Deutsche Bank
Global Equities

Global Market Structure – Europe

Execution Excellence

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MiFID II: What is new for non-equity markets? Transparency and Trading

Topic 6, Update 1

Newly inserted text is underlined.

What is new for non-equities?

- Whilst MiFID I was focused on equities, the scope of MiFID II has been extended to include dealing in equity-like and non-equity instruments. Equity-like instruments will be treated almost at par with equities (with certain regulatory upgrades); whereas trading in non-equity instruments will witness sweeping innovation.
- For the purposes of MiFID II, 'non-equity instruments' means and includes bonds, structured products, emission allowances and derivatives. On the other hand, 'equity and equity like instruments' includes shares, depositary receipts, exchange traded funds (ETFs), certificates and other similar instruments.
- MiFID II will necessitate radical changes to trading operations and post trading procedures, pushing firms to think hard about necessary technological and data management changes.
- In this document, we shall consider the trading obligation for derivatives, pre and post trade transparency requirements and trading infrastructure.

What is the trading obligation for derivatives?

- MiFID II is broadly designed to move more trading from bilateral OTC markets to multilateral public trading venues. The trading obligation for derivatives goes further, and will ensure that certain derivatives are traded exclusively on public trading venues.
- Article 28, MiFIR states that "*certain derivatives may only be traded on regulated markets, MTFs, OTFs or equivalent third country venues*".
- Derivatives[1] covered by the trading obligation are those which are sufficiently liquid and subject to the clearing obligation under the European Markets Infrastructure Regulation (EMIR).
- ESMA recently published a Discussion Paper on the trading obligation, and may follow it up with a consultation paper by Q2, 2017. In the paper, ESMA have sought feedback on

[1] Article 4(44)(c), MiFID II: *Securities (other than equities, bonds or other forms of securitised debt including depositary receipts in respect of such instruments) giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures.* Also refer Section C, Annex I, MiFID II.

(amongst others) the meaning of the phrase "traded on a trading venue"- ('TOTV'), the approach to assess liquidity of various subsets of derivatives and methods to tackle certain data challenges. On May 22, 2017 ESMA published its opinion on the concept of TOTV for OTC derivatives.
- It appears that ESMA may implement a phase-in schedule for different categories of counterparties to adhere to the trading obligation. However, it is fairly certain that large financial institutions will have to comply from January 3, 2018.
- At the same time, ESMA is also engaging with third country regulators for assessing equivalence of third country venues, but little detail about the potential outcome of such discussions has emerged. More generally, equivalence of third country venues remains a heavily speculated area.
- As regards the scope of instruments covered by the trading obligation, on the basis of available information, the industry expectation is that most benchmark G3 (EUR, GBP, USD) swaps and credit index will be covered. Currently, no equity derivatives are in scope.

What is ESMA's opinion on the meaning of derivatives "traded on a trading venue" (TOTV)?

- TOTV is relevant for pre and post trade transparency requirements, transaction reporting and the trading obligation for derivatives.
- The concept of TOTV for shares, bonds and exchange traded derivatives is relatively simple as they are centrally issued and fully standardised, it is less clear for OTC derivatives. This is due to the fact that OTC derivatives that do not have an issuer, are less standardised and often arise from bilateral contracts between two counterparties. ESMA considers it therefore important to delineate the OTC derivatives that are within the scope of the transparency and transaction reporting requirements from those OTC derivatives that are not considered TOTV and, hence, are outside the scope of the transparency and transaction reporting requirements.
- Under RTS 23, trading venues will be required to submit reference data (RTS 23- Annex 1, Table 3) for instruments traded on their platforms to their competent authorities daily, who will then relay this information to ESMA. After consolidation, ESMA will publish the collected reference data. ESMA considers that the relevant reference data submitted in accordance with the requirements will include the relevant reference data details which identify each derivative admitted to trading on regulated markets or traded on MTFs or OTFs.
- ESMA is of the view that only OTC derivatives sharing the same reference data details as the derivatives traded on a trading venue should be considered to be TOTV.
- In this context, "sharing the same reference data details" should mean that the OTC derivatives should share the same values as the ones reported in accordance with RTS 23 for derivatives admitted to trading or traded on a trading venue, except fields 5-12 as those relate to information about the trading venue and the issuer.
- ESMA also acknowledges that the meaning of "sharing the same reference data" may need to be revisited taking into account the evolution of markets post January 2018. ESMA plans to monitor the application of the concept of TOTV and in particular the ratio of derivatives that are considered TOTV compared to overall OTC derivatives trading.

What is an OTF?

- As discussed above, one of the main themes of MiFID II is to direct trading onto public "lit" venues as much as possible. Accordingly, for trading non-equity instruments MiFID II introduces Organised Trading Facilities (OTF), a new category of trading venues alongside regulated markets and MTFs.
- OTFs are similar to regulated markets and MTFs insofar as matching of third party buying and selling interests, general prohibition on trading own capital by the operator, transparency and access rules are concerned; but the most striking difference between their operations is the level of discretion employed by an OTF operator in deciding which orders to match. Unlike regulated markets and MTFs, OTF operators are required to exercise discretion over the manner in which they execute orders, as long as they fulfil their best execution obligations.
- OTF operators may exercise discretion only in the following cases:

a. When deciding to place or retract an order on the OTF, and
b. When deciding not to match a given client order with other available orders.

What are pre trade transparency requirements for non-equity instruments?

- MiFID I pre trade transparency obligations only applied to equities traded on regulated markets. Under MiFID II the pre trade transparency requirements have been extended to equity-like and non-equity instruments traded on regulated markets, MTFs, OTFs and by SIs.
- For liquid instruments quotes under the Size Specific to Instrument (SSTI), ('liquid' and 'SSTI' both as defined by ESMA), SI quotes are to be made public prior to execution. Quotes in illiquid instruments or in sizes above SSTI if made public would expose liquidity providers to undue risk and so these quotes are exempted from this requirement.
- Trading Venues may also apply to National Competent Authorities to seek waiver from pre trade transparency for the following:
  - Orders that are large in scale compared to normal market size
  - Orders held in an order management facility of a trading venue pending disclosure (iceberg orders)
  - Actionable indications of interest in request-for-quote or voice trading systems above SSTI which would expose liquidity providers to undue risk
  - Derivatives which are not subject to the Trading Obligation per Article 28, MiFIR
  - Other financial instruments for which there is no liquid market
- The implications of pre trade transparency will be different for SIs and trading venues: when making a quote public, SIs will have to include the identity of the SI, while a trading venue won't list the name of the liquidity provider. Further, the SI will be required to honour that quoted price with other clients subject to reasonable commercial terms, while a trading venue does not have the same obligation.

When will ESMA publish data for SI calculations?

- In its Q&A, ESMA provided timelines for publishing the data required to allow firms to assess their SI status.
- ESMA intends to publish total EU data for the first time by August 1, 2018 for the 6 months between January 3, 2018 and June 30, 2018. Firms will need to perform their first assessment on the basis of this data.
- For all subsequent assessments, ESMA will publish EU wide data within a month after the end of each quarterly assessment period. After quarterly data is published, firms will have 2 weeks to complete their assessment.
- Notwithstanding the timelines mentioned above, firms will still be able to voluntarily register (opt-in) as SI in all instruments from January 3, 2018 as a way to assume post trade reporting obligations when trading with buy side clients who otherwise would need to report if they are the 'seller' of the instrument.

What are post trade transparency and reporting requirements for non-equities?

The instrument scope for post trade transparency has also been expanded and now transactions in non-equities traded on regulated markets, MTFs, OTFs and by Investment Firms will need to be reported. The post trade transparency and reporting regime will comprise real-time trade reports and daily transaction reports.

- Post Trade Transparency: To contribute to price formation, trading venues are required to publish in real time the volume, price and time of all transactions concluded on them, unless a deferral is allowed (see below). This information has to be made publicly available on reasonable commercial terms and on a non discriminatory basis (Article 10, MiFIR).

  Investment firms, including SIs, are also required to publish this information in relation to transactions in instruments capable of being traded on a trading venue, whether concluded by them on own account or on behalf of the clients (Article 21, MiFIR). Investment firms have to publish this information through an Approved Publication Arrangement (APA) where they conclude transactions outside the rules of a trading venue. Only one party to the transaction is required to publish this information; in a transaction between an investment firm and an SI (typically how DB interacts with clients), the SI will publish the information.

- Transaction Reporting: Investment firms are required to supply daily transaction reports in relation to all transactions concluded by them to the regulators to assist them in monitoring and detecting market abuse and investment mandate breaches (Article 26, MiFIR). Firms will need to include a wide range of information about each transaction, including flags related to algorithms, waivers etc. For more details about the contents of these reports, refer our document on Topic 1.

On what grounds can trading venues and investment firms seek authorisation for deferred publication?

Regulators may allow trading venues and investment firms to delay the publication of trade reports on the basis of the type and size of transaction. In particular, deferred publication may be granted for the following:

- Large in scale transactions compared to normal market size for that instrument or class of instrument
- Transactions in illiquid instruments
- Transactions larger than the size specific to an instrument or a class of that instrument where the investment firm is dealing on its own account other than on matched principal basis.

National Competent Authorities may decide which deferrals to grant, and therefore deferrals may vary among jurisdictions. The deferral time ranges from two days to four weeks, and includes an aggregation option for certain instruments. Unlike US post-trade reporting for large transactions, the actual trade volume will be published (rather than a bucket).

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