Market Structure under MiFID2/MiFIR

Chris Bates
27 January 2016
Agenda

- The new venues
- Systematic internalisation
- “Traded on venue”
- Bias to trading on venue
- Package trades
- Impact on best execution policies
- Corporate market users
- Cross-border business with non-EU clients
New market structure

Key changes:
- New trading venue – OTFs
- SIs wider in scope
- Trading pushed on venue or SI
- Align RM and MTFs

* “trading venues”

Market Structure under MiFID2/MiFIR
The new venue type

- Organised trading facility
  - Non-equities only
  - Trading venue for derivatives
  - Restrictions on proprietary trading/systematic internalisation
  - Need for discretion
  - Physically settled contracts on power and gas
  - C6 energy derivatives (coal, oil)
  - “Traded on venue” – impact on OTC trading

- Prohibition on other multilateral systems
  - Bulletin boards, portfolio compression
  - Agency and matched principal business
Systematic internaliser

“an investment firm which, on an organised, frequent systematic and substantial basis, deals on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system”

Article 4(1)(20) MiFID2
Systematic internalisers: proposed thresholds

<table>
<thead>
<tr>
<th>Frequent and systematic basis threshold (liquid instruments)</th>
<th>Shares, etc.</th>
<th>Bonds</th>
<th>SFPs</th>
<th>Derivatives</th>
<th>Emission allowances</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of own account * OTC transactions/ total no. of transactions in EU in same instrument/class</td>
<td>0.4% and at least once a day</td>
<td>2% to 3% and at least once a week</td>
<td>3% to 5% and at least once a week</td>
<td>2% to 3% and at least once a week</td>
<td>3% to 5% and at least once a week</td>
</tr>
<tr>
<td>Frequent and systematic basis threshold (illiquid instruments)</td>
<td>Minimum own account OTC trading frequency</td>
<td>at least once a week</td>
<td>at least once a week</td>
<td>at least once a week</td>
<td>at least once a week</td>
</tr>
<tr>
<td>Substantial basis threshold (Criteria 1)</td>
<td>Size of own account* OTC trading/firm’s total volume in same instrument/class</td>
<td>15%</td>
<td>25%</td>
<td>30%</td>
<td>25%</td>
</tr>
<tr>
<td>Substantial basis threshold (Criteria 2)</td>
<td>Size of own account* OTC trading/total EU volume in same instrument/class</td>
<td>0.4%</td>
<td>0.5% to 1.5%</td>
<td>1.5% to 3%</td>
<td>0.5% to 1.5%</td>
</tr>
</tbody>
</table>

Source: ESMA technical advice to Commission (December 2014)
Conditions assessed on a quarterly basis based on data from last 6 months. If a firm satisfies both the frequent and systematic basis threshold and the substantial basis threshold (Criteria 1 or 2), then it must comply with SI rules within 2 months.
For shares, etc., bonds and structured finance products (SFPs), conditions are assessed on instrument by instrument basis. For derivatives and emission allowances, they are assessed by reference to the class or type of instrument.
* For shares, the advice only counts trades executed on own account when executing client orders.
## Pre-trade transparency for SIs: Non-equities v equities

<table>
<thead>
<tr>
<th></th>
<th>Non-equities</th>
<th>Equities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Coverage</strong></td>
<td>Bonds, structured finance products, emission allowances and derivatives traded on a trading venue</td>
<td>Shares, depository receipts, ETFs, certificates and other similar financial instruments traded on a trading venue</td>
</tr>
<tr>
<td><strong>Obligations do not apply</strong></td>
<td>Transactions above size specific to the instrument (SSTI)</td>
<td>Transactions above standard market size (SMS)</td>
</tr>
<tr>
<td><strong>Notification to competent authority</strong></td>
<td>Yes, if SI</td>
<td>Yes, if SI</td>
</tr>
<tr>
<td><strong>Liquid classes: quote obligation</strong></td>
<td>If agree to provide a quote to a client, must publish a firm quote (no level 2)</td>
<td>Must publish firm quote on a regular and continuous basis during normal trading hours (as specified by delegated acts)</td>
</tr>
<tr>
<td><strong>Manner of publication</strong></td>
<td>Manner easily accessible to other market participants (no level 2) On a reasonable commercial basis (as specified by delegated acts)</td>
<td>Manner easily accessible to other market participants (as specified by RTS and delegated acts) On a reasonable commercial basis (as specified by delegated acts)</td>
</tr>
<tr>
<td><strong>Non-liquid classes: quote obligation</strong></td>
<td>Must disclose quotes to clients on request, if agree to provide a quote (but obligation may be waived)</td>
<td>Must disclose quotes to clients on request (no provision for waiver of obligation)</td>
</tr>
<tr>
<td><strong>Execution obligation</strong></td>
<td>Must allow other clients to execute against published quotes on published conditions (only liquid classes)</td>
<td>Must execute client orders at quoted prices at time of reception of order (may execute at quote for hits above quote size and below SMS or between quote sizes)</td>
</tr>
<tr>
<td><strong>Price improvement in justified cases</strong></td>
<td>Permitted within a public range close to market conditions (no level 2)</td>
<td>Permitted within a public range close to market conditions (specified by RTS)</td>
</tr>
<tr>
<td><strong>Execution of orders away from quote</strong></td>
<td>No provision</td>
<td>Permitted for professional clients for package transactions and orders subject to conditions other than current market price (as specified by delegated acts)</td>
</tr>
</tbody>
</table>
## Pre-trade transparency for SIs: Non-equities v equities (continued)

<table>
<thead>
<tr>
<th></th>
<th>Non-equities</th>
<th>Equities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Multiple hits</strong></td>
<td>SI may set non-discriminatory and transparent limits on number of transactions with clients against one quote (no level 2)</td>
<td>SI may limit number of transactions with one client at published conditions. May also limit total number of transactions at same time from different clients (where number / volume considerably exceeds norm – as specified by delegated acts).</td>
</tr>
<tr>
<td><strong>Client access to quotes</strong></td>
<td>SI can limit on basis of commercial policy and in objective, non-discriminatory way (must set clear standards on access to quotes)</td>
<td>SI can limit on basis of commercial policy and in objective, non-discriminatory way (must set clear standards on access to quotes)</td>
</tr>
<tr>
<td><strong>Client relationships</strong></td>
<td>SI may accept or end client relationships based on commercial considerations</td>
<td>SI may accept or end client relationships based on commercial considerations</td>
</tr>
<tr>
<td><strong>Quote size</strong></td>
<td>Not restricted</td>
<td>At least 10% of SMS</td>
</tr>
<tr>
<td><strong>Two-way quote required</strong></td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Price quoted</strong></td>
<td>Must reflect prevailing market conditions (no level 2) and must enable compliance with best execution obligation if applicable</td>
<td>Must reflect prevailing market conditions (as specified by RTS) and must comply with best execution obligation when executing orders</td>
</tr>
<tr>
<td><strong>Updating of quotes</strong></td>
<td>Permitted at any time (no level 2)</td>
<td>Permitted at any time (as specified by delegated acts)</td>
</tr>
<tr>
<td><strong>Withdrawal of quotes</strong></td>
<td>Permitted under exceptional market conditions (no level 2)</td>
<td>Permitted under exceptional market conditions (as specified by delegated acts)</td>
</tr>
</tbody>
</table>
Can you trade OTC derivatives in the dark?

**KEY**

- * No OTC for derivatives subject to venue trading obligation
- † If instrument is also traded on a venue
- ** If venue has relevant waiver

SSTI – Size specific to instrument
LIS – Large in scale
OMF – Order management facility
Non-equities pre-trade transparency: Liquid classes (transaction size below SSTI)

- **Systematic Internaliser**
  - SI not obliged to quote
  - But any quote must:
    - meet best execution standards (if applicable); and
    - reflect prevailing market conditions
  - SI may:
    - update quote at any time
    - withdraw quote under exceptional market conditions

- **Requesting client**
  - For execution
  - SI can price improve in justified cases within public range close to market conditions

- **Public**
  - For information (not execution)
  - Quotes must be easily accessible to other market participants on reasonable commercial basis

- **Other clients**
  - For execution (on published terms)
  - SI can establish transparent, non-discriminatory limits on numbers of transactions executed on any quote
  - SI can price improve in justified cases within public range close to market conditions
  - SI can limit client access to quotes by its commercial policy (in objective, non-discriminatory way)
Other rules for SIs

- Permitted trading venue for mandatory trading of shares
- Restrictions on:
  - Operation of SI and OTF in same legal entity
  - OTFs connecting with SIs to enable interaction
- Suspension of trading powers for instruments traded on venues
- Must publish execution quality data
- Post trade transparency discloses “SI” execution
- Transaction reporting
- Obligation to provide reference data
- Restriction on “use” of benchmarks
“Traded on venue”

- Relevant rules
  - Pre- and post-trade transparency
  - Transaction reporting
  - Trading mandate for shares and OTC derivatives
  - Position limit/reporting regime
  - Market abuse regime
  - Restriction on “use” of benchmarks

- Sources of data
  - Venue information under Market Abuse Regulation
  - Reference data under MiFIR

- Application to OTC derivatives
## MTF v SI – RFQs for non-equities

<table>
<thead>
<tr>
<th></th>
<th>MTF</th>
<th>SI: non-equities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Permitted execution venue for OTC derivatives subject to trading mandate</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Obligation to quote</td>
<td>No (subject to algo rules)</td>
<td>No</td>
</tr>
<tr>
<td>Quote can be subject to &quot;last look&quot;</td>
<td>Yes (subject to algo rules)</td>
<td>No?</td>
</tr>
<tr>
<td>Rules regulate the price quoted</td>
<td>No (subject to algo rules)</td>
<td>Yes</td>
</tr>
<tr>
<td>Best execution duties apply</td>
<td>No</td>
<td>Possibly</td>
</tr>
<tr>
<td>Pre-trade transparency:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>■ Quote must be publicly disclosed</td>
<td>Yes (exc. NFCs' hedges)</td>
<td>Yes</td>
</tr>
<tr>
<td>■ Public quote disclosure identifies dealer</td>
<td>No</td>
<td>Yes?</td>
</tr>
<tr>
<td>■ Quote must be made available to other participants/clients for execution</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Corporate or other unregulated entity can access quotes</td>
<td>Restricted</td>
<td>Yes</td>
</tr>
<tr>
<td>Dealer's use of algorithmic trading subject to MTF operator review</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Dealer must comply with rules on direct electronic access</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Responsibility for:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>■ public quote disclosure (pre-trade transparency)</td>
<td>MTF</td>
<td>SI</td>
</tr>
<tr>
<td>■ post-trade transparency</td>
<td></td>
<td></td>
</tr>
<tr>
<td>■ including trade in periodic execution quality reports</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Responsibility for transaction reporting</td>
<td>Dealer</td>
<td>Dealer</td>
</tr>
<tr>
<td>Trades count towards thresholds for SI status</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Assumes that trade size is below SSTI, that there is a liquid market for the instrument and that the instrument is already traded on a trading venue. Additional issues apply in relation to "commodity derivatives" (including inflation swaps) under the position limits and reporting regimes.
Package trades
- Pre-trade obligations for venues and SIs
- Trading mandate for derivatives

Impact on best execution policies
- Availability of pre- and post-trade transparency data
- Execution quality data published by trading venues, SIs and execution venues
- Data on top 5 venues and execution quality published by firms executing client orders

Corporate users of trading venues
- Article 2(1)(d) MiFID2 exemption for firms dealing on own account
- Not available if a member of a venue or have direct electronic access

Impact on cross border business
- EU booking vehicles for cross-border business
- Impact on firm and client behaviour
- Trading on non-EU venues
Questions?
Market Structure under MiFID2/MiFIR