public, and when, ranging from two days to four weeks after the trade. This creates a potential problem, since both liquidity providers and liquidity takers have a natural incentive to avoid information leakage following large trades, particularly in illiquid bonds, in order to protect themselves or each other from the risks of subsequent adverse market moves. Accordingly, this is likely to drive activity in these trades to jurisdictions with the least conservative deferral regimes. Not only will this fragment bond market liquidity across the EU, it will also create an uneven playing field, disadvantaging investors, liquidity providers and trading venues operating in more conservative jurisdictions.

Breaking the hybrid model of trading: Pricing and liquidity in bond markets are generally provided by market makers, particularly for large trades or less liquid bonds, and, in most cases, buy-side firms will put their orders to a market maker: calling their dealer-banks directly, communicating via electronic messaging, or sending a request-for-quote (RFQ) through a trading platform. Traditionally these firms would provide a price for the client's full order, and, assuming the client is happy with the price, they take the trade onto their books (either going long or short). They will then look to trade out of these positions over the following days

or weeks. However, as dealer balance sheets become more constrained, it is now becoming quite common for dealers to offer to work client orders instead; effectively acting as a principal broker. They will look for an offsetting client interest, and then match the client interests, standing as principal intermediary between the two clients. In fact, it is not unusual for market makers to apply a hybrid model of both risk and riskless-principal, taking part of the client order onto their balance sheet, and working the remainder on a riskless-principal basis. This allows clients to keep their entire order with one dealer, so minimising information leakage.

However, MiFID II/R looks set to break this hybrid liquidity model. MiFID II/R makes a clear distinction between risk-principal trading (true market making), which can be carried out by investment firms (most likely to be categorised as Systematic Internalisers), and riskless-principal trading (or "matched principal" trading), which should be carried out by Organised Trading Facilities (OTFs). Importantly, Systematic Internalisers and OTFs cannot operate within the same legal entity, nor interact within the same group. In other words, buy-side firms will be able to get a firm market quote from market makers, but will need to work orders through OTFs. This is likely to create additional challenges for buy-side firms in terms of deciding how best to work their orders, and with whom, not least since they are unlikely to want to split these across multiple counterparties given the risk of information leakage.

ICMA is facilitating ongoing discussions between its active sell-side and buy-side members, interdealer brokers, as well as the regulatory community, in order to highlight and address these potential challenges to bond market functioning.

Governance and compliance

MiFID host governance over third country branches: Where a "host" MiFID firm is located within the EU, but has branches outside of the EU (such as a Singapore branch of a French bank), the branches are required to comply with MiFID II/R. Implementation is likely to be extremely challenging for non-EU branches, particularly with respect to the application of the transparency rules with its various security and instrument level liquidity thresholds and waiver calculations.

Information: In order to comply with MiFID II/R, MiFID firms will require a substantial amount of pre-trade information before they can enter into a transaction. This includes data such as the Legal Entity Identifier of their counterparty, a list of authorized Systematic Internalisers for any instrument they are looking to trade, the relevant transparency deferral regime of their counterparty, whom is responsible for transaction reporting, and whether or not their counterparty is a MiFID firm. This is likely to result in firms having to construct complex information matrices for their potential counterparties in order to inform their trading decisions.

Data

An SI database: It will be important for buy-side firms to know which firms are authorised Systematic Internalisers (SIs) for any instrument they are looking to trade, not least since this will affect the reporting requirements (and who should report). However, ESMA will not support a centralised and up-to-date database of SIs (at the legal entity and ISIN level), which would seem to be the obvious solution. It is expected that the Approved Publication Arrangements (APAs) will collate and maintain this information. However, it is unlikely to be either centralised or widely available.

FIRDS reference database matching for TOTV: MiFIR provides a number of provisions with respect to financial instruments that are determined to be "traded on a trading venue" (TOTV), including pre- and post-trade transparency requirements. For instruments classified as TOTV, which includes derivatives that reference TOTV instruments, trading venues (including SIs) are required to submit instrument reference data to ESMA's Financial Instruments Reference Data Systems (FIRDS). This will require the linking of data feeds between ESMA, the 28 NCAs, and around 300 separate trading venues across the EU. However, the success of the FIRDS infrastructure will rely on exact data matches between all the contributing constituents, raising concerns that many instruments may be forced to trade OTC.

LEIs for third country counterparties: To be able to transact under MiFID II/R, market participants are required to have a Legal Entity Identifier (LEI). This is likely to prove problematic for a number of non-EU counterparties, as well as issuers, who neither have LEIs nor are likely to prioritise attaining them.

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ESMA guidance on implementing MiFID II/R in secondary markets

As the deadline for the implementation of MiFID II and MiFIR on 3 January 2018 is fast approaching, the European Securities and Markets Authority (ESMA) has provided further clarifications during the second quarter of 2017.

The following briefing is designed to provide a non-exhaustive summary of key issues impacting market structure and fixed income trading, notably:

- market structure, the distinction between the newly created category of Organised Trading Facilities (OTFs) and Systematic Internalisers (SIs);
- best execution requirements;
- pre- and post-trade reporting requirements;
- reporting obligations for trades executed outside the EU; and
- the concept of "Traded on a Trading Venue" (TOTV).

MiFID II / MiFIR

Overview of selected ESMA guidance in Q2 2017:

31 May: Q&As on transparency topics

31 May: Opinion on determining third-country trading venues for the purpose of transparency

22 May: Opinion on OTC derivatives traded on a trading venue (TOTV)

5 April: Q&As on market structure topics

5 April: Q&As on transparency topics

4 April: Q&As on investor protection topics

Market structure: riskless or matched principal trading and trading at risk

Organised Trading Facility (OTF)

To increase transparency of over-the-counter trading activity in fixed income, MiFID II introduced the concept of Organised Trading Facility (OTF)[48], a new category of multilateral trading venues.

ESMA further specified the characteristics of OTFs, which consist in the following:

- First, "trading is conducted on a *multilateral* basis". This includes, for instance, "matched-principal trading" (where both sides are executed simultaneously and the facilitator makes no profit or loss other than a previously disclosed fee); *or* riskless principal trading (involving two orders, with the execution of one of these orders dependent upon the receipt or execution of the other); *or* "market-making" provided the investment firm acting as market-maker on the OTF operates on an "independent basis".[49]
- Second, "the trading arrangements in place have the characteristics of a *system*", for instance, "automated crossing of client trading interests" or arrangements used repeatedly.
- Third, "the execution of the orders takes place on a *discretionary* basis".

These provisions apply equally to electronic and voice trading. Importantly, investment firms operating an OTF are required to seek authorisation from their national regulator.

48. MiFID II, Article 4 (1) (23) defines an OTF as "a multilateral system which is not a regulated market or an MTF and in which multiple third-party buying and selling interests in bonds [...] are able to interact in the system in a way that results in a contract [...]".

49. See MiFID II, Article 20 (2) and (5).

Systematic Internaliser (SI)

ESMA furthermore delineated OTFs from the concept of "Systematic Internaliser"[50], a term introduced by MiFID I (2007) and extended to the fixed income space under MiFID II. It is highlighted that a "key characteristic" of an SI is to provide "liquidity *bilaterally* to clients by *trading at risk*".

However, SIs "operating functionally similar to a trading venue" would be classified as such (ie either as MTF or OTF) and should request authorisation if the following criteria are met:

- the SI does not *de facto* undertake risk facing activity, and interaction with clients is not only bilateral;
- transactions are *not ad hoc*, but arrangements are used on a *regular* basis and can be considered "a system or facility"; and
- transactions that result from "bringing together multiple third party buying and selling interests and are executed OTC, outside the rules of a trading venue".

Note: These criteria are not meant to prevent SIs from undertaking hedging activities provided the whole transaction does not result in riskless transactions between third-party buying and selling interests. Hedging on a trading venue is permissible.

An exception consists in the possibility for an SI to undertake matched-principal trading on an "occasional basis" only as opposed to a "regular basis", further to Recital (19) of the Commission Delegated Regulation (EU) 2017/565. The key questions to assess such a scenario are as follows:

- Are systems or arrangements in place designed to match opposite client orders?
- Do non-risk facing activities account for a *recurrent* or *significant* source of revenue for the investment firm's trading activity?
- Does the investment firm *market*, or otherwise *promote*, its matched-principal trading activities?

If the answer to *any* of these questions is "yes", the trading activity is not considered "occasional" and falls under the OTF category.

ESMA stressed that OTF and SI activities must not be undertaken by the same legal entity across asset classes and instruments since MiFID II sets out "a blanket prohibition". In practice, this entails that OTFs and SIs have to be operated as separate legal entities. These may, for instance, operate separately under the umbrella of a group of legal entities. However, even if an OTF and an SI are separate legal entities, they are not permitted to interact.

It is worth noting that the European Commission proposed on 20 June 2017 a MiFIR Level 2 amendment on Systematic Internalisers and riskless principal trading[51], which would apply across all asset classes: "An investment firm shall not be considered to be dealing on own account for the purposes of Article 4 (1) (20) of MiFID II where that investment firm participates in matching arrangements with the objective or consequence of carrying out de facto riskless back-to-back transactions in a financial instrument outside a trading venue". The Commission has requested feedback from industry market participants.

Best execution

MiFID II introduces more stringent requirements in terms of best execution, which are specified in RTS 27 for execution venues and RTS 28 for investment firms.

Best ex publication timelines:

RTS 27: First quarterly report to be released by 30 June 2018.

RTS 28: First annual report to be published by the end of April 2018.

ESMA stated that investment firms may not be able to provide certain data that are unavailable for the first report covering a full calendar year under RTS 28. Firms that are part of a legal or corporate group are required to provide data on their top five trading venues by individual firm rather than combined on a group level.

Regarding Organised Trading Facilities (OTFs), ESMA stressed that a firm's best execution policy should take into account, and also distinguish, orders executed at OTF level and at the investment firm level. In particular, the choice of the execution venue (including on its own OTF), the use of an appropriate protocol (eg voice, RFQ, or order book), and the application of discretion should be addressed.

Pre- and post-trade reporting requirements

Under MiFIR[52], market participants are required to publish information on executed trades via an Approved Publication

50. MiFID II, Article 4 (1) (20) defines a systematic internaliser as "an investment firm which, on an organised, frequent systematic and substantial basis, deals on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system".

51. Amending Delegated Regulation (EU) 2017/565

52. MiFIR, Article 21.

Arrangement (APA), which is essentially a provider of reporting solutions authorised by a competent authority. Trades executed on a multilateral trading platform – ie a regulated market such as a stock exchange, an MTF such as a specialist bond trading platform, or OTFs such as an interdealer broker – are made public by the respective platform operator.

However, further guidance has been provided on bilateral, OTC transactions. Where an investment firm executes a trade with a client, the reporting obligation lies with the investment firm regardless of whether securities were purchased or sold. However, where a transaction is executed between two investment firms, *only the seller* of the financial instrument is mandated to publish the transaction.

An exception applies to Systematic Internalisers. If an SI acts as the buyer of a financial instrument from an investment firm that is not an SI, the reporting obligation shifts to the SI who has to trade report via an APA. A transaction concluded between two SIs, however, is made public only by the SI acting as a seller according to the established reporting hierarchy.

With respect to "back-to-back" trades, for instance, where one investment firm (A) sells 500k of a corporate bond at 101.20 to another investment firm (B), which the latter (B) then sells on to another counterparty (Z) at the same price, the trade would be considered a single transaction. The initial seller, investment firm (A), would be responsible for publishing the trade via an APA. However, should the price not be identical (eg in case investment firm (B) re-sells at 101.35), *each transaction would have to be reported separately by each respective seller.*

ESMA has further clarified that post-trade reporting of OTC transactions to an APA can be outsourced to a third party. However, full responsibility remains with the investment firm, which has to ensure that the third party informs the APA of applicable transparency requirements. In the same vein, the investment firm is responsible for informing the APA of any applicable post-trade deferrals. Notwithstanding any deferrals, trades should be reported to the APA as soon as technically possible.

Additionally, ESMA has elaborated on the reporting obligation of an SI quoting illiquid instruments as defined in MiFIR, Article 18 (2). Accordingly, an SI is not required to publish quotes or disclose them to other clients, provided a waiver is in place for trades in non-equity instruments which are "Large in scale" (LIS) or above the "Size specific to the instrument" (SSTI) thresholds.

Reporting obligations for trades executed on a third country trading venue

ESMA has clarified the reporting obligation for trades executed outside the EU both in a Q&A and in an Opinion. In brief, bilateral trades executed by EU investment firms on third country trading venues that would *not* be subject to a certain level of post-trade transparency should be made public in the EU through an APA. However, if similar transparency requirements apply, reporting via an EU APA is not required.

This would be the case where *all* of the following conditions are met:

- The third-country venue operates a multilateral system.
- It is subject to authorisation, supervision and enforcement in the third country by a competent authority.
- It is a full signatory to the IOSCO MMoU (multilateral memorandum of understanding).
- A post-trade regime is in place whereby transactions executed on the third-country trading venue are published as soon as possible after the transaction was executed or, in clearly defined situations, after a deferral period.

A list of third-country trading venues that are deemed to be subject to "similar" transparency requirements will be published by ESMA.

The concept of "traded on a trading venue" (TOTV)

The concept of TOTV was introduced in MiFIR, but not defined. MiFIR extends the scope of transparency[53] and transaction[54] reporting requirements to financial instruments that are not only traded on Regulated Markets, but also on MTFs or OTFs. TOTV establishes a set of characteristics based on "reference data" to determine whether a financial instrument is subject to reporting requirements.

The lack of clarity on TOTV has proved to be particularly challenging for OTC derivatives, and ESMA therefore has issued an Opinion to distinguish between OTC derivatives that are in scope and those that are not. Note: *It is clear, however, that for bonds, Legal Entity Identifiers (LEI) will be required to trade on-venue, regardless of the location of the counterparty.*

ESMA has stated that "only OTC derivatives *sharing the same reference data details* as the derivatives traded on a trading venue should be considered to be TOTV." The "same reference data details" in this context means "same values" as specified in the reporting templates in RTS 23 (Regulation (EU) 2017/585), including, for instance the ISIN, full name of

53. Ie quotes and executed trades to be made public, see MiFIR, Articles 3, 8, 10, 11, 18, and 21.

54. ie trades to be reported to a competent authority, see MiFIR Articles 26 and 27.

the financial instrument, and with respect to interest rate derivatives, the reference rate, and fixed or floating rates of each leg.

Note: The reference data, which will be submitted by trading venues to ESMA's FIRDS (Financial Instruments Reference Data Systems), will be subject to reporting and transparency obligations on-venue and will have to be an exact match in order to trade on-venue.

Further information on the implementation of MiFID II/R, including ICMA position papers, briefing notes and related resources, can be found on the ICMA website.

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