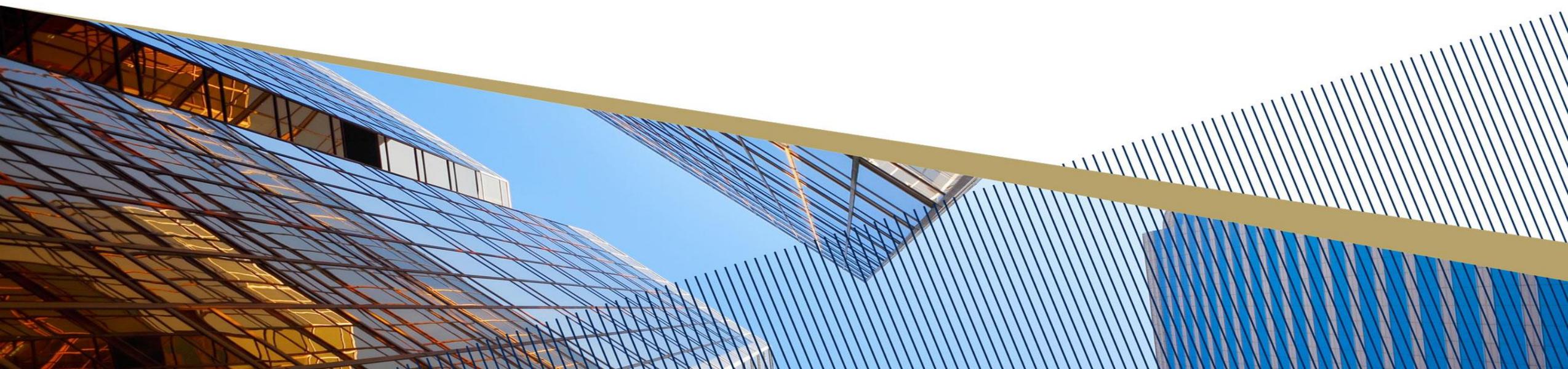


MiFID II/MiFIR and Fixed Income

August 2017



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Introduction: key objectives of MiFID II/R

Key objectives of MiFID II/R

- **Key objectives of MiFID II:** Improve the functioning of financial markets making them more efficient, resilient and transparent.
- **Key objectives of fixed income transparency obligations under MiFID II:**
 - Create a price discovery mechanism in fixed income markets
 - Move fixed income trading practices (currently over the counter [OTC]) onto trading venues, such as *Regulated Markets* (RMs), *Organised Trading Facilities* (OTFs) and *Multilateral Trading Facilities* (MTFs)
 - Extend transparency obligations into the OTC space
 - Whilst not a trading venue in the classic sense of the term, the *Systematic Internaliser* (SI) regime (an investment firm that deals on its own account by executing client orders outside a trading venue) ensures the internalisation of order flow by investment firms, does not undermine the efficiency of price formation on RMs, MTFs and OTFs
 - Increase available reference data for fixed income instruments
- **MiFID II/R is scheduled to take effect from January 3 2018**

The new market structure paradigm

The new market structure paradigm

- **Regulated Market (RM)**

A multilateral system operated by and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments.

- **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 in which multiple third-party buying and selling interests in bonds, 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)**

An investment firm that deal on its own account by executing client orders outside a trading venue.

- ❖ *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.*

The new market structure paradigm

	Regulated Market	MTF	OTF	Systematic Internaliser (SI)
Financial instruments	Equity and non-equity	Equity and non-equity	Non-equity only	Equity and non-equity
Execution of transactions	Non-discretionary	Non-discretionary	Discretionary	Discretionary
Proprietary capital	Prohibited	Prohibited	Prohibited, with exceptions	Expected
Matched principal trading	Prohibited	Prohibited	Permitted in some cases with client consent	Only in exceptional circumstances

The Systematic Internaliser regime

Systematic Internalisers (SIs)

- MiFID II/R extends the SI regime (traditionally found in equities) to a broader range of financial instruments, including bonds.
- It applies to an investment firm which, on an organised, **frequent and systematic**, and **substantial** basis, deals on its own account by executing client orders outside a RM, MTF, or OTF.
- The key aim is to bring OTC activity in scope of the pre- and post-trade reporting obligations.

Frequent and systematic test

- For **liquid bonds**, this is where the number of trades during the last six months is equal to or larger than 2.5% of the total number of transactions in the relevant financial instruments in the EU executed on any venue or OTC during the same period. At a minimum, the firm should deal on its own account in the instrument once a week.
- For **illiquid bonds**, this is where the firm has dealt on its own account OTC in the financial instrument on average once a week during the last six months.

Substantial test

- The firm internalises on a substantial basis if the size of OTC trading on own account during the last six months is equal to or larger than:
 - **25% of the total nominal amount traded** in that financial instrument executed by the investment firm on its own account or on behalf of clients, and carried out on any trading venue or OTC; or
 - **1% of the total nominal amount traded** in that financial instrument executed in the EU and carried out on any EU trading venue or OTC.

The SI regime: determination, requirements, and discretion

Determination:

- For new instruments, the assessments shall only be considered once the data covers a minimum period of six weeks.
- MiFID II/R allows firms to choose to opt-in to be a systematic internaliser for a financial instrument, even where it does not meet all or any of the quantitative criteria, provided it complies with the requirements for SIs.

Requirements:

- The investment firm will be identified in the case of an SI quote, whereas on a venue quotes will be averaged across all quoting firms and anonymized.
- In the case of liquid bonds, SIs must make public firm quotes to all their clients when (a) they are requested for a quote by a client, or (b) they agree to provide a quote.
- In the case of illiquid bonds, SIs must disclose firm quotes to their clients on request only where they agree to provide a quote.

Discretion:

- SIs may update their quotes at any time, and may also withdraw quotes under exceptional circumstances.
- Notwithstanding, SIs are allowed to decide which clients have access to, and can execute on, their quotes, on the basis of their commercial policy and in an objective, non-discriminatory way (thus SIs retain control over their trading activity).

Once a firm becomes an SI, what are the key differences?

	Trading Venue Obligation	SI Obligation	Non-SI Obligation
Pre-trade Transparency applies	✓ (non-firm)	✓ (firm)	✗
Post-trade Transparency applies	✓	✓	✓
Best Execution Data provided	✓	✓	✓
Reference Data provided	✓	✓	✗
Post-trade <i>Reporting</i> obligation	✓	✓	Only if selling

If an SI in one bond: requirement is to be an SI for that issuer for all bonds, regardless of currency.

Pre- and post-trade transparency

Transparency regime

- **Pre-trade requirements**: extended to non-equities (including bonds, structured finance products, emission allowances and derivatives) which means RMs, MTF and OTFs are required to publish current bid and offer prices and depth of trading interest at those prices in electronic form (at least above SSTI – i.e. block size) and to the public
- **Pre-trade transparency** waivers available for (i) large in scale (LIS) orders; (ii) actionable indications of interest in RFQ and voice systems above size-specific to instrument (SSTI) threshold; and (iii) illiquid instruments. Thresholds to be set by ESMA.
- **Post-trade reporting requirements** near-real time (within 15mins) to the public by venue or via APA.

Liquidity waiver

Starting in 2018, a bond is classified as liquid if:

	<u>Products Eligible for Liquidity Tests</u> issue size (euros)		Liquidity Test (Floors)	Liquidity Test Level	Calculation Frequency: Liquidity Test & Thresholds
Bonds	Sovereigns	1bn+	2 trades & 100k on 80% of days <i>(no Liquidity test for new issues)</i>	By ISIN (IBIA) & By Class (COFIA) for new issues	Quarter
	Corporates Covered bonds Convertibles	0.5bn+			

Phased-in liquidity test*:

	Year 1 (2018)	Year 2 (2019)	Year 3 (2020)	Year 4 (2021)
Liquidity Test:	15 trades per/day	10 trades per/day	7 trades per/day	2 trades per/day

* Subject to assessment of market impact by ESMA

Large In Scale (LIS) waiver

Pre-trade: for RMs, MTFs, OTFs, and SIs

An order is considered large in scale compared with standard market size if its equal to or larger than a determination of standard market size for the class of instrument. The threshold is calculated based on a percentile threshold of the distribution of trade sizes for the class of instrument.

Post-trade: for RMs, MTFs, OTFs, SIs, and other investment firms

A transaction is considered large in scale compared with standard market size if its equal to or larger than a determination of standard market size for the class of instrument. The threshold is calculated based on a percentile threshold of the distribution of trade sizes for the class of instrument.

Size Specific To the Instrument (SSTI) waiver

Pre-trade: RMs, MTFs, OTFs, and SIs (for RFQ and voice trading systems)

An actionable IOI is considered above the size specific to the financial instrument if its equal to or larger than a determination of the minimum size of an actionable IOI for the class of instrument. The threshold is calculated based on a percentile threshold of the distribution of trade sizes for the class of instrument.

Post-trade: RMs, MTFs, OTFs, SIs, and other investment firms

A transaction is considered above the size specific to the financial instrument if its equal to or larger than a determination of the minimum size of transaction for the class of instrument. The threshold is calculated based on a percentile threshold of the distribution of trade sizes for the class of instrument.

LIS and SSTI thresholds

Pre & Post Trade Thresholds

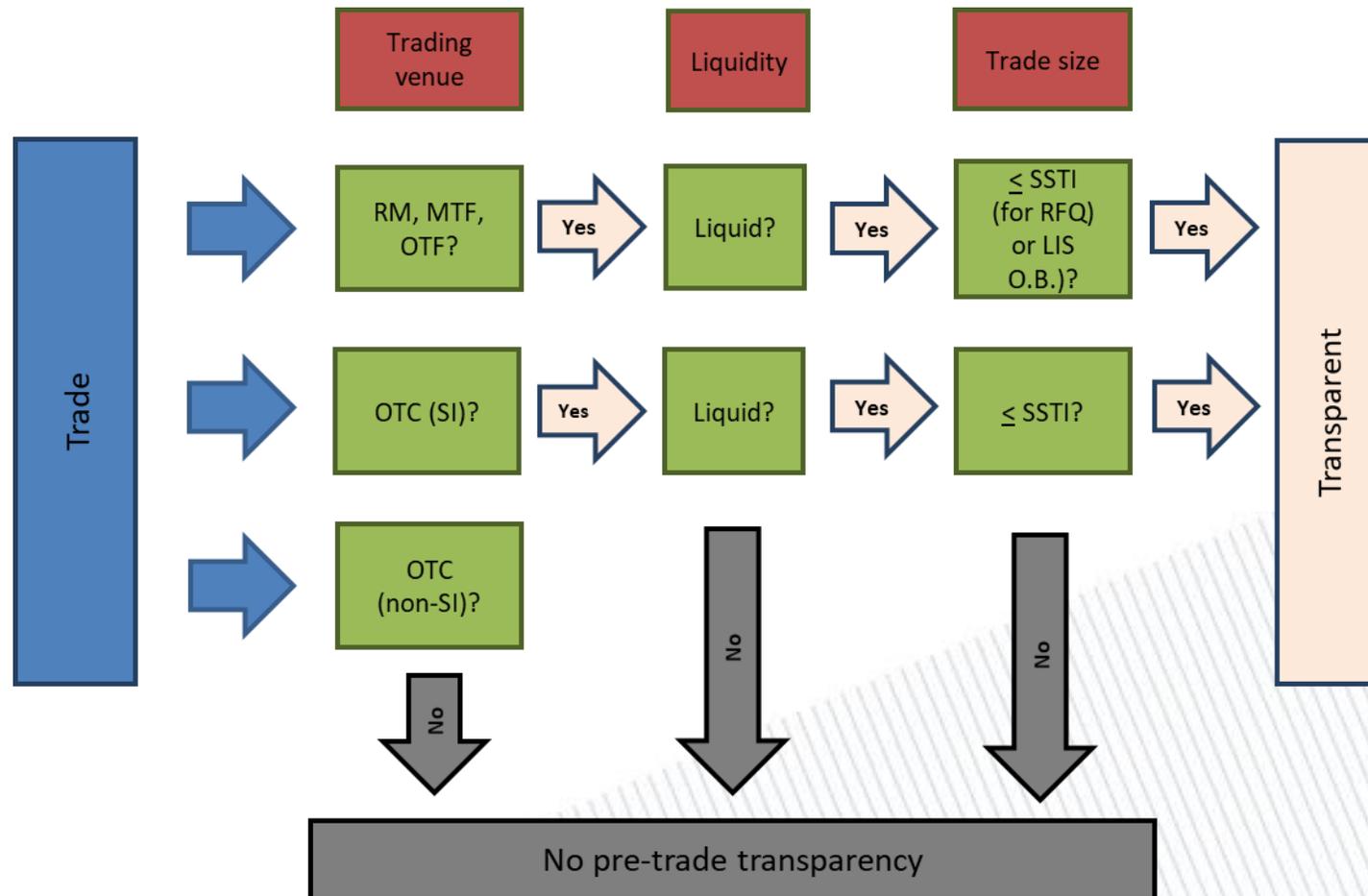
Quarterly calculation of thresholds excluding trades smaller than 100k

Direct implications of thresholds on required transparency

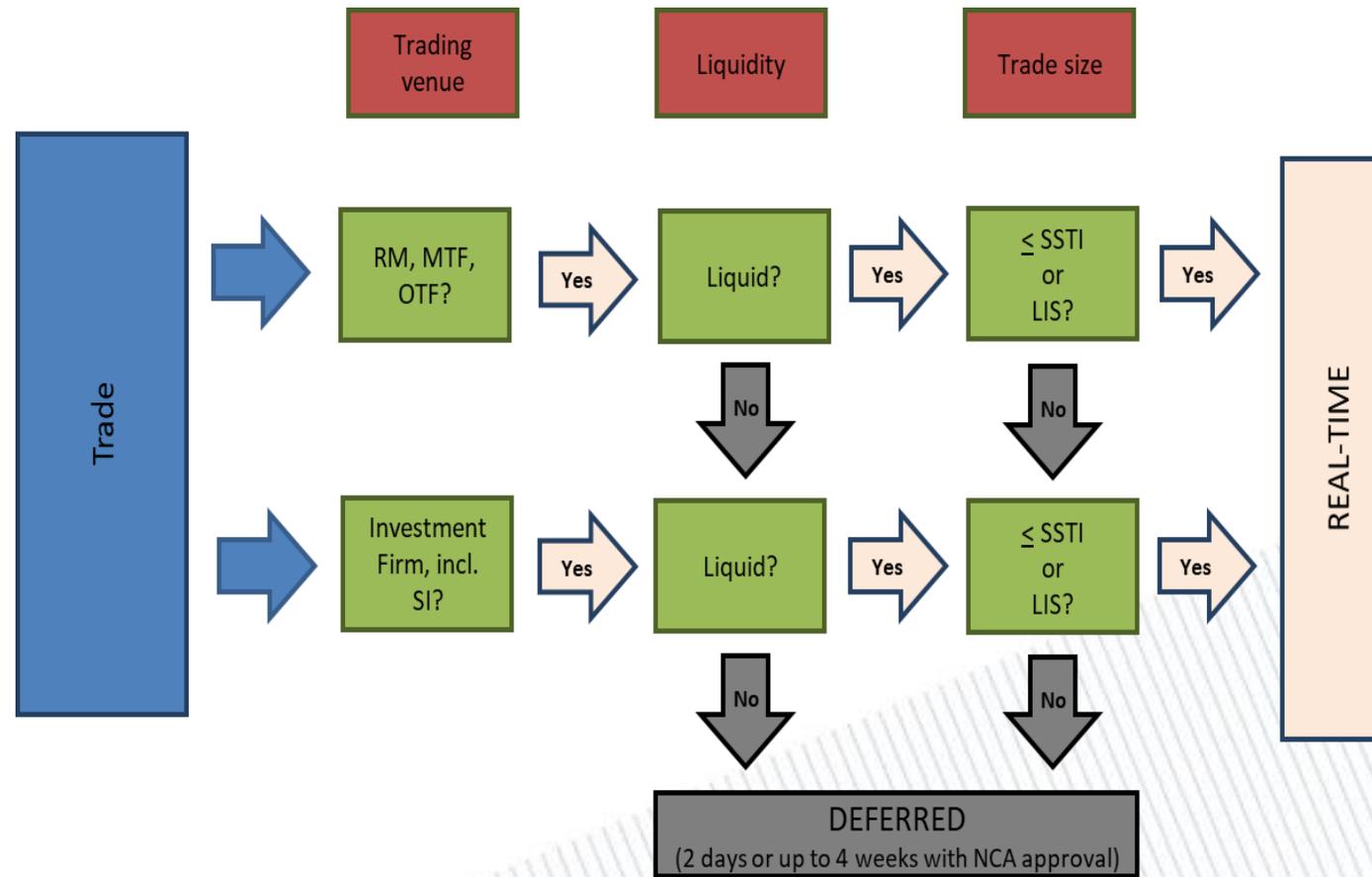
Calculation	SSTI pre-trade	LIS pre-trade	SSTI post-trade	LIS post-trade
Trade-percentile (excl. trade tickets smaller than 100k)	30	70	80	90

	Up to pre-trade SSTI	Up-to post trade SSTI	Up-to post trade LIS
Liquid Bond	Pre trade transparency	Real time post trade	Possible delays (price T+2; volume up to 4 weeks)
Illiquid Bond	No pre trade transparency	Possible delays (price T+2; volume up to 4 weeks)	Possible delays (price T+2; volume up to 4 weeks)

Pre-trade transparency requirements



Post-trade transparency requirements



Post-trade reporting obligations



Best Execution reporting

RTS 27: Data to be published by execution venues on the quality of execution of transactions

- Trading venues, systematic internalisers (SIs), and execution venues (including market makers and other liquidity providers) shall make available to the public, at no charge, **data** relating to the **quality of execution** of transactions on that venue on at least an annual basis (quarterly for execution venues).
- Reports shall include details about price, costs, speed, and likelihood of execution for individual financial instruments.
- In order to provide a proper context for the quality of execution obtained, the amount and **nature of reported data will be segregated according to trading systems**, trading modes, and trading platforms.
- The information should be made available in a machine-readable electronic format available for downloading by the public.
- Execution venues shall publish the information quarterly and no later than three months after the end of each quarter, as follows:
 - 1 Jan to 31 Mar: by 30 Jun
 - 1 Apr to 30 Jun: by 30 Sep
 - 1 Jul to 30 Sep: by 31 Dec
 - 1 Oct to 31 Dec: by 31 Mar

RTS 28: Annual publication by investment firms of information on the identity of execution venues and on the quality of execution

- Investment firms who execute client orders are required to summarise and make public on an annual basis, for each class of financial instrument, the top five execution venues in terms of trading volumes where those firms executed client orders in the preceding year, as well as information on the quality of the execution obtained.
- This will be for each class of financial instrument and will be **expressed in percentages (% of investment firm's total execution volumes and number of executed orders in that class of financial instrument, rather than absolute values)**.
- Information published will be split between retail client flow and professional client flow.
- In a separate report, investment firms will summarise and make public the top 5 execution venues where they executed **securities financing transactions**.
- Investment firms will clearly indicate the classes of financial instruments for which they execute a very small number of orders.
- **Investment firms shall publish** for each class of financial instruments, **a summary of the analysis and conclusions based on the quality of execution on the execution venues**.

Reporting obligations on third-country trading venues

Post-trade reporting obligations on third-country trading venues

- Trades executed on a third-country trading venue that would not be subject to a certain level of post-trade transparency equivalency should be made public in the EU through an Approved Publication Arrangement (APA). It is expected that most major fixed income trading platforms within the EU will be operating an APA to enable their clients to meet post-trade reporting requirements.
- However, if the third-country trading venue is subject to a transparency regime similar to the EU's, EU investment firms will not be required to publish additional post trade reports when executing trades on a third country venue.
- A list of third-country trading venues that are deemed to have a similar post trade transparency regime in place will be published by ESMA.

ESMA [Opinion](#) (ESMA70-154-165) “Determining third-country trading venues for the purpose of transparency under MiFID II / MiFIR” issued on 31 May 2017

- Third-country trading venues cannot directly approach national regulators within the EU (national competent authorities, NCAs) to be considered.
- EU investment firms should contact their competent authorities to make them aware of the third-country trading venue(s) on which they are trading.

ESMA [Q&A](#) updates on MiFID II / MiFIR transparency topics published on 31 May 2017

Costs and charges

Disclosure of costs and charges

- MiFID II introduces an obligation for investment firms to provide clients with detailed ex ante and ex post information related to the costs and associated charges of providing investment services, including the execution of client orders.
- Article 24 of [MiFID II](#) requires MiFID firms to provide information on all related costs and associated charges with respect to the provision of MiFID services:

Appropriate information shall be provided in good time to clients or potential clients with regard to the investment firm and its services, the financial instruments and proposed investment strategies, execution venues and all costs and related charges.

- MiFID II introduces an obligation for investment firms to provide clients with detailed ex ante and ex post information related to the costs and associated charges of providing investment services, including the execution of client orders.
- During the legislative implementation of the Level 1 requirements it was clear early on from ESMA's [Technical Advice to the Commission](#) that the obligation to provide clients with *ex ante* and *ex post* information on costs and charges are intended to apply to transactions in MiFID instruments where the MiFID firm acts as principal, and where any costs or charges (in the form of mark-ups or mark-downs) are 'embedded' in the price. Annex 2.14.1 of the Technical Advice outlines the information that should be disclosed:

Cost items to be disclosed		Examples:
All costs related to transactions initiated in the course of the provision of an investment service	All costs and charges that are related to transactions performed by the investment firm or other parties.	Broker commissions, entry- and exit charges paid to the fund manager, platform fees, mark ups (embedded in the transaction price) , stamp duty, transactions tax and foreign exchange costs.

Research unbundling

Research unbundling

- MiFID II defines research as an inducement and therefore research cannot be accepted free of charge by investment firms when providing portfolio management services or independent advice. ICMA's Asset Management and Investors' Council (AMIC)* is helping ICMA's buy-side members with implementation.
- Investment firms will need to either pay for research with their own money (P&L) or to establish a Research Payment Account (RPA) which will then be funded by clients via commission sharing arrangements (CSA) or via a direct charge. Fixed income research cannot be paid for by commissions, so can only be covered by P&L or by direct charge through an RPA.
- If using an RPA, investment firms will need to establish an annual research budget in advance and be able to disclose the costs of research for each individual client.
- To help implement the new framework, ESMA has issued Q&A on research (as inducements) including a section on fixed income within a broader release of [Q&As on investor protection](#). AMIC has created a [summary briefing](#) of the research Q&A, which will be updated when more questions are added by ESMA.
- AMIC wrote a [Summary of Market Surveys](#) in June 2017 compiling the findings of a number of surveys on research unbundling into one document. The summary is available to members. Some findings include:
 - Up to a third of asset managers not decided how to pay for research;
 - Use of RPAs is more popular for equity research, P&L more popular for fixed income;
 - Firms expect research budgets to stay the same or go down;
 - US firms expect to be impacted by the new rules and many considering unbundling brokers; and
 - Pricing research is the biggest implementation challenge.

*AMIC is ICMA's buy-side representative body. AMIC represents the views of the buy-side members of ICMA by discussing investment issues of common interest, reaching a consensus and recommending any action that ICMA should take.

Securities Financing Transactions (SFTs)

Securities Financing Transactions (SFTs)

- SFTs are out of scope of **transaction reporting** to the extent that they are in scope of SFTR or EMIR. The notable exception is SFTs with Central Banks in the European System of Central Banks (ESCB), which will be reportable under MiFID II/R once SFTR reporting requirements come into force.
- SFTs are **not** subject to pre- or post-trade transparency requirements.
- SFTs are not subject to RTS 27 Best Execution reporting requirements, but **are in scope of the RTS 28** obligations.
- MiFID II prohibits investment firms concluding title transfer collateral arrangements with '**retail clients**'. This would include most forms of repo and securities lending. Such counterparties will be required to change their status to 'professional clients'.
- There are other aspects of the regulation that **may** apply to SFTs, but do not specifically mention SFTs (e.g. Costs and Charges disclosure requirements). The general assumption is that SFTs are in scope of MiFID II/R, except for where they are specifically exempted.

Also see ICMA [FAQs on MiFID II/R and SFTs](#)

Useful links to the regulation

Level 1:

[Markets in Financial Instruments \(MiFID II\) - Directive 2014/65/EU](#)

[Markets in Financial Instruments \(MiFIR\) - Regulation \(EU\) No 600/2014](#)

Level 2:

[Overview and state of play of RTS and ITS relating to MiFID/MiFIR](#)

[ESMA – Policy activities related to MiFID \(II\) and MiFIR](#)

[RTS 2: Transparency requirements for trading venues and investment firms in respect of bonds, structured finance products, emission allowances and derivatives](#)

[Annex to RTS 2](#)

[RTS 27: Best Execution – Reporting criteria](#)

[Annex to RTS 27](#)

[RTS 28: Best Execution – Quality of execution](#)

[Annex to RTS 28](#)

Level 3:

MiFID (II) - Investor Protection:

[Q&A on MiFID \(II\) and Investor Protection](#)

Useful links to the regulation

Level 3:

MiFID (II) MiFIR and Secondary Markets:

[Q&A on MiFID II and MiFIR transparency topics](#)

[Q&A on MiFIR data reporting](#)

[Q&A on MiFID II and MiFIR market structures topics](#)

[MiFID II Transitional Transparency Calculation](#)

[FAQs on MiFID II - Interim Transparency Calculations](#)

Notes & Briefings:

[ESMA Briefing - MiFID II technical data reporting requirements](#) - 16 January 2017 (ESMA00-6-265)

[ESMA Note on MIFID/MIFIR implementation: Delays in the go-live date of certain MIFID provisions](#) - 17 November 2015 (ESMA/2015/1514)

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