

# MiFID2/MiFIR

## Systematic internalisation of OTC derivatives

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**C L I F F O R D**  
**C H A N C E**

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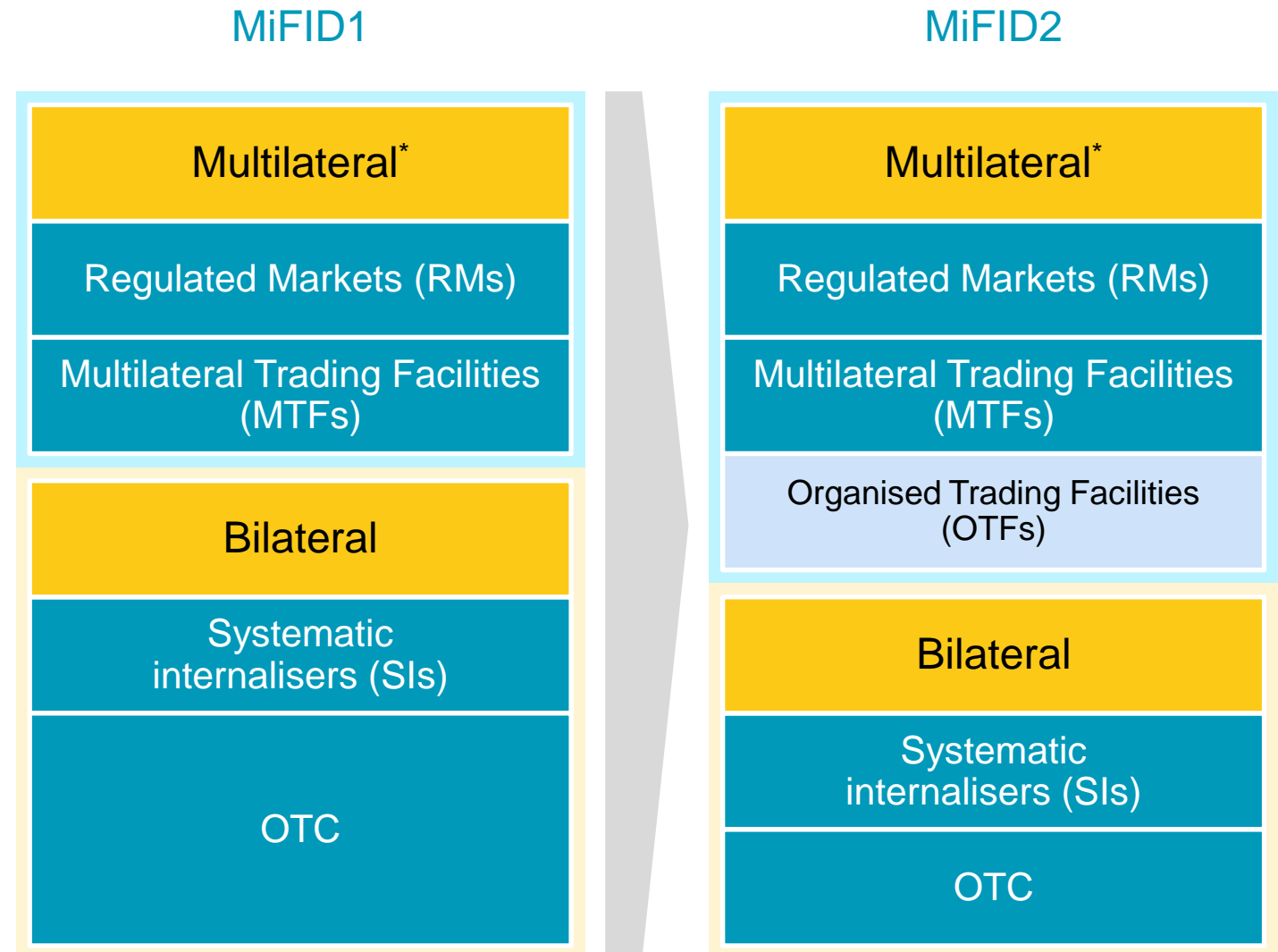
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This document is not intended to be comprehensive or to provide legal advice. For more information contact one of the lawyers below.

# 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"

## 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

# Definition of systematic internaliser

... on an organised, frequent, systematic and substantial basis

“frequent and systematic basis” to be measured by the number of OTC trades in the financial instrument carried out by the investment firm on own account when executing client orders

“substantial basis” to be measured either by:

- The size of the OTC trading carried out by the investment firm in relation to the total trading of the investment firm in a specific financial instrument; or
- The size of the OTC trading carried on by the investment firm in relation to total trading in the EU in a specific financial instrument

Thresholds to be set by delegated acts adopted by the Commission following ESMA technical advice

- But firms can opt in even if they do not cross the threshold

... deals on own account when executing client orders

Definitions in MiFID2:

- Dealing on own account means trading against proprietary capital resulting in the conclusion of transactions in financial instruments
- Execution of orders on behalf of clients means acting to conclude agreements to buy or sell financial instruments on behalf of clients
- Dealing on own account when executing client orders includes firms executing orders from different clients by matching them on matched principal basis (back-to-back trading) – Recital 24 MiFID2

... outside a regulated market, MTF or OTF without operating a multilateral system.

Firms that are SIs must notify their competent authority and ESMA will establish a list of all SIs in the EU (Article 18(4) MiFIR)

# Systematic internalisers: proposed thresholds

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

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 – OTC derivatives (Article 18 MiFIR)

## Scope of obligations

Applies to SIs for derivatives traded on a trading venue where the SI deals in sizes at or below the size specific to the financial instrument (SSTI).

## Obligations for liquid classes of OTC derivatives

**SI must make public firm quotes where SI is prompted for a quote by a client and it agrees to provide a quote**

- Must be made public in a manner easily accessible to other market participants on a reasonable commercial basis
- No obligation to execute with public on the basis of those quotes
- Obligation ceases if pre-trade transparency obligation of trading venue suspended because instrument falls below threshold of liquidity

**However, SI must make those quotes available to its other clients and must undertake to transact with those clients on the quote**

- SI must have clear standards on access to quotes but can decide on basis of commercial policy and in objective and non-discriminatory way which clients get access to quotes and may refuse to or discontinue business relationships on basis of commercial criteria, including credit status, counterparty risk and settlement
- SIs may establish non-discriminatory and transparent limits on the number of transactions they will execute pursuant to a quote

## Obligations for non-liquid classes of OTC derivatives

**SI must disclose quotes to clients on request if they agree to provide a quote (competent authorities can waive in some cases), but no obligation to publish those quotes or make them available for execution to other clients**

# Pre-trade transparency for SIs – OTC derivatives (Article 18 MiFIR) (cont.)

## Obligations with respect to quotes

Quotes for liquid classes of instrument must be “firm quotes”

SIs may update their quotes at any time

SIs may withdraw their quotes “under exceptional market conditions”

Quotes must “reflect prevailing market conditions in relation to prices at which transactions are concluded for the same or similar financial instruments on a trading venue”

Quotes must be such as to ensure that SI complies with its best execution duties, where applicable

SIs may execute orders at a better price than quote “provided that price falls within a public range close to market conditions”

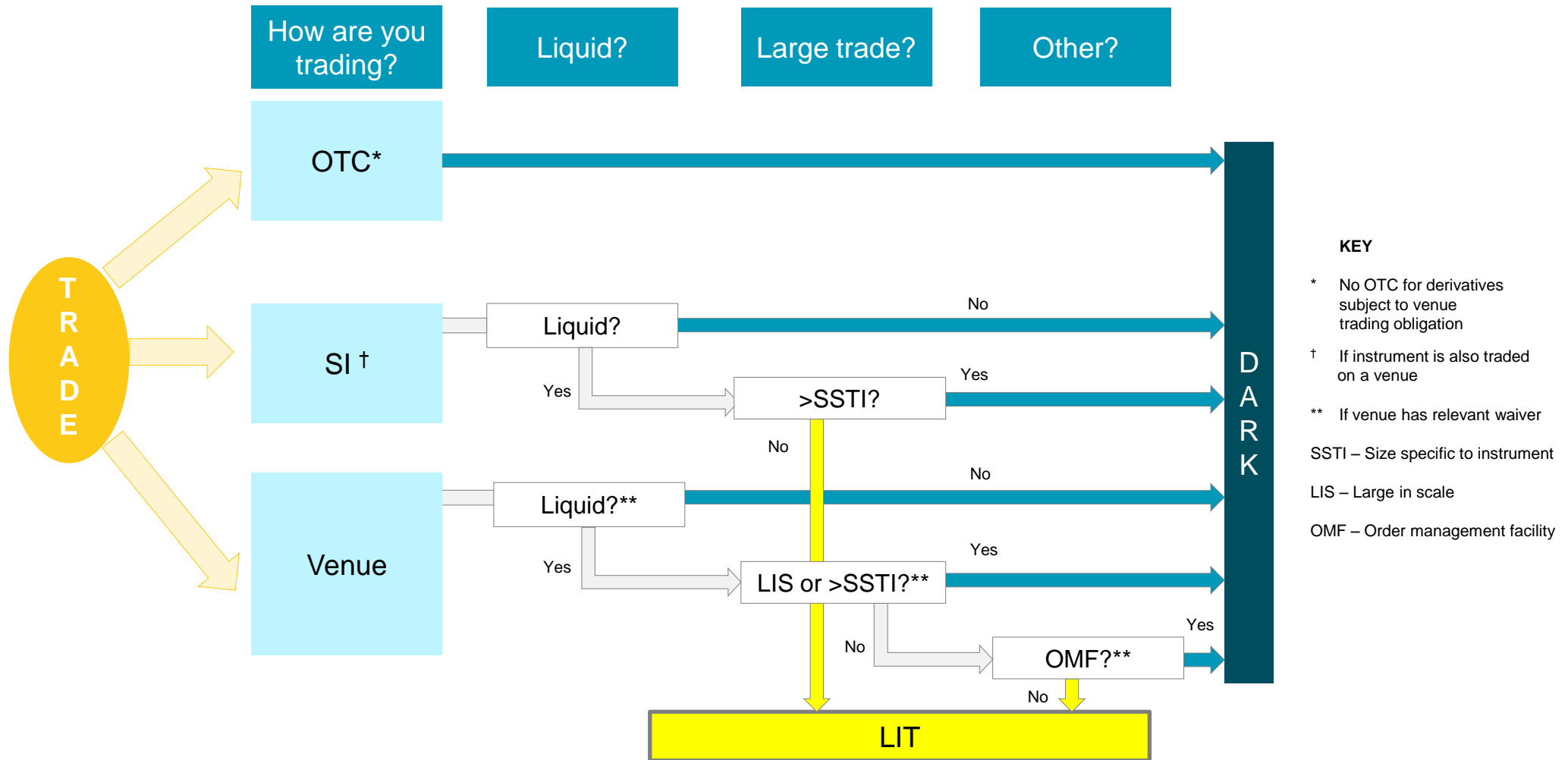
## Level 2 measures

Commission will adopt delegated acts:

- specifying sizes at which SI must enter into transactions with other clients
- Clarifying what constitutes a “reasonable commercial basis” to make quotes public



# 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

Table 11  
Interest rate options – liquid classes

INTEREST RATE OPTIONS - LIQUID CLASSES					
UNDERLYING TYPE	UNDERLYING	TIME TO MATURITY		LIS (€)	SSTI (€)
Interest rate	Three month euro (euribor)	up to	3 months	15,000,000,000	7,500,000,000
Interest rate	Three month euro (euribor)	equal or longer than	3 months	15,000,000,000	7,500,000,000
Interest rate	Three month euro (euribor) 2 year mid-curve	up to	3 months	15,000,000,000	7,500,000,000
Interest rate	Three month euro (euribor) 2 year mid-curve	equal or longer than	3 months	20,000,000,000	10,000,000,000
Interest rate	Three month euro (euribor) 3 year mid-curve	up to	3 months	10,000,000,000	5,000,000,000
Interest rate	Three month euro (euribor) 3 year mid-curve	equal or longer than	3 months	20,000,000,000	10,000,000,000
Interest rate	Three month euro (euribor) mid-curve	up to	3 months	75,000,000	37,500,000
Interest rate	Three month euro (euribor) mid-curve	equal or longer than	3 months	125,000,000	62,500,000
Interest rate	Three month sterling	equal or longer than	3 months	15,000,000,000	7,500,000,000
Interest rate	Three month sterling 2 year mid-curve	up to	3 months	20,000,000,000	10,000,000,000
Interest rate	Three month sterling 2 year mid-curve	equal or longer than	3 months	15,000,000,000	7,500,000,000
Interest rate	Three month sterling 3 year mid-curve	equal or longer than	3 months	15,000,000,000	7,500,000,000
Interest rate	Three month sterling mid-curve	up to	3 months	15,000,000,000	7,500,000,000
Interest rate	Three month sterling mid-curve	equal or longer than	3 months	15,000,000,000	7,500,000,000

Table 12  
Interest rate options – classes not having a liquid market

INTEREST RATE OPTIONS - CLASSES NOT HAVING A LIQUID MARKET	LIS (€)	SSTI (€)
OTHERS	10,000,000	5,000,000

# Systematic internalisers – other relevant rules for OTC derivatives

## Relations with trading venues

The operation of an OTF and an SI cannot take place within the same legal entity (Article 20(4) MiFID2)

An OTF must not connect with an SI in a way that enables orders in an OTF or quotes on an SI to interact (Article 20(4) MiFID2)

Operators of MTFs and OTFs must disclose to competent authority links to or participation by, amongst others, an SI owned by the same investment firm or market operator (Article 18(10) MiFID2)

Where SI trades in the same instrument as is also traded on a trading venue (or derivatives on such an instrument), the competent authority may require it to suspend trading in the instrument where trading is suspended on the trading venue

- If suspension due to suspected market abuse, take over bid or non-disclosure of inside information in contravention of MAR (Articles 32(2) and 52(2) MiFID2)

## Best execution

For shares and OTC derivatives subject to the on venue trading obligations under MiFIR, trading venues and SIs and, for other financial instruments, each execution venue must publish execution quality data (Article 27(3) MiFID2)

- But SIs are not a permitted execution venue for OTC derivatives subject to the trading obligation under MiFIR

## Post-trade transparency and transaction reporting

APAs must make public information reported to them, including where trade executed via SI, the code “SI” (Article 64(2) MiFID2)

SI must provide its competent authority with reference data for financial instruments traded on its systems (Article 27(1) MiFIR)

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