

October 2015

MIFID II pre- and post-trade transparency - Impact on bond markets

ECB Bond Market Contact Group, 13th October 2015

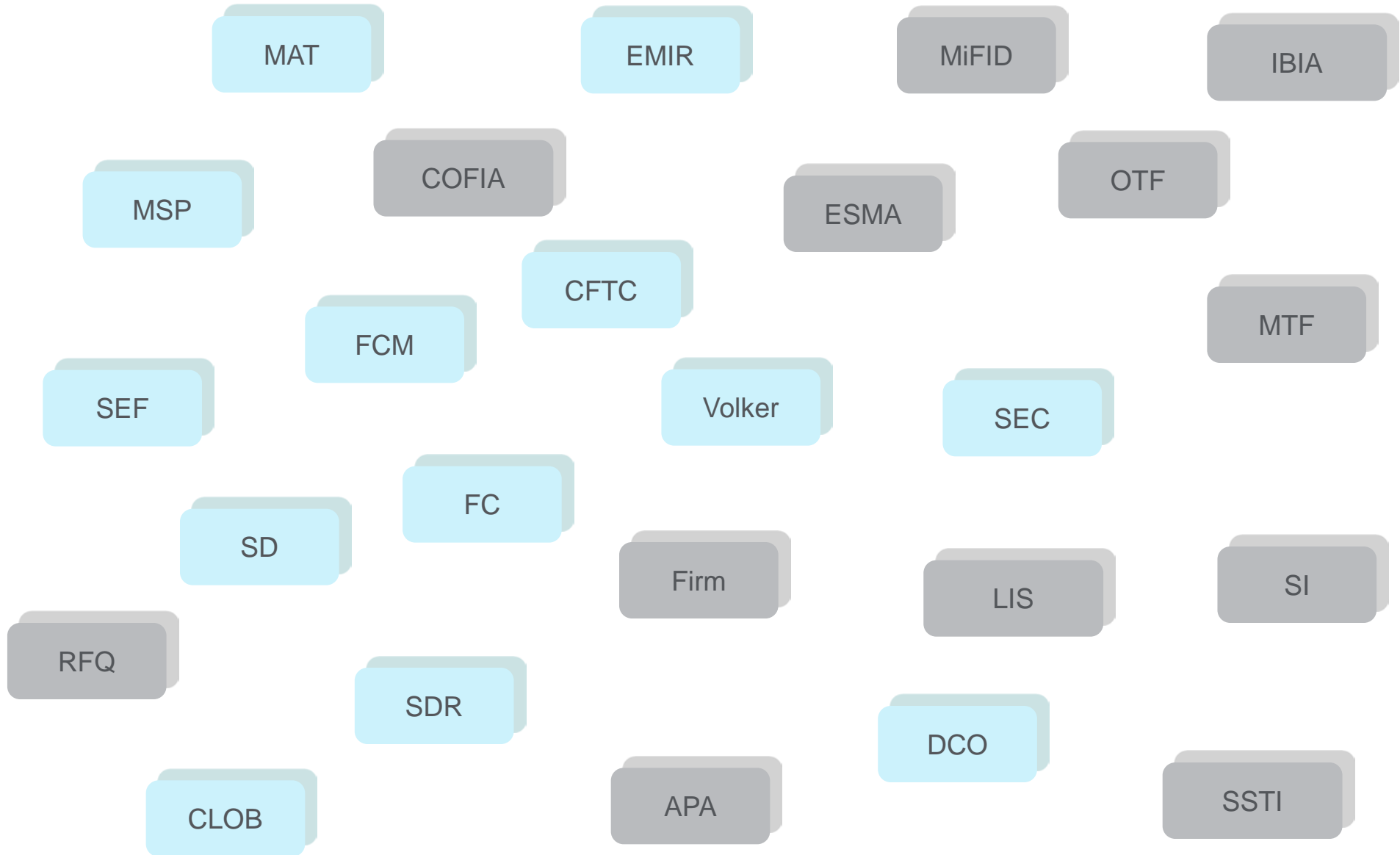
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Another regulation... another plethora of new acronyms



MiFIR / MiFID II extends to non-equity products

Market Structure & Transparency

Products

- Bonds
- Derivatives
- Structured Finance Products
- Emission Allowances

Trading

- Venues: Exchanges, MTFs, **OTF***
- Bilateral: **Systematic Internaliser***, OTC

*New

Transparency

- Transparency requirements intended to encourage venue trading
- Mandatory venue trading only for selected derivatives

Investor protection, Governance & more

& The rest....

- Investor protection
- Internal controls / governance
- External controls / reporting
- High Frequency / Algo trading
- Unbundling Research
- 3rd country regime....etc

*** Fully enforced: 1 Jan 2017 ***

Bond Market: Pre-Trade Transparency

Goal: encourage more venue trading+

Venue / Multilateral Trading



If liquid & below SSTI

- **Order book:** Make public firm bids, offers & depth on continuous, viewable basis
- **RFQs (incl voice):** Responses public on viewable basis

• Waivers

- Instruments that are not liquid
- Instrument above Size Specific To Instrument (SSTI)
- Instruments above Large In Scale (LIS)

Test: frequent, systematic & substantial per instrument

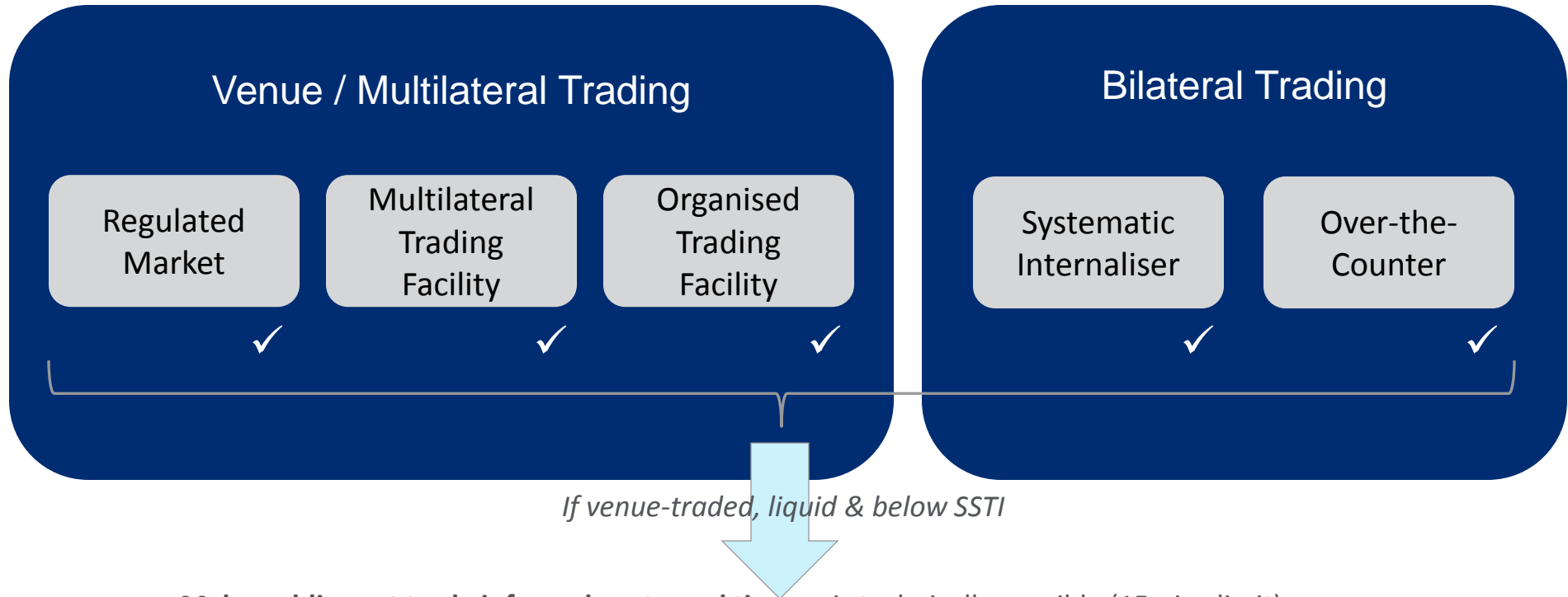
Bilateral Trading



If venue-traded, liquid & below SSTI

- **Firm Quote Response** (includes **voice**) & according to commercial policy
 - Provide to **all** clients on tradable basis; &
 - Provide to **public** on viewable basis
- Update prices possible

Bond Market: Post-Trade Transparency



If venue-traded, liquid & below SSTI

- **Make public post trade info as close to real time** as is technically possible (15mins limit)
- **Post Trade Info = Price, Volume, Time, Venue**
- Publication to authorised **Approved Publication Agencies (APAs)** only
- Post- (& pre-) trade data must be made available on a reasonable commercial basis & free after 15mins
 - **Delay possible at NCA discretion but price & full volume*** must be disclosed
 - Instruments that are not liquid
 - Instrument above Size Specific To Instrument (SSTI)
 - Instruments above Large In Scale (LIS)
 - *Indefinite aggregation of volume possible for sovereigns

Bond Market: Impacts of Implementation

→ ... yet to be seen but key is to get the calibrations correct for illiquid instruments

Level 1 rule & MiFID II use

SI thresholds

L1: "frequent & substantial per instrument"

SI determination per instrument

Liquid

L1: "ready and willing buyers and sellers on a continuous basis"

Pre-trade SI scope & Venue Waivers

Post trade delays

Pre- & Post-SSTI

L1: no "undue risk exposed to liq providers"

LIS

L1: "large in scale compared with normal market size"

Pre-trade transparency

Post trade delay

RFQ (e- & v-)

L1: "actionable indications of interest in request-for-quote"

ESMA Current Thinking

Quarterly Calculation:	e.g. Bonds
Frequent (liquid) vs EU	2% to 3% trades
Substantial vs EU	0.5% to 1.5% volume

Bond Liquidity Definition	
IBIA (instr-by-instr)	Liquidity test is 2x/day & €100k for 80% of the time in Europe (ie. 1.6x/day)

Calculation	Pre-trade SSTI	Post-trade SSTI	Post-trade LIS
Percentile trades excl sub-100k tkts	60 th	80 th	90 th

How does that look?	Pre- & post SSTI & LIS, estimate excl sub-100k [incl sub-100k]	
European Sov Bond 2bn+ (& new issues <3mths, 1bn+)	5 / 14 / 30	[3 / 10 / 25]
Corporate Fin'l Bond 1bn+ (& new issues <2wks, ½bn+)	0.5 / 2 / 5	[0.2 / 1 / 2]

Size & Timing	Up to Pre-trade SSTI	Up to Post-trade SSTI	From Post-trade LIS
Liquid Bond	Pre-trade	Real time post trade	Possible delays* Price T+2; + 4wks vol
Non-Liquid Bond	No Pre-trade	Possible delays* Price T+2; + 4wks vol	Possible delays* Price T+2; + 4wks vol

Venue RFQ	"no later than at the time when the requester is able to execute a transaction under the system's rules" - Implying a certain time where pre- and post- at same time?
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- Too High: un-level playing field
- Too Low: prohibit small/new firms
- Buy side caught?
- Where do we get denominator?

- IBIA outcome agreed
- Liquidity test too low (2x per day)

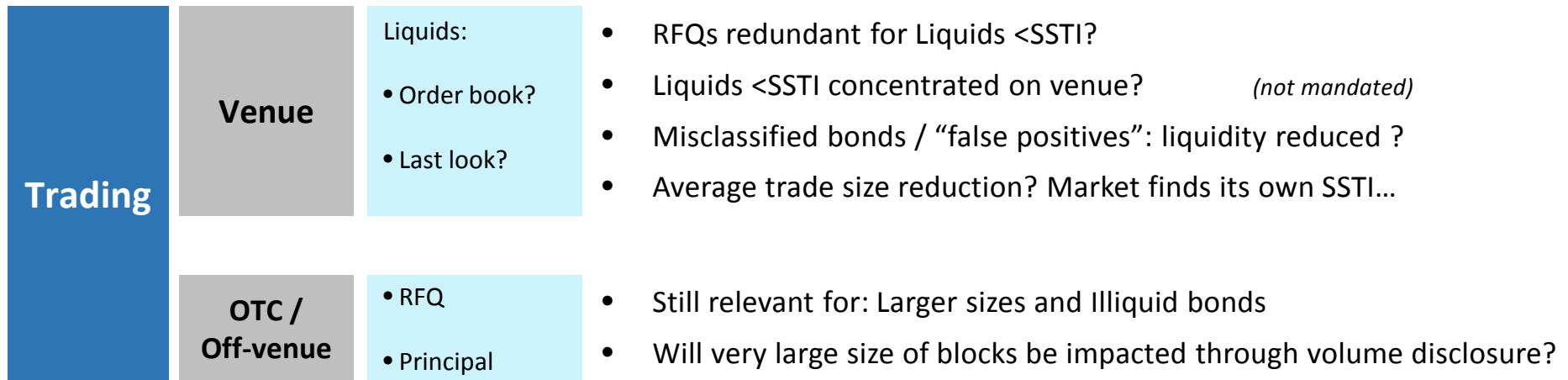
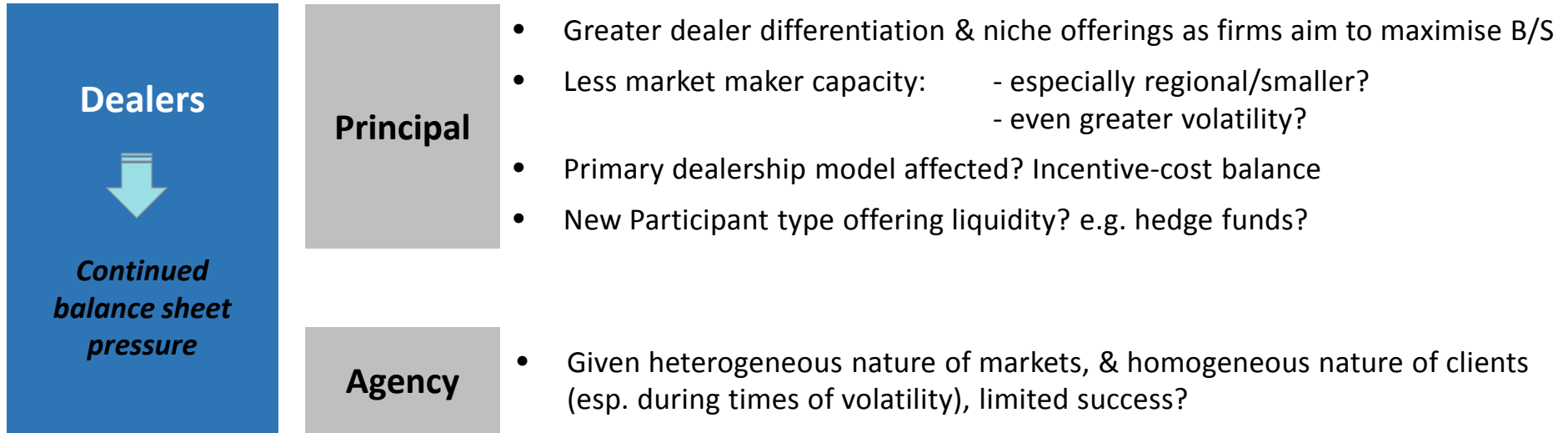
- SSTI levels are greater than average sz & exceed "undue risk"

- SSTI calc must include sub-100k tickets to calibrate accurately

- Possible Delays at NCA discretion:
 - Price disclosure at T+2
 - Volume disclosure up to 4 weeks
- Risk of inconsistency?

- Must be designed to incentivise dealers to quote quickly
- What about last look?

MiFID II – Fixed Income Trading Impact



Opportunities

- **A well-implemented transparency regulation allows markets to not only survive, but thrive**
(cf. DF SEF where volumes flourished: no pre-trade, RFQs permitted, full block size withheld, no action reliefs)

MiFID 2 Threats

- Paradox: less liquidity in false positives? lower volumes?
- Data quality reliability
- Unconsolidated data creates a differentiator?
- Inconsistency within Europe e.g. NCA discretion with delays
- Inconsistency internationally e.g. no pre-trade anywhere else globally in fixed income
- Implementation costs
- Unpredictable behaviours through intervention policies like QE

And....

- Unbundling research
- Broker evaluation
- SI discrimination
- Price differentiation

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- Appendices

Quotes

Quotes: Letter from European Parliament's MiFID/R Negotiating Team (ECON) to ESMA 23 July 2015

1. "At this stage ... the **Parliament's preference is for IBIA for the classification of bonds**, as that approach would appear to be more accurate".
2. "We stress that the definition for bonds **should be tested to meet the requirements for continuous trading and therefore a test of 2-3 trades per day cannot be perceived to be liquid**. In our view, this test for false positives must be increased significantly"
3. "regarding the RFQ system...Full transparency of each single quotation provided, on request, by market makers could promote phenomena such as front running, which reduce the incentive to the buy-side to use such systems... **Against this backdrop it would be preferable to require RFQ operators to disclose information on prices and volumes on an aggregate basis** i.e. the average of provided quotes with the average of attached volumes. Such a solution would not encroach of the transparency objective and, in the meantime, would better cater for the characteristics of the RFQ trading systems"

Quotes: Joint DE/FR/UK Finance Ministry Letter to ESMA 25 August 2015

1. Regarding Liquid definition
 - "We had a clear expectation that..."
 - ..."ESMA would follow the definition of Liquid Market"
 - ..."ESMA would...identify instruments or classes of instruments...without significant misclassifications"
 - ..."ESMA would determine LIS and SSTI according to factors set out in Article 9"
2. "The unintended consequence of ESMA's proposed approach could be that many financial instruments which MiFIR determined should be eligible for waivers or deferrals may have **inappropriate transparent requirements applied** to them with resulting **significant negative implications for the proper functioning of these vital markets**. Conversely many financial instruments to which the MiFIR transparency regime should legitimately apply will not be included. This is **not acceptable particularly given the current widespread concern about the provision of liquidity in Europe's bond markets.**"

Pre-Trade Transparency

For “Liquid” instruments “traded on a trading venue” up to SSTI

- RFQs in scope
- Waivers: >SSTI, Illiquid instruments
- *NB: Level 1 SSTI is up to the size where there is no “undue risk” to investment firm*

Post-Trade Transparency

For “Liquid” instruments “traded on a trading venue” up to SSTI

- Up to SSTI size: As Real-time as technically possible (up to 15 minutes)
- \geq LIS or illiquid: - Price Delay of up to T+2;
- Volume Delay of up to 4 weeks (NCA discretion)
- *NB: LIS = orders that are large in scale compared with normal market size*

Liquid Definition & Traded on a Trading Venue

Sets scope for pre-trade and real-time post-trade transparency

- Liquid market: “where there are ready and willing buyers and sellers on a continuous basis”.
Four criteria for assessing liquidity:
 - *Frequency of transactions*
 - *Average transaction size*
 - *Number of market participants (complex task to define/ distinguish)*
 - *Average size of spreads (lack of info for transactions executed OTC)*
- Liquid definition proposed to be set at COFIA level (vs. IBIA)
- “Traded on a Trading Venue” still undefined

MiFID II – Industry suggestions to address issues

SSTI

SSTI must consider “Undue Risk” and Include Sub-100k trades

- ESMA has ignored “undue risk” element as required by level 1
 - *Must be set as being up to the level at which probability of de-risking is highest*
- ESMA is excluding significant part of institutional market by excluding sub-100k trades from SSTI calculation
 - *ESMA justifies as “retail” size but significant number of all tickets traded by institutional clients in corporate bonds are less than 100k (>35%)*
 - *Retail size should be clarified to mean retail clients: EuroMOT average trade size is less than 20k*

Liquidity Calibration

Consider IBIA for best results

- IBIA approach is optimal in order to limit negative impacts to the market
- COFIA approach will *always* be imperfect but a more granular approach can limit the negative impacts to the market by considering:
 - Higher issue size threshold
 - Extension of proposed sub-class for “old” bonds of > 3 years
 - Additional sub-class for currency

Delays & RFQ

Longer Post-trade delays for illiquid bonds & > LIS, RFQ composite

- T+2 not sufficient to de-risk large positions and/or illiquid bonds;
- RFQ pre-trade transparency with individual quotes severely damaging

MiFID II: Citi's critical issues list re fixed income transparency

- **SI thresholds:** all maker makers must be caught in SI definition to maintain level playing field; a low test is therefore essential
- **Liquidity thresholds:**
 - Potentially a large number of illiquid fixed income instruments will be incorrectly classified as liquid (“false positives”)
 - ESMA’s choices risk resulting in (1) an overly broad definition of liquid markets that does not recognise the dynamic nature of liquidity; and (2) unsuitably high size thresholds for pre- and post-trade transparency. Thresholds should be set higher for all the asset classes (e.g. currently 2x trades a day for bonds)
- **SSTI thresholds:**
 - Are set too high for pre-trade SSTI (>median number of transactions; no analysis of undue risk)
 - Post trade transparency does not account for different types and levels of market impact risk
- **RFQ & Firm Quotes:**
 - Due to the large number of “false positives”, liquidity provision in such illiquid instruments is severely discouraged and any dealers deciding to quote will demand compensation for increased risk, hence increasing costs to buy side clients
 - Outcome: a curtain time has been included such that pre-trade quotes and post-trade price can occur simultaneously
 - Clarification of firm quote definition: if last look not permissible, spreads will be impacted
- **Post-trade extended deferrals:**
 - Whilst four weeks would assist with risk mitigation for a number of trades, additional time would still be required for particularly large and/or illiquid trades.
 - The same time frame should be mandated across all NCAs to encourage level playing fields & lower complexity
- **IBIA vs. COFIA:**
 - IBIA approach will have the benefit of being more precise and simpler to implement with an appropriate operational structure.
 - Positive outcome: The latest RTS define liquid bonds at an instrument/ISIN level.
- **Other challenges:**
 - Best execution reports unnecessarily burdensome for both sell- and buy-side
 - Very little consolidation proposed by ESMA therefore risk of poor data quality & high cost of integration of data

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