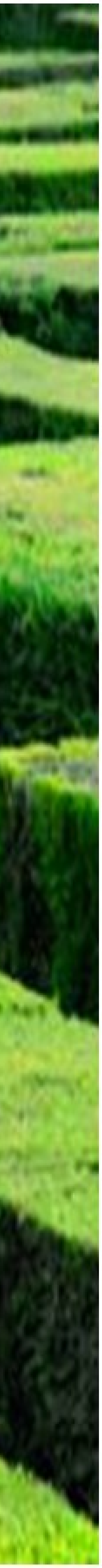
Fixed Income

Pre-Trade Bond Transparency:
Understanding the MiFID II Maze

Rebecca Healey | V13-048 | October 2015 | www.tabbgroup.com



Vision

The world of fixed income trading in Europe is changing – and fast. The European Securities and Markets Authority has now published its Regulatory Technical Standards (RTS) outlining its expectations on how firms should implement MiFID II. While the RTS have yet to be endorsed by the European Commission and are subject to approval by the European Parliament and Council, the regulatory direction is clear: Firms need to make traditionally opaque processes more transparent ahead of trading.

Although regulators have reduced the number of bonds that fall under the liquidity regime (and are therefore subject to pre-trade transparency), establishing the relevant obligation per bond pre-trade will require a wholesale approach by many.
Buy-side firms will now need to embrace automated workflows to ensure they can achieve compliance at point of trade. More automated flow and more data points will equal a reduction in information flow controlled by traditional bilateral trading desks. As a result, fixed income trading will slowly shift to a quasi-agency model from a capital intensive principal-based model.

The fact that the regulation is emerging at the same time as profound change within the European fixed income markets adds to its significance. Whether this is because of, or aside from, European regulation is up for debate; the reality is that the world order axis has already begun to pivot. European investment banks are fighting to keep a seat at the table, realigning capital to ensure they deliver a return on equity; changing both the products and services they are willing to offer their clients, as well as selecting which clients will be the beneficiaries.

As the sell side retracts, evaluating the clients and balance sheets they want to put to best use, buy-side dealing desks will be forced to look elsewhere for trading partners. Investors still need to find and access liquidity, but many fixed income electronic platforms are far from where they need to be. As the disruptors move in, the ability for the buy side to connect instantaneously with new sources of liquidity will challenge traditional fixed income businesses models still further. The winners on the sell side will be those that are lean and nimble, with the ability to create automated, scaleable business models.

Yet automation models based on equities trading will not provide the answers. Here automated processes are built around order facilitation – not order creation. Improving pre-trade information flows could build the potential to trade by unlocking nascent liquidity, as well as the need to focus on TCA and venue analysis for best execution purposes.

The crack in the dominance of traditional fixed income bilateral relationships is now self-evident. As execution ownership shifts to the buy side, how liquidity is formed and trades are executed will continue to evolve, necessitating a change in both the products and services required. Greater transparency in bond markets is under starters' orders and the necessary innovation in technology to support this has only just begun.

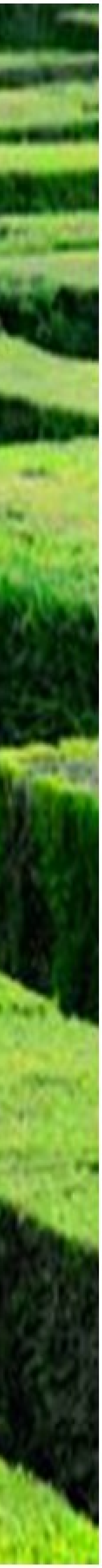
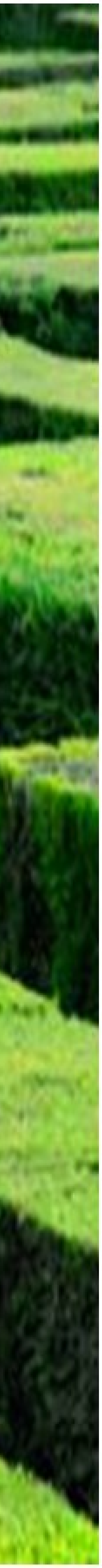


Table of Contents



The Methodology

All roads lead to Rome, or in this case, Brussels. There is no doubt that the main driver is MiFID II, which will fundamentally change every buy side, every sell side, every vendor. However, despite the size (in pages) of the new rules, regulators intend to provide a level of clarity in terms of the methodology. In order to meet the European regulators' demand for pre-trade transparency for bonds, and assuming that available pre-trade waivers have been authorised by NCAs, and implemented by trading venues, participants have three initial criteria to consider:

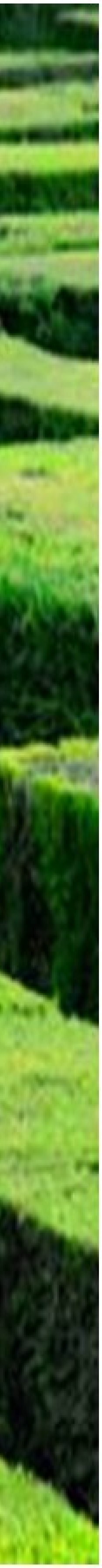
1. Is my bond liquid?

2. In which size am I trading?
    - SSTI (Size Specific to the Instrument) – relevant only for RFQ and voice trading systems
    - LIS (Large in Size) thresholds;

3. How am I trading?
    - Via a Trading Venue (TV) including OTFs, ; or
    - Via a Systematic Internaliser (SI); or
    - Via non SI over-the-counter (OTC) trading.

While this three-pronged approach appears clear cut, the decision process is not static and for many will require a technological upgrade in terms of automation of workflows. Although it is estimated that just four percent of ISIN's will fall under transparency requirements this process has to be reviewed on a quarterly basis.

In addition to the methodology, there are a number of exemptions. Firstly, bond transactions below €100,000 are excluded from any pre-trade transparency thresholds. Also while exchange-traded commodities (ETCs) and exchange-traded notes (ETNs) are considered debt instruments due to their legal structure, they are traded in a similar way to exchange-traded funds (ETFs). Therefore, for consistency, the liquidity of ETCs and ETNs is assessed differently from bonds and in a way similar to ETFs.



Assessing Bond Liquidity

Under the Instrument by Instrument Approach (IBIA) adopted by ESMA, the liquidity status of each bond traded on a European trading venue will be assessed individually on a quarterly basis. Here's how:

- Liquidity will be assessed on trading activity and, initially on issuance size
- When making the liquidity calculation, ESMA will include all European on-venue and OTC trading in the relevant bond during the preceding calendar quarter
- The list of liquid and illiquid bonds will be made available on ESMA's website on the first of February, May, August and November each year.
- The updated liquidity list will start to apply on the 16th of the month in February, May, August, and November for a three month period.

Trading activity thresholds

For all bond types, an individual financial instrument will be considered "illiquid" if it fails to meet one or all of the following three thresholds over the previous quarter:

Exhibit 1: Trading Activity Thresholds

Average daily notional amount (nominal value)	Average daily number of trades	Percentage of days traded over the period considered
€100,000	2	80%

Source: TABB Group

ESMA will publish the first assessment of bonds liquidity on its website by 1 December 2016, based on the reference period 1 August 2016-31 October 2016.

The results of the calculations will apply from 3 January 2017 to 15 May 2017.

While bonds that are admitted to trading or first traded on a trading venue between 1 October 2016 and 2 January 2017 will be considered as illiquid until 15 May 2017.

While the theory is that only 4% of ISINs, predominantly larger sovereigns, will be caught within these thresholds, the risk is that at certain times this will also include corporates. Recent examples of market activity would have included Deutsche Bank, VW and Petrobras, but the liquidity threshold is then applicable for the following quarter, irrespective of the possible decline in market activity.

The Investment Association in the UK has called for a re-calibration of the thresholds to include not only two days traded but with a minimum of five trades per day with at least two principal dealers involved.   Others have taken the view that the introduction of principal dealers would increase the level of complexity still further.

Initial thresholds based on issuance size

For bonds that are admitted to trading or traded on a trading venue during the first two months of the quarter, the initial liquidity assessment will remain valid until the results of the calculation of the calendar quarter are applied.

If the bond is first admitted to trading or traded during the third (last) month of the quarter, the initial liquidity assessment will remain valid until the results of the calculation of the following calendar quarter are applied.

Pending assessment based on trading activity, each individual bond is temporarily considered as not having a liquid market if the issuance size is below the following threshold:

Exhibit 2: Thresholds based on Issuance Size

Bond type	Issuance size
Sovereign bond	Smaller than €1,000,000,000
Other public bond Convertible bond Covered bond, as referred to in article 52(4) of Directive 2009/65/EC Corporate bond	Smaller than €500,000,000
Other bond	Illiquid

Source: TABB Group

Practicalities and Implications

Quarterly assessment of liquidity means that firms will need to check liquidity status on a periodic basis. While this is considered an improvement by the industry given the previous requirement for a consistent recalibration of liquidity, investment will still need to be made in the requisite technology to automate workflows.

Changes in liquidity status from one quarter to another are more likely to affect bonds issued by medium-sized corporates than sovereign bonds. Pricing of such bonds may become more challenging for smaller investment firms that concentrate on niche markets, whereas the larger investment firms typically concentrate on sovereign or other public bonds.

ESMA has produced research illustrating that 80% of the bonds deemed to be liquid in the first quarter of reference considered, and more than 98% of bonds deemed to be illiquid in the first quarter considered, are correctly classified in each quarter[1] However, those figures do not distinguish between sovereign and corporate bonds, which may have different liquidity stability. In addition, uncertainties as to the liquidity status of a bond after the initial issuance size test may also potentially affect pricing.

Static Thresholds ETCs and ETNs

The liquidity of each ETC and ETN is assessed on an annual basis, taking into account EU trading during the period 1st January-31st December. ESMA will publish the results of the calculations on its website by 30th April each year. The results will apply from 1st June.

The first liquidity assessment of ETCs and ETNs will be made public by 3rd July 2016, based on a reference period 1st July 2015-31st December 2015, and will be valid from 3rd January 2017 to 31st May 2018.

Each ETC or ETN will be considered not to have a liquid market if it does not meet one or all of the following thresholds:

Exhibit 3: Liquidity Thresholds for ETCs and ETNs

Bond type	Average Daily Turnover	Average daily number of trades
ETCs	€500,000	10
ETNs	€500,000	10

Source: TABB Group

Those liquidity criteria are the same as those proposed by ESMA in its December 2014 Technical Advice to the Commission for the definition of a liquid ETF.

[1] ESMA Annexe Cost Benefit Analysis, p73

Size Matters

MiFIR establishes that NCAs may waive pre-trade transparency for orders that are above the SSTI or Large in Scale (LIS) thresholds. The pre-trade SSTI and LIS thresholds are higher than the post-trade SSTI and LIS thresholds, except for illiquid instruments.

The pre-trade SSTI and LIS thresholds will be made public by ESMA by 30th April of each year and the results of the calculations will apply from 1st June following publication.

The calculation methodology for the SSTI and LIS thresholds is based on trade percentiles across liquid and illiquid bonds:

Exhibit 4: Pre-trade SSTI and LIS Thresholds for Bonds

Bond type	Pre-trade SSTI	Pre-trade LIS
Liquid and illiquid bonds (except for covered bonds)	60^{th} trade percentile	70^{th} trade percentile
Covered bonds	40^{th} trade percentile	70^{th} trade percentile

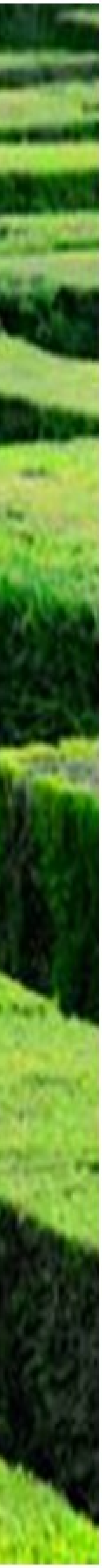
Source: TABB Group

Key Points:

1. **The calculations will be based on all EU trading (on-venue and OTC), excluding trades below €100,000**. Transactions below €100,000 are excluded from the calculation of the SSTI and LIS thresholds as allegedly in ESMA's view the calculation of those thresholds, which are based on trade percentiles, could be biased by a very significant number of retail transactions representing only a small proportion of market volume. The €100,000 threshold is taken from Directive 2010/73/EU (Prospectus Directive) where the distinction between retail and professional investors in terms of investor capacity is set at €100,000. Excluding trades below €100,000 from the calculations establishes an implicit floor for the SSTI and LIS.

2. **Where the number of transactions considered for the calculations is less than 1,000** and in order to avoid arbitrary results, either too high or too low, ESMA has chosen to take the same figure of €100,000 for the SSTI and LIS pre-trade and post-trade thresholds.

3. The first publication of SSTI and LIS pre-trade and post-trade thresholds will be by 3 July 2016, based on a reference period 1st July 2015-31st December 2015, and valid from 3rd January 2017 to 31st May 2018. First publication of calculation results after entry into application of MiFIR is expected by 30th April 2018.



It should be noted when pre-trade transparency is waived for orders above SSTI, RFQ and voice trading systems will nonetheless have to publish some indicative prices.

SSTI AND LIS THRESHOLDS FOR ETCs AND ETNs

The calculation methodology is based on static thresholds.

Exhibit 5: Pre-trade SSTI and LIS Thresholds for ETCs and ETNs

Bond type	Pre-trade SSTI	Pre-trade LIS
Liquid ETCs and ETNs	€1,000,000	€1,000,000
Illiquid ETCs and ETNs	€1,000,000	€1,000,000

Source: TABB Group

The €1,000,000 pre-trade thresholds are identical to the pre-trade LIS threshold for ETFs.

Pre-trade Transparency for Trading Venues

Regulated markets, MTFs and OTFs – collectively "trading venues" – that offer trading in bonds have to meet pre-trade transparency obligations. Systematic internalisers in bonds (including ETCs and ETNs) are subject to a separate set of pre-trade transparency obligations.

On Venue Trading

Trading venues are required to make public bids and offers – and the associated volumes – in bonds admitted to trading or traded on an EU trading venue. This extends to actionable indications of interest (IOIs).

The pre-trade transparency information required to be made public depends on the trading model, such as order-driven or quote-driven trading systems. In particular, RFQ systems have to make public the quotes and the attaching volume from any responding member, which, if accepted, would lead to a transaction under the system's rules.

However, so members or participants who provide quotes to the requester first are not put at a disadvantage, all submitted quotes in response to an RFQ may be published at the same time, but no later than when they become executable, i.e., at the time the requester is able to execute a transaction under the system's rules.

Trading venues that operate a voice trading system have to make public bids and offers and the attaching volumes from any member or participant, which, if accepted, would lead to a transaction under the system's rules.

However NCAs may waive pre-trade transparency obligations for:

- Orders that are large in scale
- Orders held in an order management facility pending disclosure: i.e., the order is sent to the trading venue but not disclosed until the triggering event materializes, e.g., stop orders, hidden/iceberg orders.
- Actionable IOIs on RFQ and voice trading systems that are above pre-trade SSTI. See above for pre-trade SSTI thresholds for bonds other than ETCs and ETNs, and for ETCs and ETNs.

  In that case, the RFQ or voice trading system must make public "at least indicative pre-trade bid and offer prices which are close to the prices of the trading interests advertised through their systems."

To meet this requirement, the RFQ or voice trading system can make public either of

i) the best available price
ii) a simple average of prices or
iii) an average price weighted on the basis of the volume, price, time or number of actionable IOIs.

The trading venue has to make public the calculation methodology and the time of publication when entering and updating pre-trade prices.

- Orders in illiquid bonds (including ETCs and ETNs).

There are no waivers such as the equity pre-trade reference price or negotiated transaction waiver for non-equity instruments under MiFIR. ESMA had no mandate to set out a specific pre-trade transparency regime for orders related to packages.

There is considerable industry disquiet around request for quote (RFQ) transparency protocols. The understanding of the regulation is that if quotes and attached volumes from any member or participants are accepted, as they would lead to a transaction under the system's rules, they are subject to transparency. While all submitted quotes in response to a request for quote may be published at the same time, it is to be no later than when they become executable.

One industry view holds that any RFQ activity below the SSTI threshold will still leave a significant footprint, and with the thresholds so high, it will be easy for firms to establish the direction of trades, thus removing the economic incentive for brokers to provide competitive quotes. Brokers will need to price in higher market risk; also increasing transaction costs. This may also inadvertently increase the prevalence of front running if made public at the point of execution, potentially moving quotes away from the requester.

The Investment Association in the UK favours a different approach whereby individual bids and offers should not be made public on a pre-trade basis or at the point of execution. But bids and offers can be made public on a post-trade basis as a *composite average of prices and volumes* at the point of execution. This protects the original requester's ability to execute at the most competitive quote and ensures an investor's order is not front run.

Pre-Trade Transparency for Systematic Internalisers

A systematic internaliser is an investment firm which, on an organised, frequent, systematic and substantial basis deals in a financial instrument on its own account when executing client orders[2] outside a regulated market, an MTF or an OTF without operating a multilateral trading system.

Trading thresholds have yet to be set by the European Commission to quantify "frequent and systematic" and "substantial." The SI definition applies only when two pre-set limits are both crossed or when the investment firm chooses to opt-in, on an instrument-by-instrument basis.

ESMA delivered its Technical Advice to the EU Commission on those thresholds[3] in December 2014 for all asset classes. They are a complex combination of number and volume of OTC transactions compared either to a firm's overall OTC transactions in that instrument or to the EU's market-wide turnover; criteria and thresholds vary depending on whether the instrument is liquid or not. It is uncertain whether the EU Commission will retain the same thresholds in the upcoming Delegated Act.

For bonds, ESMA proposed to use the following SI criteria at the ISIN level. The assessment would cover the last six months and would be made on a quarterly basis (first working day of January, April, July and October). Newly-issued instruments would be considered when historical data covers at least six weeks.

Exhibit 6: Criteria to establish eligibility for Systematic Internaliser Regime

Frequent and systematic basis threshold (liquid instruments)	Number of transactions executed by the IF on its own account OTC/total number of transactions in that same financial instrument in the EU.	2 to 3% and at least once a week
Frequent and systematic basis threshold (illiquid instruments)	Minimum trading frequency	At least once a week
Substantial basis threshold Criteria 1	Size of OTC trading by the IF in a financial instrument on its own account/total volume in that instrument	25%

[2] A firm may only deal on its own account when executing client orders if it is authorized both for the execution of orders on behalf of clients and for the dealing on its own account investment services.

[3] See ESMA's Technical Advice to the Commission on MiFID II and MiFIR ESMA/2014/1569 p 230-235

	executed by the investment firm.	
Substantial basis threshold Criteria 2	Size of OTC trading by the IF in a financial instrument on its own account/total volume in that instrument in the EU (on-venue + OTC)	0.5% to 1.5%

Source: TABB Group

When an investment firm passes the test, it would have two months to comply with the SI obligations. An investment firm meeting the SI definition/thresholds in at least one financial instrument must register as such with its NCA.

The Obligations

Pre-trade transparency obligations depend on the quoting size and the liquidity of the bond(s) for which the investment firm qualifies as an SI.

When dealing in sizes above the pre-trade SSTI threshold, SIs do not have any pre-trade transparency obligations.

When dealing in sizes below pre-trade SSTI in non-liquid instruments, SIs have to disclose quotes to their clients on request if they agree to provide a quote. However, when the pre-trade transparency obligation is waived by the CA for illiquid instruments (See above 3.1.2 Pre-trade transparency waiver iv), this obligation no longer applies.

When dealing in sizes below the SSTI in liquid instruments, an SI must publish firm quotes with respect to the financial instrument(s) in which it is an SI when it is prompted for a quote by a client and the SI agrees to provide a quote.

Public quotes must be easily accessible to other market participants on a reasonable commercial basis.

A firm’s quotes are to be made available to its other clients but SIs may decide, based on commercial policy and in an objective non-discriminatory way, the clients to whom it gives access to its quotes.

The SI must execute transactions at or below the SSTI under the published conditions with any clients to whom it gives access to its quotes. Quoted prices have to reflect prevailing market conditions for the same or similar financial instruments on a trading venue. Price improvement is permitted “in justified cases” provided the price falls within a public range close to market conditions.

Quotes may be updated and may be withdrawn under exceptional market conditions.

The Exemptions

Transactions entered into by a member of the European System of Central Banks in the performance of monetary, foreign exchange and financial stability policy are not subject to any transparency requirement. Transactions entered into by a member of the ESCB for the management of its own funds, for administrative purposes (staff pension scheme) or for its investment portfolio do not benefit from this exemption.

An NCA responsible for supervising one or more trading venues on which a class of bonds is traded may temporarily suspend pre-trade transparency obligations when there is **a significant decline in liquidity across all venues within the EU for that class of bonds** not due to seasonality. The temporary suspension is valid for an initial period not to exceed three months and may be renewed for further periods of three months at a time. ESMA is expected to issue an opinion on the suspension or renewal of suspension.

For liquid bonds, a significant decline in liquidity is defined as when the total volume traded over the previous 30 calendar days represents less than 40% of the average monthly volume calculated for the 12 full calendar months preceding those 30 calendar days.

For illiquid bonds, a significant decline in liquidity is defined as when the total volume traded over the previous 30 calendar days represented less than 20% of the average monthly volume calculated for the 12 full calendar months preceding those 30 calendar days.

The assessment is to be carried out at the same level of the class of instruments as for determining the liquidity of a class of instruments.

The Road Ahead

Fixed income markets are at the start of a long road. Much has been spoken of the reduction of liquidity in secondary markets, but liquidity is not only declining, it is shifting and market structure needs to adjust as a result.

MiFID II is one in a long line of increasing regulation. From the gradual reduction in market-making activity due to Basel III, MAR and CSDR, sell-side firms are having to reposition their roles. This repositioning is not only due to regulation; firms also need to put their balance sheet to best use to ensure they can deliver the highest return on equity to their investors. As such, they are tiering clients and those left out of the party, (or who choose not to go), are rethinking trading strategies.

The obligation to increase pre-trade transparency may raise more issues than the supposed benefit of increased transparency will solve. While more information and data will be key at the point of trade, the buy-side trader will need to assess the options at each stage of the transaction. Liquid/illiquid, above or below a relevant threshold, each stage will require an assessment of the impact of this new transparency and whether trading strategies will need to be adjusted accordingly.

In addition, sell-side firms required to deliver best execution will need to assess how they alter their own trading behavior. Should client instructions now be bundled together to keep orders at block level to avoid real-time transparency? Will firms target venues or off venues to seek out or avoid systematic internalisers? The reality is the answers are as yet unknown. This is virgin territory with potential headaches to resolve and overcome.

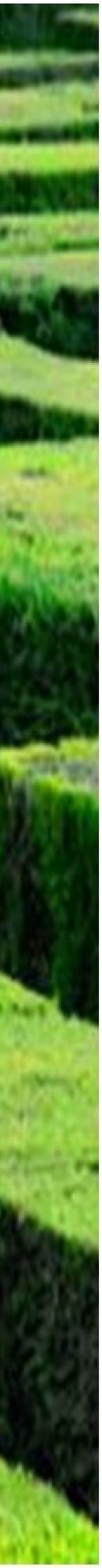
The first step will require improving data flows ahead of trading. There is still much to be done to alleviate concerns around the access and accuracy of the data with which to inform and assess trading decisions.   However greater transparency over data flows does not automatically equate to improved liquidity. Investors will still need to find and access liquidity in continuing challenging environments. As traditional methods close down, new alternative sources to access liquidity need to be found, but many electronic platforms are far from where they need to be to fulfill this need currently. While industry incumbents struggle to adapt to requirements, it may yet take a new disruptor to deliver the amalgamation of liquidity now required.

The current challenges in all-to-all or buy side to buy side models is that most buy-side firms trade the same way. In addition, a growing imbalance in the number of buyers and sellers – as well as the fact that liquidity is concentrating in a smaller range of assets – will all require new approaches to age-old problems. The shift in asset ownership from sell to buy side will underpin the need for the buy side to step up and become price makers as well as price takers to unlock liquidity through order creation. This will create further challenges to workflows, skill sets as well portfolio mandates.

Innovation in fixed income capital markets has only just begun. The tipping point may be transparency requirements or the automation of workflow processes but both of these developments will shift fixed income trading from a capital intensive, principal-based bilateral workflow to a collaborative quasi-agency automated model.

Greater bond transparency can deliver advantages provided fixed income players take this opportunity to enhance equities and FX automation and advance to the next level. Who still remembers Friends Reunited? Just think Facebook, Instagram or Twitter, sometimes being the later adopter can have its distinct advantages.

Disclaimer: This note contains general information on MiFID/MiFIR and on the RTS published by ESMA on 28 September 2015. The information is not legal advice and should not be treated as such. TABB Group accepts no liability for the content of this note, or for the consequences of any actions taken on the basis of the information provided.



About

TABB Group

TABB Group is a financial markets research and strategic advisory firm focused exclusively on capital markets. Founded in 2003 and based on the methodology of first-person knowledge, TABB Group analyzes and quantifies the investing value chain, from the fiduciary and investment manager, to the broker, exchange and custodian. Our goal is to help senior business leaders gain a truer understanding of financial markets issues and trends so they can grow their businesses. TABB Group members are regularly cited in the press and speak at industry conferences. For more information about TABB Group, visit www.tabbgroup.com.

The Author

Rebecca Healey

A recognized thought leader in market structure, regulatory reform and financial trading technology, Rebecca Healey joined TABB in March 2011, bringing over 15 years of direct industry experience in e-trading and financial services. Widely quoted in the financial, business and trade media, she has appeared on TV and radio discussing ongoing changes in capital markets for the *Financial Times, The Wall Street Journal, The Times, DeTelegraaf, Het Financieele Dagblad, IlSore24*, *Handelsblatt, Finanz und Wirtschaft, L'Agefi, Le Monde, Les Echos*, CNBC TV, BBC TV, BBC Radio, Bloomberg and Reuters, among others. In 2012, Rebecca was invited to provide evidence for the UK House of Lords review into electronic trading and regularly contributes to wider debates on regulatory reform.

Rebecca has held various sales and trading positions with Bankers Trust, Goldman Sachs and Credit Suisse, where as vice president she was instrumental in launching the firm's successful Advanced Execution Services product to hedge funds from its inception in 2002 until 2008. Prior to this, she was the first electronic trader at Credit Suisse to be registered for all-electronic European cash equity markets and covered sales trading into Asia and then Europe between 1997 and 2000. She was based in the Middle East from 2008 to 2010, employed by the British Embassy in Bahrain, where she successfully launched the UK government's financial services strategy and set up the Bahrain Financial Services Roundtable, which remains a key source of information for the UK government today, especially in relation to Islamic finance.

Rebecca holds a Bachelor of Arts degree in Spanish and Latin American History and Politics from the University of London.

At TABB Group, Rebecca has authored an expanding catalogue of research papers and commentary covering European equities, FX, fixed income, dark pools, TCA, HFT, FTT, market surveillance, market structure and regulatory reform.

www.tabbgroup.com

New York
+ 1.646.722.7800

Westborough, MA
+ 1.508.836.2031

London
+ 44 (0) 203 207 9477