afme/ Finance for Europe

Association for Financial Markets in Europe

Briefing note

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MiFID II and fixed income transparency

Overview

AFME fully supports the MiFID II proposal to extend public price transparency requirements to the secondary market for bonds and structured finance products. Transparency, in the form of the publication of post-trade details and pre-trade indicative quotes, has important benefits such as improved price discovery and price formation. There are however certain risks, which can lead to increased transaction costs for investors and increased borrowing costs for issuers.

This note summarises the views and concerns of participants in the fixed income markets regarding the MiFID II requirements, which are currently being discussed in the Council. It is composed of four sections. The first section focuses on concerns that apply to both pre- and post-trade transparency, while the second section focuses on concerns that are unique to post trade transparency requirements. The third section is about pre-trade transparency for market makers and the fourth on pre-trade transparency for brokers and venues. **A summary of AFME's recommendations is provided on page 6**. Lastly, the note describes the estimated timeline of the regulatory process and provides a table that compares the views of the European Parliament, Council and Commission on key elements of the regulation.

AFME's position

Pre- and post-trade transparency

Definition of liquidity [MiFIR Article 2(7a), Council text]

MIFIR enables competent authorities to authorise deferred publication or grant waivers from the transparency requirements based on the liquidity of the security. We fully support the introduction of the concept of 'liquidity'. However, we believe that ***the parameters for setting the liquidity thresholds should not be defined in an exhaustive manner at level 1 and should not be defined without technical analysis. Technical aspects should be specified by ESMA in level 2 implementing measures after a detailed analysis.***

As an example of this, the Council text introduces parameters of liquidity that, as our analysis[1] demonstrates, are insufficient for a correct measurement of this concept. **Concepts such as the total volume traded in a security and its issue size are critical elements of a proper definition.** ***We therefore recommend adding these as parameters for liquidity.***

Another example is the introduction in the Council text of liquidity parameters that are based on 'averages'. An average is a specific mathematical term that could raise problems when introduced without undertaking a technical analysis. Firstly, liquidity is not a static concept; it varies over time. Liquidity can drop rapidly due to a sudden change in market circumstances and in times of high volatility. An 'average' would be ineffective at detecting the full extent of liquidity events.

[1] See AFME's analysis of fixed income trading activity in the context of MiFID II

Furthermore, averaging creates distortions when there is a wide range of trade sizes[2], where an instrument has a very low turnover and where there is a small proportion of extremely large trades (e.g. where 1% of trades are greater than €100m and 99% are less than €2m). ***We therefore advise against confining the parameters to averages only.***

The need for a dynamic calibration, a central calibrating entity and a phased implementation

Currently, MIFIR does not stipulate that the non-equity transparency requirements should be calibrated in a dynamic way by a central entity. We believe that these are essential features of a properly configured transparency regime that is a consistent, predictable and harmonised across Europe.

We are concerned by the introduction of the new Article 20b in the Council MiFIR text, which allows national Competent Authorities (CAs) to require trade data for the purpose of carrying out the calibration of the transparency requirements at the national level. This insertion indicates a preference for a fragmented approach, where each CA performs the calibration for instruments issued within in their jurisdictions. We strongly advise against such an approach. The infrastructure needed to support multiple CAs identifying the securities in scope and collecting trade data and producing a dynamic calibration, would need to be very complex, would produce poor data quality, and could create confusion and asymmetry of information in the markets.

We believe that a centralised approach is necessary to appropriately implement and maintain the transparency regime. AFME has, as part of its cross-industry transparency initiative, defined an optimal set of features for the central calibrating entity: its role, business model, governance, costs and technology. A single European entity should perform the following functions: (i) produce and maintain a list of the instruments that are within scope; (ii) collect trade data to produce the results of the transparency calibrations; and (iii) produce the calibration of those instruments using the trade data. These functions do not have to be undertaken by ESMA; they could be outsourced to an independent entity subject to ESMA oversight. For example, the US has a single calibrator (FINRA), which outsources its technology functions to the commercial provider (NASDAQ). At level 1, ***we recommend that legislators grant sufficient powers to the EC and ESMA to set up the appropriate pan-European infrastructure to enable an efficient implementation and ongoing operation of the MiFID II non-equities transparency requirements.***

Finally, as recommended by the EC, we believe that a phased implementation is critical to ensure the minimal adverse impact on liquidity. This technical aspect should be specified by ESMA in the level 2 implementing measures, following a detailed technical analysis. ***We therefore recommend that legislators grant, in the level 1 text, sufficient powers to ESMA to design the necessary conditions for phasing-in the transparency requirements***.

Process for granting waivers or suspensions from pre-trade transparency [MIFIR Article 8(2) and (4)] and the temporary suspension from post-trade transparency [MiFIR article 10(2)].

MIFIR enables competent authorities to grant waivers from pre-trade transparency for venues or, as mentioned in the latest versions of the Presidency text, to allow temporary suspensions from both the pre- and the post-trade transparency requirements based on the liquidity of the security. However, for the waivers there is a three-month notification period per ISIN, subject to individual ESMA opinions. Furthermore, for every ISIN, a suspension has to be renewed every three months. We welcome the introduction in MIFIR of the possibility to suspend a security from the requirements. However, given the many hundreds of thousands of ISINS in Europe, the proposed procedures are not workable in practice. ***We therefore reiterate our recommendation above for a dynamic calibration performed by a central calibrating entity.***

[2] See page 28 of the AFME's analysis of fixed income trading activity in the context of MiFID II.

Post-trade transparency

We support the EC's objective to increase transparency through post-trade reporting, including the proposal to publish post-trade information as close to real time as possible subject to the appropriate calibration for less liquid trades and large trade sizes. Over the last two years, AFME has led an initiative for investors, dealers, trading venues, data vendors and issuers to develop an industry-designed transparency framework for fixed income cash bonds. Through its work, AFME has identified the following critical recommendations in relation to the level 1 text on non-equities post trade transparency:

Volume omission [MiFIR Article 10(3) and 20(3) Council text]

According to the latest version of the Council text, when a transaction is made public (either immediately or after a deferral), the trade size or 'volume' should be revealed in full. The text enables the temporary omission of the volume of certain transactions; however, the volume must be published after an extended deferral period.

AFME believes that the compromise proposed by the Irish Presidency could be workable if 'extended delay' in the final ESMA technical guidance is long enough and is in generic terms. We stress that our strong preference would be for indefinite volume omission to be reinstated as proposed by the Commission. Indefinite volume omission makes it easier for a dealer to hedge and it reduces the time delays that are needed before publication of the trade information. To be specific, as trade sizes increase and/or liquidity of an instrument decreases, hedging of risk becomes more difficult. Therefore, the time the market maker will require for hedging will increase. Importantly, pre-determining the exact length of time the market maker will require for such trades will become more difficult, if not impossible. Indefinite volume omission therefore limits the risk exposure of the market maker for these transactions. Nonetheless, if the extended delay was of such a length that it could be safely assumed that the market maker could always hedge himself for large trades and illiquid instruments, then the proposed compromise could work.

It is therefore essential that the resulting "extended time delay" is set in generic terms; this would mean that there wouldn't be a specific "extended period" for each individual type of transaction or instrument (e.g. the extended time period would be generally set to one year, six months or whatever time period is fit for purpose). As explained above, for certain illiquid bonds and/or large sizes, it is impossible to predict the time required for hedging and it is important to avoid adding an extra layer of complexity to the transparency model.

Reference to 'normal' trade sizes [(MiFIR Article 10(1), Commission & Parliament texts]

As mentioned above, it is essential that there are appropriate time deferrals for the public reporting of trade sizes, dependent on the length of time required for the market maker to hedge their risk. Currently, the Commission and Parliament propose to only allow time deferrals for trades that are larger than 'normal' trade sizes. The fixed income market is a heterogeneous market, consisting of large and small trades dependent on the instrument and counterparties. Therefore, the concept of a 'normal' trade size for fixed income is deceptive. In addition, if a trade size is below the "normal" size for the instrument, it may not mean that the market maker does not have risk to hedge; this is especially the case for a market which is infrequently traded in large volumes (e.g. if an instrument of issue size of €600m trades five times in a month in sizes of €50m, the normal trade size is €50m). However, this would not mean trade sizes below €50m, e.g. €30mm, would not require time for the market maker to hedge his risk. Therefore, the concept of a "normal" or "standard" or "usual" trade size for fixed income is not appropriate. Further, as the fixed market is heterogeneous, defining "normal" trade sizes at group level is also not appropriate.

As recognised by the pre-trade transparency waivers and by article 10(1)(c) of the Council text, deferrals should be based on sizes that are "above a size specific to the instrument,

which would expose liquidity providers to undue risk and takes into account whether the relevant market participants are retail or wholesale". This ensures a consistent approach to transparency with minimal impact on liquidity provision.

Pre-trade transparency for market makers

Firm quoting obligations and disclosure requirements for investment firms (MiFIR Article 17)

According to the Commission's proposal, all quotes that market makers agree to provide must be firm. These quotes must be disclosed to other clients. Market makers are also obligated to transact on such quotes with other clients when the ticket is below a certain size. These quotes are to be publicly disseminated.

Market participants have expressed several concerns regarding the Commission's proposal:

- The requirements do not enable market makers to determine whether or not to share the quote with other clients based on legitimate commercial considerations. If investment firms were obliged to trade with any other client under the same conditions, they would quote prices based on the 'worst' client to the detriment of other clients' best execution.
- The obligation to share quotes with the entire pool of clients would increase the risk of a third party taking contrary positions in the market before the dealer has been able to hedge himself (the so-called 'winner's curse'). The increase in risk will be incorporated in transaction costs and ultimately be reflected in the borrowing costs that are incurred by governments and companies.
- For the same reason, it is critical that the thresholds for the public disclosure of quotes are targeted to the retail markets, so as not to damage the functioning of the wholesale markets.
- If indicative quotes were made binding, market makers would be unable to adjust prices to all market circumstances. Hence, they would be more reluctant to quote prices in times of market stress. They would also be unable to improve on a quote, thereby hindering best execution.

The Council introduced several changes which address the above concerns. The Council text limits the requirements to transactions below a certain size specific to the instrument. Also, the Council draft explicitly limits the requirements to trades in liquid instruments and introduces an obligation for market makers dealing in illiquid instruments to disclose quotes upon clients' requests. Finally, market makers are allowed to refuse to enter or discontinue business relationships with clients on the basis of commercial considerations. Although these changes are certainly positive, several important concerns remain.

Quoting obligation for illiquid instruments [MiFIR Article 17(1)]

The latest Council text introduces an obligation for market makers to provide quotes on illiquid instruments on a clients' request. It is unclear whether these quotes should be firm or not. In the case where a market maker would be forced to provide a firm quote in an illiquid bond, his risk profile would increase significantly which would have an adverse effect on the market. In the case where the quote should be indicative, it still raises the question of how this requirement will contribute to price formation. If a market maker is forced to provide an indicative quote in an illiquid bond that he is not willing to trade, the price information will be meaningless to the investor. ***We therefore believe that the requirement to disclose a quote on an illiquid bond to an investor should be removed from the text.***

Obligation to publish firm quotes [(MiFIR Article 17(1)]

We note that in article 17 (1), the Council amended the obligation to 'provide' firm quotes proposed by the Commission and aligned the wording with the requirement for equities SI's (article 14.1). The new article 17(1) states that SI's shall 'make firm quotes public'. It is unclear what this obligation would entail and how it differs from the obligation to 'make available firm quotes' under article 17(2). ***To avoid confusion, we suggest reverting to the original 'provide' wording as proposed by the Commission in Article 17(1).***

Ability to update, withdraw and improve quotes [Article 17(1b), EP text)]

We note that article 17 offers no ability for SIs to update or remove quotes. Updating or removing quotes is important to enable SIs to react to changing market conditions or to correct technical errors. It is also still unclear whether SIs will have the flexibility to improve their price to ensure investors' best execution. ***We recommend that the Council follow the Parliament's approach, allowing flexibility to update and withdraw quotes (MiFIR Article 17(1b), EP text).***

Pre-trade transparency for brokers and venues (MiFIR Articles 7 and 8)

Obligation to publish continuous quotes upon which multiple parties can act (MiFIR Article 7)

The Commission proposal includes a requirement that brokers and trading venues should publish quotes on a continuous basis upon which multiple parties can act. Market participants have been concerned that the obligation would make voice broking activities no longer possible. It was also unclear as to whether RFQ trading methods would still be allowed. The main developments in both the Council and European Parliament texts have been the following:

- Both the Council and the Parliament limit the requirements to liquid instruments only. However, the Council still requires publish indicative quotes for illiquid instruments. AFME has a strong preference for the Parliament's text.
- The Council introduces waivers for RFQ and voice trades. However, waivers will only be granted for trades above a certain size.
- Both the Council and the Parliament introduce a system, whereby Competent Authorities can allow a temporary suspension from the requirements when the liquidity of an instrument suddenly drops. However, the procedure for allowing the suspension is based on a three-month notification period per ISIN subject to individual ESMA opinions (in this respect we reiterate our recommendation for a dynamic calibration performed by a central calibrating entity, see page 2).

In general, the provisions appear to be moving in the right direction given the link to the liquidity of the instrument and a number of waivers supporting the non-equity market models. However, we still have important concerns.

Waivers (MiFIR Article 8(1)): We broadly support the latest Presidency compromise in respect of waivers, which continues to recognise the range of trading models that support the non-equity markets. However, with respect to the accommodation of voice and Request For Quote (RFQ) functionality, we oppose the introduction of a size threshold to allow waivers for RFQ and voice trading systems. The vast majority of non-equity instruments are traded on an RFQ basis regardless of their size. We also believe that this would add an element of uncertainty as to whether or not a quote on a certain instrument will be subject to a waiver. ***We therefore recommend reverting back to the wording proposed by the former presidency, which allows waivers for request-for-quote and voice trading systems without any size thresholds.***

MiFID II regulatory process

- On 26 October 2012, the European Parliament plenary adopted the ECON[3] motions on MiFID and MiFIR with the support of a strong majority of MEPs. They voted to refer the reports back to ECON so that trialogue negotiations with the Council and Commission can begin as soon as the Council reaches a compromise amongst Member States.
- Progress in Council has been very slow with Member States to date unable to reach agreement in a number of key areas. As a consequence, the MiFID file has passed from the Cyprus Presidency to Ireland which aims to finalise the Council's negotiating position by June 2013. On that basis and the likely differing positions of the Council, Parliament and Commission, the trilogue negotiations are expected to occupy the second half of 2013:
    - The trialogue is now likely to begin in Q3 2013
    - Earliest political agreement expected by Q1 2014
    - Level 2 implementation measures expected to begin in 2H 2014
    - Full implementation expected in 1H 2016

AFME recommendations

1. *Phasing in of both the pre- and post-trade transparency regimes is critical to ensure minimal adverse impacts. We therefore recommend that legislators grant in the level 1 text sufficient discretion to ESMA to determine the conditions for phasing-in the transparency requirements.*
2. *The parameters [MiFIR Article 2(7a); Council text] and procedures for assessing liquidity threshold should be dynamic, consistent across the EU and defined following appropriate technical analysis. We therefore recommend that legislators grant in the level 1 text sufficient powers to ESMA to design the necessary pan-European infrastructure, including a central calibrating entity, along with the appropriate parameters and procedures for assessing liquidity thresholds.*
3. *As recognised by the pre-trade transparency articles [MiFIR Article 8(1)(b) and article 17(3) and (7); Council text], deferrals from post-trade publication should also be based on sizes that are "above a size specific to the instrument, which would expose liquidity providers to undue risk and takes into account whether the relevant market participants are retail or wholesale".*
4. *We believe that illiquid instruments should be exempted from the regime for Systematic Internalisers under MiFIR Article 17; we therefore recommend the removal of MiFIR article 17(1), final paragraph.*
5. *We recommend that the Council follows the Parliament's approach, allowing flexibility to update and withdraw quotes (MiFIR Article 17(1b), EP text).*
6. *The vast majority of non-equity instruments are traded on an RFQ basis regardless of their size. We therefore recommend reverting to the wording proposed by the former presidency allowing waivers for request-for-quote and voice trading systems without any size thresholds.*

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[3] The ECON is a committee at the European Parliament. As the great majority of Parliament's work is conducted at the Committee level, it is the ECON that does the bulk of the Parliamentary work on key economic and monetary policy areas.