MiFID II/R implementation workshops: key takeaways

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Throughout the autumn, ICMA carried out MiFID II/R implementation "in the weeds" workshops. These workshops targeted trading and research-related market participants from the buy side and sell side who have been immersed in preparations for MiFID II/R. The workshops were held in cities across Europe: London, Stockholm, Brussels, Luxembourg, Paris, Madrid, Frankfurt, Milan, Dublin, Lisbon and Zurich. They allowed bond trading and research participants to assess whether they were on the same track as their counterparts in other regions.

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The workshops facilitated excellent discussion regarding local implementation challenges and interpretations as well as the sharing of information. Panels featured international and local experts from the buy side and sell side covering: trading workflow, market structure and research distribution and consumption. The following are the key takeaways from the eleven workshops across Europe.

Trading workflow

We are currently experiencing an increase in electronic trading within bond trading workflow, largely driven by pre- and post-trade efficiencies, as well as the need to access alternative sources of market liquidity given the increasing capital constraints of traditional market makers. However, MiFID II/R is shifting gears and is significantly speeding up the evolution of electronification of fixed income trading.

MiFID II/R is changing trading models. Execution behaviour and language is due to change significantly as a result of MiFID II/R. Execution strategies will become much more complex. For instance, it will be more important to know which counterparties can or cannot assume trading risk.

The background to this is Article 4 of MiFID II which requires that Systematic Internalisers (SIs) should act in a risk-facing principal capacity for client orders, and should not be facilitating back-to-back trades between clients in a (riskless) "matched principal" capacity. The ability for SIs to operate a "hybrid" model of risk-facing and riskless trading will very much depend on the discretion of national regulators, and, in some situations, it may be that investment firms can either provide firm pricing or work an order, but not both.

In 2018, in the countries where the hybrid model is ending, many traders are considering not trading "orders". Buy sides may instead work on a relationship and indicative basis. Execution strategies may involve knowing which trader to "go to" for this style of trading. This and other factors will impact market makers' current mode of operation. Several in the MiFID II/R workshops commented: "market makers of today will not be the same market makers of tomorrow".

As MiFID II/R progresses through implementation, it is changing the aims of some of the definitions. SIs, originally thought to be about liquidity, are quickly becoming all about reporting capabilities. When executing with an SI, the SI has the responsibility to report in all circumstances. Execution with an SI does not guarantee best price, just the obligation for the SI to report.

Lastly, all workshop audiences and panels were asked what they thought would be the impact of MiFID II/R on liquidity. About 90% agreed that, in the beginning of MiFID II/R, there will be very low volumes, and there will also be disruption in the market. The volumes will then increase as time goes by. When things start to settle, and the data are being used (may be in two to three years), the view is that liquidity should increase due to better and more realistic pricing. Anonymous trading platforms will also become more effective, with the help of quality data to support more reliable price formation.

Market structure

Everyone in the MiFID II/R implementation workshops agreed that the greatest innovation and change will take place in bond trading market structure. Innovation is occurring in market structure today, but at the moment the focus is on compliance with MiFID II/R. Budgets are stifled for innovation, unless directly related to MiFID II/R implementation. True innovation will occur, but this is likely to be two to four years down the road. One of the key drivers for innovation will be the data that MiFID II/R will generate. The data will be used in the pre-trade and post-trade space, influencing the change of direction in trading workflow. It is believed that data and technology-led innovation will fall into four categories: new trading protocols; new routes to access liquidity; new market data products; and new trading patterns, which may emerge using Execution Management Systems (EMS) and FIX protocols.

Before data and technology-led innovation kicks in, MiFID II/R is expected to rule the direction of travel for the evolution of market structure. One of the areas of growth will be in MiFID II/R information. Knowing which investment firms can make firm prices (risk-facing) and which will only work orders (riskless principal) will only be one of many important considerations. Traders will need to know a matrix of pre-trade information in order to determine where and with whom to trade. For example, counterparties will need to know the post-trade reporting deferral regime of the counterparty they intend to trade with. The trader may also want to know whether or not the counterparty can accept "resting orders" (where the order is left and worked through the day). Finally, a counterparty will need to understand who has the reporting responsibilities. Whether a buy side is a MiFID II/R firm is also important as that could change the reporting obligations for counterparties involved.

The first evidence of MiFID II/R in 2018 is expected to be in platform trading. Platform trading is expected to increase exponentially due to the extensive reporting requirements and the nature of audit-driven regulation. The platforms or trading venues in 2018 will have an additional category: the Organised Trading Facility (OTF). There was much discussion in the MiFID II/R workshops about understanding the differences between MTFs, OTFs and agency brokers.

Regarding MTFs, all participants see the trades in a multilateral capacity: there is the ability to interact; there is no discretion; and there is a high level of technology involved. With both an MTF and an OTF, interests can be advertised on screen. However, an OTF has discretion and can choose a different counterparty to improve price, if required. By contrast, an agency broker interacts primarily on the phone or chat messaging and "finds the other side". The agency broker has similarities to bilateral trading. One panellist described an agency broker as "multi-bilateral". The key seems to be that an OTF has discretion with more sophisticated technology and operates more of a system (sometimes with streaming prices), while an agency broker is more voice-driven, but does also have discretion. A firm can operate an agency broker and an OTF. However, the firm must be able to evidence to its local regulator that the activities are separated. Any trading venue has the obligation to report its status to its regulator.

A significant change to the market structure landscape will be the increase in "move to venue" or "subject to venue" trading (sometimes called "processed" or "negotiated" trades). This allows for large or illiquid trades to be agreed (indicatively) bilaterally but executed and reported via a trading venue. Avoiding negative market impact is one of the key benefits. For example, a "subject to venue" trade allows for a bilateral discussion regarding a large trade, that would otherwise be market-moving if subject to on-venue pre-trade transparency, to be concluded on a venue for execution and reporting purposes. The benefits for the counterparties are two-fold, as the discussion is kept between two counterparties, avoiding negative information leakage, and the trade can also be transacted in a more favourable post-trade deferral regime. Other benefits of this "move to venue"/"subject to venue" (MTV/STV) trading is that it can assist private banks in keeping below SI thresholds, since on-venue trades do not contribute towards the SI threshold calculations. Lastly, for smaller firms it assists with overall "straight-through processing" (STP).

In a few panels there was robust discussion about third-country status and the conflict with privacy laws in some countries. Some market participants in third countries (ie non-EU countries) are unable or unwilling to provide the personal details required for transaction reporting by EU trading venues governed by MiFID II/R. As a result, trading venues (the operators of MiFID II/R MTFs and OTFs) have introduced innovative solutions which involve third-country firms transacting with EU counterparties on non-EU trading venues. The view is that this workflow may potentially solve this matter for third countries. However, there remains the personal data challenge (not wanting to release the privacy data) for third-country firms which transact with EU counterparties on EU trading venues. The full extent of extra-territoriality and personal data is, as yet, unknown and will be closely observed in the coming months.

Research consumption and distribution

As far as consumption is concerned, it appears that the best approach is a diversified approach that covers global, niche and local research. The challenge will be coverage for niche and local research. Many workshop participants commented on their concerns regarding reduced research teams. Many of the panellists believed small corporates may not be covered enough in the future, which is a potential issue for Capital Markets Union SME funding. However, some thought independent boutique investment firms may step in to cover small corporates as well as niche and local markets.

While independent boutique research firms may be able to step in and assist with niche, local and small corporate research, there remains a major concern in the market as to how small asset managers will be able to pay for research. The view from the panellists was that the lack of ability to pay for research could lead to an increase in consolidation in the market for small asset managers. This warrants further monitoring to see what transpires.

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Regarding research distribution, the overall model that seems to be emerging is one that bears a resemblance to "Cable TV". First, there is the free research (as a non-monetary benefit) that "Free TV" is being offered by some banks, all generic research/channels for free. Second, there is the annual or monthly fee for all research: one fee for all research, including specific analyst coverage. This is the same as one fee for all channels, including premium channels. Lastly, there is the "pay per view" model. Clients can access a portal and download research from various analysts and "pay as you view". This is the same as paying to view a specific sporting event on TV. However, in the case of research, one can pay to download and print specific individual research.

No one knows for sure how exactly the distribution models will develop. Nevertheless, the most likely outcome will be one of a flat fee. As MiFID II/R matures, the most likely outcome appears to be a combination of "flat fee" and "pay per view": one flat annual fee with a top up of "pay per view".

In the later part of the first quarter and early second, ICMA plans to hold MiFID II/R *post-mortem* discussions. We will watch with interest as MiFID II rolls out in January 2018 and beyond.

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