MiFID Seminar

25 September 2014
Citigroup Centre, London
Welcoming remarks

Simon Lewis OBE, Chief Executive, AFME
Stephen Sanders FCSI, Chair of AFME’s MiFID Steering Committee
Introduction - MiFID Review and steps towards application

Christian Krohn, Managing Director, AFME
1. Rationale for MiFID review
2. Architecture of new regime
3. Key changes agreed so far
4. Steps towards application of new regime
5. AFME engagement
Rationale for MiFID Review

- MiFID I forced more competition between venues and more choice for investors re service providers and financial instruments. But in 2010, EC commenced review of MiFID
- Scheduled review of MiFID I
- Responses to market developments:
  - Benefits of competition have not flowed equally and fragmentation implied by competition has made trading more complex
  - Market and tech developments outpaced aspects of MiFID I, putting at risk, a transparent level playing field between venues and firms
  - Crisis exposed weaknesses in regulation of instruments other than shares traded mostly between professionals.
  - Rapid innovation and growing complexity in instruments underline importance of up-to-date, high levels of investor protection
- Implementing G20 commitment to tackle less regulated and more opaque parts (esp. OTC) of financial system
- Enhancing Single Rule Book: EU committed to minimise discretions for MSs across financial services directives
MiFID I split in two:

• A Regulation (MiFIR) setting out requirements re:
  • Disclosure of trade data to public and transaction data to NCAs
  • Removal of barriers to access to CCPs
  • Mandatory trading of OTC derivatives and equities on venues
  • Provision of services by third country firms without a branch

• A Directive (MiFID II) amending /setting out requirements re:
  • Provision of investment services
  • Scope of exemptions from directive
  • Organisational and business requirements for investment firms
  • Organisational requirements for venues
  • Authorisation and ongoing obligations for providers of data services
  • Rules applicable to third country firms operating via a branch
  • Commodity derivative position limits and reporting
  • Powers available to NCAs
Three years + after EC launched initial consultation to revise MiFID I, the EP, Council and EC agreed L1 texts in Jan 2014. Very broadly, L1 texts are a mixed bag:

- Texts are helpful in some areas, eg provision of liquidity-sensitive transparency requirements for bonds and a regime for third country firms that cf. original proposals maintains more open EU markets.
- Texts fall short in other areas, including curtailment of OTC and dark trading for equities and limits on competition between CCPs and venues.
- Final L1 texts were adopted by EP in April and by Council in May and published in OJ in June
- As a directive, MiFID II must be transposed into national law by MS within two years, whereas MiFIR will have direct effect as a regulation.
- Both MiFID and MiFIR must generally apply by 3 Jan 2017
Steps to application of new regime

- 2.5-year process of developing detail necessary to make L1 provisions operational will present significant challenges to all stakeholders.

- L1 texts envisage ESMA, EC and NCAs using a complex mix of legal instruments (including regulatory and implementing technical standards, delegated acts, guidelines and FAQs) to develop, consult and implement a long list of L2 and L3 measures in a wide range of areas.

- To-do list includes: Calibrating pre and post trade transparency requirements for equities and non-equities; Defining HFT and detailing provisions on DEA users; and Scoping out inducements regime.

- First step towards implementation taken by ESMA with publication in May of a DP. CP covered technical advice to EC for its delegated acts and DP covered areas for ESMA technical standards.

- CP&DP were extensive, covering all MiFID/R areas, including investor protection, trade transparency, and market structure.
<table>
<thead>
<tr>
<th>Year</th>
<th>Jul-Dec</th>
<th>2015</th>
<th>Jun-Dec</th>
<th>2016/Jan</th>
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<tbody>
<tr>
<td><strong>Level 1</strong></td>
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<tr>
<td>2014</td>
<td>Entry into force of Level 1 MiFID/MiFIR</td>
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<td>2016/17</td>
<td>ESMA develops RTS</td>
<td>EC adopts RTS</td>
<td>Latest for publication of Delegated Acts (entry into force 20 days later)</td>
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<tr>
<td><strong>Level 2</strong></td>
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<td>2017</td>
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</table>
Cooperating with like-minded sell- and buy-side associations, AFME has produced a comprehensive response to the DP & CP. Key points included our concerns and counter-suggestions re ESMA proposals:

- to ban use of dealing commission to purchases research
- for inappropriate transparency requirements in fixed income markets
- for overly broad regulation of HFT and duplicative DEA provisions

Following submission of our response, we are re-engaging with ESMA, NCAs, EC and others as responses are digested and technical advice and further consultative materials produced in Q4 of 2014.

To support follow-up effort, we have produced a series of advocacy materials, which at varying levels of detail, highlight, summarise and clarify key aspects of our response.
The use of dealing commission to pay for research

Will Dennis, Managing Director, Compliance, Policy Division, AFME
**Historical background**

- “Soft commission” historically used by asset managers to pay brokers for various services, including corporate access and research.

- Dealing commission at, say, 15bps might be allocated as to 5bps for execution and 10bps for other services.

- FSA chipped away at this practice since 2001 (Myners report) on grounds of conflict of interest, and lack of transparency impacting client best interests.

- FCA says asset managers should meet their “core costs” out of their own P&L.
• Banned use of dealing commission to pay for corporate access
• Permitted use of dealing commission to pay for execution, and for “substantive research”
• Deferred the rest of the debate until MiFID II
“Inducements” are only permitted to be paid for out of commission if they are:

- Minor non-monetary benefits
- Disclosed
- Capable of enhancing quality of service
- Not capable of being judged to impair the ability of asset manager to act in the best interest of clients

Research stated to be a “benefit” and so an inducement; only permitted subject as above, and

- Widely distributed
- Cannot be tailored or bespoke
- However, personalised information or documentation relating to a financial instrument is acceptable

Corporate access not permitted, but some hospitality, conferences are permitted

UCITS, AIFMD to be amended to conform to MiFID
Endorses ESMA position

Would prefer to go further and ban all research from being paid for out of dealing commission

Would apply to FICC research as well as to equity research
• Research is not a benefit nor an inducement, if it is paid for in full, so
  • Commission Sharing Agreements provide a clear and separate contract between manager and broker
  • Contracts between manager and research provider for the provision of research specify a reasonable level of payment

• Thus, the ESMA/FCA position is wrong as a matter of law
  • Confirmed by Freshfields
  • Supported by ESMA Securities and Markets Stakeholder Group
Possible consequences

• Substantial increases in management charges of EU managers, affecting retail and wholesale investors and smaller EU fund managers in particular

• Disincentivising provision of research on EU SMEs, limiting their capacity to access financing and thus affecting growth

• Less diverse research coverage generally, particularly of emerging markets status and of markets not currently in favour

• International inconsistency and competitive disadvantages for EU participants, particularly vis-a-vis US

• Inconsistency with UK Investment Management Strategy
  • “... internationally consistent regulatory standards and that remain responsive”
Bond market pre- and post trade transparency

Sid Ulker, Director, Capital Markets, AFME
How will MiFID/MiFIR impact the fixed income markets?

- Market structure
- Market transparency
- Investor protection
  - Internal controls/governance
  - External controls/reporting
Result of market structure reforms

- Limits on the ways trading can be undertaken
- More regulated trading subject to greater levels of transparency
- Less pure OTC trading
- *More electronic trading?*
Transparency

Pre trade transparency

Post trade transparency

Transaction reporting

Execution of trade
Pre trade transparency – MiFIR Level 1

Multilateral Trading Venues

- Regulated Market
- Multilateral Trading facility
- Organised Trading Facility

- Bids, offers & depth of trading interest made public on a continuous basis
- Calibrated based on trading system (especially for RFQ and voice trading)
- Waivers for instruments no liquid market, SSTI (for RFQ and voice) and LIS
- Indicative prices for illiquid instruments

Bilateral Trading

- Systematic Internaliser
- Over-the-Counter

- Scope: liquid market & venue traded
- Quote must be firm & can be updated
- Must provide the firm quote to all clients if below SSTI
- May price improve
- SI must disclose quote publicly if trade below SSTI
- Disclose prices on request if no liquid market

N/A
Post trade transparency – MiFIR Level 1

**Multilateral Trading Venues**
- Regulated Market
- Multilateral Trading facility
- Organised Trading Facility

**Bilateral Trading**
- Systematic Internaliser
- Over-the-Counter

- Scope: if instrument is traded on a trading venue
- Price, volume and time of transaction published in real time after trade is executed
- Publication can be delayed if illiquid market, SSTI or LIS
- Volume omission/extended time delays permitted
- Publication must take place through an APA
- Multiple CTPs
### ESMA key focus areas – Delegated Acts

<table>
<thead>
<tr>
<th>ESMA task</th>
<th>Impact</th>
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<tbody>
<tr>
<td><strong>SI thresholds</strong></td>
<td>• Whether an investment firm is subject to the SI regime</td>
</tr>
<tr>
<td>• Thresholds for frequent and systematic</td>
<td></td>
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<td>• Thresholds for substantial</td>
<td></td>
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<tr>
<td>• Calculation of thresholds</td>
<td></td>
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<tr>
<td><strong>SSTI threshold for SI pre trade</strong></td>
<td>• SI pre trade regime that applies for a particular trade</td>
</tr>
<tr>
<td>• Calculation</td>
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<tr>
<td>• Thresholds</td>
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## ESMA key focus areas – RTS

<table>
<thead>
<tr>
<th>ESMA task</th>
<th>Impact</th>
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<tbody>
<tr>
<td><strong>Liquidity definition</strong></td>
<td>• Pre trade SI scope</td>
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<tr>
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<td>• Pre trade venue waivers</td>
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<td>• Post trade delays</td>
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<tr>
<td><strong>SSTI and LIS thresholds</strong></td>
<td>• SSTI pre trade SI threshold*</td>
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<tr>
<td></td>
<td>• Pre trade venue waivers</td>
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<td></td>
<td>• Post trade delays</td>
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<tr>
<td><strong>Pre trade regime for venues</strong></td>
<td>• SSTI waiver applicable?</td>
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<tr>
<td></td>
<td>• Pre trade regime calibration</td>
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<td></td>
<td>• Pre trade requirements</td>
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<tr>
<td><strong>Post trade regime</strong></td>
<td>• Details of post trade requirements</td>
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*To be determined under the Delegated Acts
## ESMA proposed SI thresholds

<table>
<thead>
<tr>
<th></th>
<th>Bonds</th>
<th>SFP</th>
<th>Derivatives</th>
<th>Emission Allowances</th>
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</thead>
<tbody>
<tr>
<td><strong>Frequent and systematic (liquid instruments)</strong></td>
<td>2 to 3%</td>
<td>3 to 5%</td>
<td>2 to 4%</td>
<td>TBD</td>
</tr>
<tr>
<td><strong>Frequency and systematic (illiquid instruments)</strong></td>
<td>At least once a week</td>
<td>At least once a week</td>
<td>At least once a week</td>
<td>TBD</td>
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<tr>
<td><strong>Substantial (criteria 1)</strong></td>
<td>25%</td>
<td>30%</td>
<td>25%</td>
<td>TBD</td>
</tr>
<tr>
<td><strong>Substantial (criteria 2)</strong></td>
<td>0.5 to 1.5%</td>
<td>1.5 to 3%</td>
<td>1.5 to 3%</td>
<td>TBD</td>
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</tbody>
</table>

*Number of transactions executed by the firm on own account OTC/total number of transactions in the same financial instrument in the EU

**Size of OTC trading by investment firm in a financial instrument on own account / total turnover in the same financial instrument executed by the investment firm

***Size of OTC trading by investment firm in a financial instrument on own account / total turnover in the same financial instrument in the EU
How is ESMA proposing to define “instruments with a liquid market”?

Liquidity framework

- **Class of instrument level (COFIA) vs. instrument level (IBIA)**
- Parameters: **ADT** vs AVT; **frequency of trades vs minimum number of trading days;** [EOD spread]; [market participants]
- Liquidity of classes determined annually
- Operations?

Liquidity thresholds

- ESMA proposing 6 scenarios
- 240 – 2400 trades a year (i.e. one trade a day to 10 trades a day)
- ADT of EUR 100k to 10mm
- Traded on at least 120-240 trading days
ESMA proposals for LIS and SSTI

- LIS calculated on the basis of **ADT** vs. AVT
- SSTI to be a percentage of LIS
- No specific thresholds proposed yet
- Different thresholds for pre trade vs post trade SSTI/LIS are not proposed
• **RFQ:** “A trading system where a quote or quotes are only provided to a member or participant in response to a request submitted by one or more other members or participants. The requesting member may conclude a transaction by accepting the quote or quotes provided to it on request”

• **Voice trading:** “a trading system where transactions between members are arranged through voice negotiation”

• Actionable indication of interest is when a trading system contains all the necessary information to trade

• **Disclosure requirement:** the bids and offers attaching volumes
ESMA proposed post trade regime

- **Publication details**: inclusion of SI identifier in the publication details/quarterly reports
- **Real time publication**: should be no later than 5 minutes
- **Delays**:

<table>
<thead>
<tr>
<th>Size of transaction</th>
<th>Reporting period</th>
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<tbody>
<tr>
<td>&lt;=SSTI</td>
<td>Realtime</td>
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<tr>
<td>SSTI - LIS</td>
<td>60-120 minutes</td>
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<tr>
<td>&gt;=LIS</td>
<td>120 minutes to EOD</td>
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<td></td>
<td>EOD+1</td>
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</table>
Key challenges with ESMA’s proposals

**Liquidity framework**
- Annual calibration not sufficiently dynamic
- COFIA is not appropriate for bonds
- Thresholds are too low
- No centralised calibration

**Pre trade on venue**
-Disclosure of quotes could create a race to bottom
- Significant consequences if quote with price and volume is actionable

**Post trade**
- SI indicator reveals commercially sensitive information
- Time delays are too short/no volume omission
- Inconsistency between US and EU
- 5 minutes for real time is an operational challenge
Micro-structural issues - scope of HFT regime and requirements for Direct Electronic Access

April Day, Director, Equities Division, AFME
“Trading in financial instruments where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission, with limited or no human intervention. This definition does not include any system that is only used for the purpose of routing orders to one or more trading venues or for the confirmation of orders.”
HFT Level 1 definition

• System determination of order initiation, generating, routing or execution without human intervention for individual trades or orders;

• Infrastructure intended to minimise network and other types of latencies, including at least one of the following facilities for algorithmic order entry: co-location, proximity hosting or high speed direct electronic access; and

• High message intraday rates which constitute orders, quotes or cancellations.
Option 1:

- **The distance between a firm’s server and the trading venue’s matching engine**
  The server on which the algorithms initiate, generate, route, submit, execute, amend or delete messages is directly proximate to the trading venue's matching engine.

- **Connection bandwidth**
  Recognising that trading venues offer higher bandwidths to HFT firms. 10GB would be considered among the fastest currently available.

- **Trading frequency**
  The participant/member has a “high message intraday rates” when at least 2 messages per second are submitted to the trading venue over the trading day.
Option 2:

- The daily lifetime of orders (having been modified or cancelled), and thereafter considering that when the median daily lifetime of the orders (having been modified or cancelled) of one member/participant is shorter than the median daily lifetime of the orders (having been modified or cancelled) in a given trading venue, that member/participant should be considered as HFT.

- Only instruments considered as liquid

Under both option 1 and 2 the identification of an HFT technique is at the member or participant level.
• Authorisation

• Record keeping
  • store in an approved form accurate and time sequenced records of all its placed orders, including cancellations of orders, executed orders, and quotations on trading venues and shall make them available to the NCA upon request
AFME’s position on HFT

• Potential future extrapolation of the definition

• Neither option particularly fit for purpose nor sufficiently targeted

  • Option 1 will require frequent review and will quickly be overtaken by development and proliferation of technology
  • Option 2 allows no certainty to status, and forces an HFT classification even on a slow venue

• AFME proposes the options be combined and that the Option 2 test be the lower of the median time or 500 milliseconds
“In relation to a trading venue, an arrangement where a member or participant of a trading venue permits a person to use its trading code so the person can electronically transmit orders relating to a financial instrument directly to the trading venue. This definition includes such an arrangement whether or not it also involves the use by the person of the infrastructure of the member or participant, or any connecting system provided by the member or participant, to transmit the orders.”
Level 2 Proposal

• To include Automated Order Routing (AOR) systems as defined by IOSCO

• Specifically excludes shared connectivity

AFME proposes

• DEA services are transmitted "directly" and therefore defined as where an order is submitted to a trading venue by the DEA user with the absence of any discretion from the direct member/participant of the trading venue
• Broadly organisational requirements for investment firms follow and formalise the existing ESMA Guidelines on Systems and Controls in an Automated Trading Environment, Feb 2012, but some are new and more prescriptive.

• Regard should be given to the nature, scale and complexity of their business – the proportionality principle.
DEA requirements

- Due Diligence
- Monitoring
- Notify NCA
- Pre-trade Controls
- Trading Venue Controls
Due Diligence

- User Algorithm Analysis
- KYC/Money Laundering
- Governance/Ownership Structure
- User Training/Competency
- Order Entry Access Controls
- Responsibility–Actions/Errors
- User Operational Set-up
- Financial Standing
- Historical Trading
DEA Provision Framework:
- Authorisation of Provider
- Due diligence on User
- Binding provider-user agreement
- Responsibility remaining with provider

Trading Venue Controls

ESMA considering that Venues, where willing, may choose to authorise user

Venue maintains ability to:
- Monitor Orders
- Stop Order
- Suspend/Withdraw DEA to Users
- Review member, or user’s risk control
- Restrict DEA services provision
Closing remarks

Christian Krohn, Managing Director, AFME
Leonardo Arduini, Managing Director, Head of Markets, EMEA, CITI
Annexes
### Annex 1: Glossary

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>ADT</td>
<td>Average Daily Turnover</td>
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<td>APA</td>
<td>Approved Publication Arrangement</td>
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<td>AVT</td>
<td>Average Volume Turnover</td>
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<td>COFIA</td>
<td>Class of Financial Instrument Approach</td>
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<td>CTP</td>
<td>Consolidated Tape Provider</td>
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<td>EOD</td>
<td>End of Day</td>
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<td>IBIA</td>
<td>Instrument by Instrument Approach</td>
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<td>LIS</td>
<td>Large in Scale</td>
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<td>MTF</td>
<td>Multilateral Trading Facility</td>
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<td>OTC</td>
<td>Over-the-Counter</td>
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<tr>
<td>OTF</td>
<td>Organised Trading Facility</td>
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<td>RFQ</td>
<td>Request for Quote</td>
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<td>RM</td>
<td>Regulated Market</td>
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<td>SI</td>
<td>Systematic Internaliser</td>
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<tr>
<td>SSTI</td>
<td>Size Specific to the Instrument</td>
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<td>TBD</td>
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## Annex 2: ESMA’s proposals vs. AFME’s proposals

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<thead>
<tr>
<th></th>
<th>ESMA’s proposals</th>
<th>AFME’s proposals</th>
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</thead>
</table>
| **Liquidity framework**: parameters | - ADT and frequency of trades  
- EOD spread | - ADT and frequency of trades  
- Issue size  
- Spread at snapshots |
| **Liquidity framework**: class vs. instrument approach | - Preference for COFIA | - IBIA |
| **Liquidity framework**: periodicity | - Annual calibration | - Monthly calibration |
| **Liquidity framework**: operations | - Unclear | - Centralised calibration |
| **Liquidity framework**: sub-categorisation | - Not proposed | - Issuance size |
| **Liquidity thresholds** | - 240 – 2400 trades a year (i.e. one trade a day to 10 trades a day)  
- ADT of EUR 100k to 10mm  
- Traded on at least 120-240 trading days | - Issue size EUR >=5bn: 2400 trades a year equivalent & ADT of EUR 250mm  
- Issue size EUR 500mm – 5bn: 960 trades a year equivalent and ADT of EUR 5mm  
- Issue size EUR <=500mm: illiquid |
## ESMA’s proposals vs. AFME’s proposals

<table>
<thead>
<tr>
<th>SSTI &amp; LIS: LIS calculation</th>
<th>ESMA’s proposal</th>
<th>AFME’s proposal</th>
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<tbody>
<tr>
<td></td>
<td>• Preference for ADT</td>
<td>• A risk-based methodology should be applied</td>
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<tr>
<td></td>
<td></td>
<td>• For issue sizes of EUR &gt;=5bn superliquid: EUR 20mm</td>
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<tr>
<td></td>
<td></td>
<td>• For issue size EUR &gt;=5bn, liquid: EUR 10mm</td>
</tr>
<tr>
<td></td>
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<td>• For issue size EUR 500mm-5bn, liquid: EUR 2.5mm</td>
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</table>

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<th>SSTI &amp; LIS: SSTI calculation</th>
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<th>AFME’s proposal</th>
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<tbody>
<tr>
<td></td>
<td>• Percentage of LIS</td>
<td>• A risk-based methodology should be applied</td>
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<tr>
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<td></td>
<td>• For issue sizes of EUR &gt;=5bn, post trade: EUR 1mm</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• For issue sizes of EUR 500mm-5bn, post trade: EUR 500k</td>
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<td>• For pre trade: EUR 150k</td>
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<th>SSTI &amp; LIS: pre trade vs post trade SSTI &amp; LIS</th>
<th>ESMA’s proposal</th>
<th>AFME’s proposal</th>
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</thead>
<tbody>
<tr>
<td>• A difference is not proposed</td>
<td></td>
<td>• Thresholds should be different</td>
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<table>
<thead>
<tr>
<th>SSTI &amp; LIS: liquid vs. illiquid</th>
<th>ESMA’s proposal</th>
<th>AFME’s proposal</th>
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</thead>
<tbody>
<tr>
<td>• No SSTI for illiquid</td>
<td></td>
<td>• SSTI for illiquid should be applied for post trade for issue size EUR &gt;500mm</td>
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<tr>
<td>• No further liquidity differentiation</td>
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<table>
<thead>
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<th>SSTI &amp; LIS: liquidity categories for LIS</th>
<th>ESMA’s proposal</th>
<th>AFME’s proposal</th>
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</thead>
<tbody>
<tr>
<td>• Preference for no additional liquidity categories for LIS</td>
<td></td>
<td>• A superliquid category should be applied for LIS for issue sizes EUR &gt;=5bn</td>
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<tr>
<td></td>
<td>ESMA’s proposal</td>
<td>AFME’s proposal</td>
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<td>--------------------------------</td>
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<td>--------------------------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>Pre trade for venues:</strong> actionable indication of interest</td>
<td>• Actionable indication of interest is when all price and volume information is provided</td>
<td>• Actionable is when indicated as actionable</td>
</tr>
<tr>
<td><strong>Pre trade for venues:</strong> disclosure requirements</td>
<td>• Price and volume of quotes</td>
<td>• Aggregate prices</td>
</tr>
<tr>
<td><strong>Post trade transparency:</strong> information to be made public</td>
<td>• SI identifier&lt;br&gt;• Price, time and size of transaction</td>
<td>• No SI identifier&lt;br&gt;• Price, time and size of transaction</td>
</tr>
<tr>
<td><strong>Post trade transparency:</strong> time delays</td>
<td>• For liquid instruments, price at real time (&lt;SSTI), 60-120 minutes (SSTI-LIS), 120 minutes- EOD (&gt;LIS)&lt;br&gt;• For illiquid instruments, price at EOD+1&lt;br&gt;• Volume at real time (&lt;SSTI), 60-120 minutes (SSTI-LIS), 120 minutes- EOD (&gt;LIS) and EOD+1 (illiquid)</td>
<td>• For liquid instruments, price at real time (&lt;SSTI), 60 minutes (SSTI-LIS), 120 minutes (&gt;LIS)&lt;br&gt;• For illiquid instruments, price at EOD+1, except issue sizes &gt;500mm where &lt;=SSTI is real time&lt;br&gt;• Volume at real time where &lt;=SSTI, 60 minutes where SSTI-LIS, and 6-12 months where &gt;LIS</td>
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<td><strong>Post trade transparency:</strong> definition of real time</td>
<td>• Up to 5 minutes</td>
<td>• Up to 15 minutes</td>
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The Association for Financial Markets in Europe advocates stable, competitive and sustainable European financial markets that support economic growth and benefit society.

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