by Elizabeth Callaghan

# 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.

**Contacts: Elizabeth Brooks Callaghan and Andy Hill**
elizabeth.callaghan@icmagroup.org
andy.hill@icmagroup.org