
Briefing note

January 2013

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 7.** 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)]

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 analysis¹ 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 sudden 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 distribution 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.***

Operational aspects: the need for a dynamic calibration, a central calibrating entity and a phased implementation

Currently, MIFIR art. 10 does not specifically stipulate that the procedure for deferrals should be *dynamic*. **To account for a decrease or increase in liquidity of an asset over time, it is important that the need for a *dynamic* calibration is reflected in the regulation.** Liquidity generally changes over the term of a bond. Also, events may cause liquidity to change. An example of this is how the liquidity of Spanish government bonds changes by the week (or even by the day), depending on developments in the Eurozone crisis. Extensive research of the AFME cross-industry transparency initiative points to an optimal calculation interval of one month. To ensure an optimal calibration process that takes account of all relevant elements, requirements should charge ESMA to establish the exact procedure in technical standards.

Secondly, **the calibration should be produced by a central calibrating entity at European market wide level.** First, this guarantees that the process for identifying and maintaining the list of securities within scope of the requirements is robust. This is important as the publication requirements will apply to many hundreds of thousands different fixed income securities. Second, it collects and centralises all EU market data to produce calibration at instrument level. Third, it makes the calibration requirements for each instrument available to all market participants ensuring that there is no asymmetry of information. Fourth, it enables authorities to operationalise the calibration requirements by granting waivers/delays based on an assessment that takes into account the entire EU market, at regular intervals and in a timely fashion. Fifth, the single calibrating entity complements a competitive APA regime. Sixth, centralising data collection and calibration ensures optimum data quality (e.g. preventing duplicative reporting). This will ultimately ensure a consistent, predictable and harmonized approach in Europe.

AFME, as part of its cross-industry transparency initiative, has defined an optimal set of features for the central calibrating entity. This includes suggestions for its role, business model, governance, costs and technological capabilities. The calibrator operates in an environment with multiple APA's as suggested by the Commission. These features could be developed and confirmed by the EC and ESMA in level 2 legislation.

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

^[2] This trend for fixed income is exhibited in '[AFME's analysis of fixed income trading activity in the context of MiFID II](#)'.

ESMA opinions². Furthermore, for every ISIN a suspension has to be renewed every 3 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 from section 1 of this document for a dynamic calibration performed by a central calibrating entity.***

Post-trade transparency (MiFIR article 10 and 20)

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 of 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)]

According to the new draft of articles 10 (3) and 20 (3) MIFIR, when a transaction is made public (either immediately or after a deferral), the trade size or 'volume' should always be revealed in full. Specifically, the recent text from the Presidency enables volume omission within the period of deferral; however, the volume must be published after the deferral period. Therefore it is no longer possible to publish a transaction while omitting its volume.

We have several concerns regarding the removal of the possibility of permanently omitting the volume of a transaction. First, market makers would be less willing to commit capital to facilitate clients' trades; second, this situation will be further exacerbated in period of market stress; third, as a result, issuers will find it more difficult to raise financing by issuing debt; fourth, a time delay calibration reflecting the risks of all trades and instruments would be complex and impractical; fifth, European standards for post trade transparency would not be aligned with global standards.

Market makers would be less willing to commit capital

Under a regime with mandated post trade transparency without indefinite volume omission, market makers would have a predetermined set period of time to hedge their risk prior to publication of the trade volume (i.e. the time delay). If the market maker failed to hedge their risk in that time, other market participants could take contrarian positions ("winner's curse"). Therefore, ensuring market makers have sufficient time to hedge the risk associated with the trade is essential. As trade sizes increase and/or the liquidity of the instrument decreases, hedging of risk becomes more difficult; therefore, the time the market maker will require for hedging will increase and pre determining the exact length of time he will require for such trades will become more difficult, if not impossible. Preventing indefinite volume omission would put the market maker at constant risk of being unable to hedge his risk in the predetermined time period and therefore would result in market makers becoming less willing to commit capital to facilitate clients' trades, especially wholesale trades, which make up 95% of the fixed income market³.

It would cause procyclicality during periods of market stress

The aforementioned impact will be exacerbated during periods of market stress when the liquidity of the secondary market decreases: due to the risks associated with less liquid assets and the lack of volume omission, market makers will become even less willing to commit capital, further reducing the liquidity of the market. Therefore, the removal of volume omission could

² See procedure for granting waivers & temporary suspension [MiFIR Article 8(2) and (4)].

³ See TABB report on [MiFID II and fixed income transparency](#).

cause continuously diminishing secondary market liquidity in periods of stress, thereby procyclicality.

Issuers will find it more difficult to raise financing by issuing debt

The removal of indefinite volume omission will result in market makers becoming less willing to commit capital to the detriment of the ability of investors to enter/exit positions. Also, the exact amounts invested by investors following issuance of a bond will become known to the market. The ultimate result of these effects will be that investors will refuse to buy issues in a meaningful size and therefore, issuers (including governments and corporates) will find it more difficult to raise financing through the debt capital markets. Further, where the market maker does decide to facilitate a trade, due to the additional risks described above, the market maker will price the risk into the transaction costs, which will ultimately cause institutional investors to demand higher yields from issuers or will they will simply refuse to purchase issues.

A time delay calibration reflecting the risks of all trades and instruments would be too complex

The fixed income market is highly heterogeneous and comprises of hundreds of thousands of bonds in Europe alone. Therefore, a calibration without volume omission would need to be highly complex, extremely impractical and very difficult, if not impossible to develop. Pre determining the exact time required for hedging for each trade within fixed income is particularly difficult, if not near impossible for larger trades and trades in less liquid instruments.

European standards for post trade transparency would not be aligned with global standards

Fixed income post trade transparency practices like those in the United States (the 'TRACE' regime) already include provisions for indefinite volume omission and the post-trade reporting requirements under Dodd-Frank for derivatives. If all volumes had to be made public in Europe, market makers would be subject to significantly more onerous requirements than in the US; this would create greater fragmentation of the markets at global level and could have unintended consequences for Europe.

We therefore recommend reinstating indefinite volume omission as originally drafted by the EC, allowing for the omission of the actual trade volume even after the deferral time period has lapsed and trade prices are published.

Reference to 'normal' trade sizes [(MiFIR Article 10(1a))]

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 Council text proposes to only allow time deferrals for sizes 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 articles [MiFIR Article 8(1)(b) and article 17(3 and 7)] time 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 (MiFIR Article 17)

Firm quoting obligations and disclosure requirements for investment firms

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 Presidency introduced several changes. 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 some of these changes are certainly positive, several important concerns remain.

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

We are concerned that this proposed requirement introduces a more stringent regime for illiquid instruments than for liquid instruments. Presently, for liquid instruments, SIs are only obliged to provide a quote to a client when they agree to do so. According to the latest Presidency proposal, quotes in illiquid instruments must now be disclosed to a client even when the SI does not agree. It is unclear whether these quotes should be firm or not. In case a market maker would be forced to provide a firm quote in an illiquid bond, his risk profile will increase significantly which will have an adverse effect on the market. In case the quote should be indicative, it still raises the question why the regime is more stringent for illiquid than for liquid bonds. 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 art 17 (1), the Council amended the obligation to 'provide' firm quotes proposed by the Commission and aligned the wording with the requirement for equities SIs (article 14.1). The new article 17(1) states that SIs 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 art 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 public indicative quotes for illiquid instruments.
- 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 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.

Indicative Prices (MiFIR Article 7(3)): We note the proposed requirement for venues to provide indicative prices on a continuous basis and through electronic means for instruments that are subject to waivers. This will severely hamper voice broking activities in instruments that, due to their illiquidity or size, are only traded via voice. While we agree with the objective to maximize pre-trade transparency, we are concerned that this requirement will curtail the ability of venues to offer many of the less liquid products. Enhanced transparency, particularly for many of the bespoke non-equities products, is likely to be of limited use to investors given the very specific characteristics of the trade. For such instruments, post-trade transparency will be much more accurate and meaningful for overall transparency. ***As suggested by the Commission, we believe that illiquid instruments and large in scale transactions traded via voice should be exempted from the pre-trade regime for brokers and venues. We therefore recommend removal of MiFIR Article 7(3).***

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 Danish 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 ECON⁴ 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 trilogue 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 now effectively passed from the Cyprus Presidency to Ireland which aims to finalise the Council's negotiating position by end-March 2013. On that basis and the likely differing positions of the Council, Parliament and Commission, the trilogue negotiations are expected to occupy much of 2013:
 - The trilogue is now likely to begin in Q2 2013
 - Earliest political agreement expected by the end of 2013
 - ESMA technical standards/EC delegated acts expected in 2014
 - Entry into force expected at the beginning of 2015

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 powers to ESMA to determine the conditions for phasing-in the transparency requirements.*
2. *The parameters and procedures for assessing liquidity threshold for deferred publications [MiFIR Article 10 and 20] and pre-trade waivers [MiFIR Article 8(2) and (4)] 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. *We recommend for volume omission to be reinstated in article 10(3) and 20(3) MiFIR as originally proposed by the Commission.*
4. *As recognised by the pre-trade transparency articles [MiFIR Article 8(1)(b) and article 17(3 and 7)], 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".*
5. *As suggested by the Commission, 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.*
6. *We recommend that the Council follow the Parliament's approach, allowing flexibility to update and withdraw quotes (MiFIR Article 17(1b), EP text).*
7. *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 DK presidency allowing waivers for request-for-quote and voice trading systems without any size thresholds.*

⁴ 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.

Overview table

AFME position	EC proposal	European Parliament	Council
Transparency			
Phasing in of the transparency regime is critical to ensure minimal adverse impacts.	X Note: However, the EC in one of its non-papers recommended a phased implementation.	X	X
The parameters for setting the liquidity thresholds should not be defined in an exhaustive manner at level 1. These technical aspects should be specified by ESMA in Level 2 implementing measures, following a detailed analysis.	✓	✓	X
The procedures for assessing liquidity threshold should be dynamic and consistent across the EU. These technical aspects should be specified by ESMA in Level 2 implementing measures, following a detailed analysis.	X	X	X
The regulation should cater for a central calibrating entity subject to ESMA oversight.	X	X	X
Post Trade Transparency			
Volume omission should be enabled	✓	✓	X
Time deferrals should not be based on "normal"/"standard"/"usual" trade size	✓	✓	X
The L1 text should include 'liquidity' as criteria for deferred calibration.	X	✓	✓
Pre-Trade Transparency for market makers			
Scope should be limited to liquid instruments.	X Note: However, the latest EC non-paper clarifies that pre-trade transparency only applies to liquid instruments.	✓	X
Requirements for SIs to provide binding quotes should be limited to trades below sizes that are specific to the instrument, so to take into account the differences between the wholesale and retail markets.	X	X Note: However, the ECON text limits the obligation to make the firm quotes provided to one client available to other clients below a certain size specific to the instrument to be determined in level 2 legislation.	✓
Market makers should be allowed to update and withdraw quotes.	X	✓	X
Market makers should be allowed to consider commercial factors, costs of trading and portfolio impact when quoting.	X	✓	✓

Pre-Trade Transparency for brokers and trading venues			
Quoting requirements for venues should allow voice and RFQ trading methodology.	X	✓	X
	Note: The latest EC non-paper clarifies that pre-trade transparency means firm or executable prices and not indicative prices.		Note: The Council allows the publication of indicative prices for RFQ and voice only for trades <i>above a certain size specific to the instrument</i> .

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