MiFID II/ MiFIR
Impact of regulation on euro area bond markets
ECB Bond Market Contact Group, October 2017
Oliver Eichmann

All documents are meant as a discussion paper for the ECB Bond Market Contact Group.
MiFID II/R – Impact on bond markets

Key objectives of MiFID/R

- Key objectives of MiFID II: Improve the functioning of financial markets, making them more **efficient, resilient** and **transparent**

- **Transparency Obligations in fixed income trading**
  - Improve price discovery mechanism in fixed income markets
  - Move fixed income trading practices further onto trading venues (RMIs, OTFs and MTFs) and away from OTC trading
  - Extend transparency obligation into the OTC space (e.g. via Systematic Internalizer)
  - Improve data availability for fixed income instruments (Best execution reporting)

- **Research Unbundling**
  - Defines research as an inducement. Research cannot be accepted free of charge by investment firms when providing portfolio management services or independent advice
MiFID II/R - Impact on bond markets
Research Unbundling

- Investment firms will need to either pay for research with their own money (P&L) or to establish a Research Payment Account (RPA)
- The RPA model requires that firms establish annual research budgets in advance and disclose the costs of research to each individual client.
- Research price setting process for fixed income cannot rely on an established market structure and is “in the making”. ESMA “...acknowledges that the current lack of established market practices and mechanisms for investment firms to pay for FICC research separately from execution costs may limit certain operational arrangements.” (ESMA, Q&A, p. 52)

Forecasts are not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

Source: Financial Times, Deutsche Asset Management Investment GmbH, * sample only
MiFID II/R - Impact on bond markets
Research Unbundling

- Implementation costs to fulfill regulatory requirements (e.g. transparency, cost allocation etc.) probably higher within RPA models (IT infrastructure, personnel costs)
- Asset Manager tend towards payment out of own P&L (see chart page 2)
- Price for research offering seems to be in the motion, price indications trended lower over time

Topics for discussion
- Are research costs embedded in bid/offer spreads? Will bid/offer come down under the new regime?
- Implications of additional costs. Will price/quality differentiation lead to a consolidation and specialization on the buy- and/or sell-side?

“…In fixed income, costs of research, as well as some other discrete costs, are usually embedded within the negotiable bid/offer spreads quoted by brokers. We believe this would mean that, in the new regime, a manager would have the option either to pay directly for research, or use the research charge and payment account to do so, which can be applied to clients with fixed income portfolios in the same way as for equities. If research is currently a material part of a broker’s costs, we would expect a narrowing of spreads as a result of the decoupling of research from trading spreads.” (FCA, Feedback statement on DP14/3 – Discussion on the use of dealing commission regime, 02.15)

Source: Financial Conduct Authority, 02/2015

Forecasts are not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.
MiFID II/R - Impact on bond markets
Trade Transparency, Best execution

- Pre- and Post-Trade Transparency rules likely to change market structure more towards trade venues. This trend could be enforced by increased requirements on best execution (e.g. determination of “fair prices”)
- Reporting requirements and transparency rules will increase data availability and reduce information asymmetries. Requirement to publish top five execution venues used for each subclass of financial instruments they trade for managed portfolios

**Topics for discussion**
- Trade transparency requirements likely to increase trade volumes via trade venues (electronic trading). Will this lead to a more oligopolistic structure on the sell-side? Will it create room for new entrants?
- Will the substantial increase in publicly available data improve the price setting?
- Is it reasonable to assume that pre-trade requirements will affect bid/offer spreads?
- Will liquidity be affected through post-trade transparency, esp. for less liquid bonds?

---

**Thresholds for instruments/markets**

<table>
<thead>
<tr>
<th>Volume in mn. €</th>
</tr>
</thead>
<tbody>
<tr>
<td>28,000,000</td>
</tr>
<tr>
<td>23,000,000</td>
</tr>
<tr>
<td>18,000,000</td>
</tr>
<tr>
<td>13,000,000</td>
</tr>
<tr>
<td>8,000,000</td>
</tr>
<tr>
<td>3,000,000</td>
</tr>
<tr>
<td>-2,000,000</td>
</tr>
</tbody>
</table>

- **Sovereign Bond**
- **Other Public Bond**
- **Other Bond**
- **Covered Bond**
- **Corporate Bond**

Source: European Securities and Markets Authority

Forecasts are not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.
MiFID II/R - Impact on bond markets
Asset Management – Who is in scope?

Mifid I framework imposes direct obligations on discretionary portfolio managers who manage segregated accounts. Many investment fund management entities like UCITS management companies and alternative investment fund managers (AIFMs) are not directly covered by the framework

- UCITS and AIMFs are indirectly affected if they delegate portfolio management to MiFID regulated firms
- EU member states could impose requirements for non-MiFID firms voluntarily ("Gold plate")
- MiFid II will continue to apply directly to EU discretionary portfolio management and will be extended to apply to UCITS management companies and EU AIFMs who manage separate discretionary accounts
- EU AIFMs and UCITS companies acting as management companies continue to be indirectly impacted.

Non-EU Discretionary Portfolio Managers

- Introduction of “third country” requirements for non-EU managers who wish to provide portfolio management investment services to EU investors

Topics for discussion

- Regulatory arbitrage
- Conflicting regulation regarding payment for research
MiFID II/R - Impact on bond markets
Trade Transparency - Pre-Trade Requirements

Trading Venue
- Regulated Market (RM), Multilateral Trading Facility (MTF), or Organized Trading Facility (OTF)?
  - Yes
  - Sovereigns, Corporates Covered's
    - Eligible? Yes
    - >= 1bn
    - >= 0.5bn

- OTC (Systemic Internalizer)?
  - Yes
  - Sovereigns, Corporates Covered's
    - Eligible? Yes
    - >= 1bn
    - >= 0.5bn

- OTC (no Systemic Internalizer)?
  - No

Products eligibility for liquidity test (issue size in €)
- Eligible? Yes
- Sovereigns, Corporates Covered's
  - >= 1bn
  - >= 0.5bn

Liquidity/ Liquidity Test
- Liquid? Yes
- 100k* on each 80% of days (no test for new issues)

- Sovereigns, Corporates Covered's
  - Liquidity test
  - 15* trades/ day (2018) – 2* trades/ day (2021)

Trade Size/ Waiver
- <= SSTI (Size To Specific Instrument) or LIS (Large In Scale)?
  - Yes

No pre-trade transparency

Source: ICMA International Capital Market Association, Deutsche Asset Management Investment GmbH

For illustrative purposes only

*Daily average, no liquidity test for new issues
MiFID II/R - Impact on bond markets
Trade Transparency - Post-Trade Requirements

Trading Venue
- Regulated Market (RM), Multilateral Trading Facility (MTF), or Organized Trading Facility (OTF)?
  - Yes
- Investment Firm, Incl. SI?
  - Yes

Products eligibility for liquidity test (issue size in €)
- Eligible?
  - Sovereigns
    - >= 1bn
    - >= 0.5bn
  - Corporates
    - Covered’s
    - >= 0.5bn

Liquidity/ Liquidity Test
- Liquid?
  - 100k* on each 80% of days (no test for new issues)
  - Liquidity test
    - 15* trades/day (2018) – 2* trades/day (2021)

Trade Size/ Waiver
- <=SSTI (Size To Specific Instrument) or LIS (Large In Scale)?
  - Yes

Real Time
- Yes

Deferred (2 days up to 4 weeks)

ICMA International Capital Market Association, Deutsche Asset Management Investment GmbH
*Daily average, no liquidity test for new issues

For illustrative purposes only
MiFID II/R - Impact on bond markets

Trade Transparency - Post-Trade Requirements

- For transactions that are “large” for individual instruments (Size Specific To the Instrument (SSTI)) or compared to market size (Large in Scale (LIS)) pre-trade transparency rules do not apply and post-trade transparency rules are deferred.

- Thresholds are defined based on percentile calculations and increasing over time (e.g. SSTI pre-trade for govis 30 to 80 in 2021)

<table>
<thead>
<tr>
<th></th>
<th>Up-to pre-trade SSTI</th>
<th>Up-to post-trade SSTI</th>
<th>Up-to post-trade LIS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquid Bond</td>
<td>Pre-trade transparency</td>
<td>Real time post-trade</td>
<td>Possible delays (price T+2, volume up to 4 weeks)</td>
</tr>
<tr>
<td>Illiquid Bond</td>
<td>No pre-trade transparency</td>
<td>Possible delays (price T+2, volume up to 4 weeks)</td>
<td>Possible delays (price T+2, volume up to 4 weeks)</td>
</tr>
</tbody>
</table>
Important Information

All documents and information placed at the disposal for ECB Bond Market Contact Group are intended for them only.

Deutsche Asset Management represents the asset management activities conducted by Deutsche Bank AG or any of its subsidiaries

All opinions and estimates herein, including forecast returns, reflect our judgment on the date of this report and are subject to change without notice and involve a number of assumptions which may not prove valid.

This publication contains forward looking statements. Forward looking statements include, but are not limited to assumptions, estimates, projections, opinions, models and hypothetical performance analysis. The forward looking statements expressed constitute the author’s judgment as of the date of this material. Forward looking statements involve significant elements of subjective judgments and analyses and changes thereto and/or consideration of different or additional factors could have a material impact on the results indicated. Therefore, actual results may vary, perhaps materially, from the results contained herein. No representation or warranty is made by Deutsche Asset Management Investment GmbH as to the reasonableness or completeness of such forward looking statements or to any other financial information contained herein.

This document may not be reproduced or circulated without our written authority. The manner of circulation and distribution of this document may be restricted by law or regulation in certain countries, including the United States.

© Deutsche Asset Management Investment GmbH, 10.10 2017. All rights reserved. No further distribution is allowed without prior written consent of the Issuer.