MiFID II
Transparency Rules

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MiFID II : Executive Summary

MiFID II ("Markets in Financial Instruments Directive"):  
• Updated EU financial markets regulation, effective Jan 2018  
• Regulation is primarily designed for uniform and small transaction market (equity-like)  
• Application to heterogeneous and large transaction market (i.e. fixed income) not straightforward  

Focus on Transparency:  
• Pre-trade transparency for "small-size" quotes  
• Post-trade transparency of trade details, including price and volume for all trades.  
• Choice of execution method (venue, counterparty, slicing/dicing) impacts level of transparency and reporting obligations.  
• Liquid derivatives are subject to obligation to be traded on electronic venue.  

Territorial Scope:  
• All trades done out of the EU or trades where one counterparty is regulated in Europe  

Implementation Considerations:  
• Multiple business areas involved (Legal & Compliance, Tech, Ops, Risk, PM, Client-Facing)  
• Costly and time-consuming technology build-out  

Expected Market Implications:  
• Trading and markets will be mainly affected via increased transparency on trade details  
• Potential increase in liquidity premia  
• Potential increase in cost of trading for programs that are executed over an extended period of time  
• Expect an increase in frequency of frozen market episodes when transfer of risk becomes difficult
**MiFID II Overview: Regulatory Scope Across 4 Quadrants**

1) **Market Structure**
   - Trading Venues
   - Systematic Internalizers
   - Derivatives Trading Obligation
   - Equities Trading Obligation
   - Algos/GFT/DMA

2) **Investor Protection**
   - Unbundling research
   - Cost and Charges Disclosures
   - Product Governance and Distribution
   - Inducements
   - Best Execution
   - Suitability
   - Appropriateness
   - Enhanced Supervisory Powers
   - Third country access

3) **Transparency**
   - Product classification and liquidity definition
   - Size thresholds
   - Pre-trade
   - Post-trade
   - Enhanced Transaction reporting

4) **Organisational Requirements**
   - Governance and Senior Management
   - Remuneration
   - Conflicts of Interest
   - Compliance and Risk Requirements
   - Client Classification

**Summary of MiFID II Regulatory Objectives (source: ICMA):**

- **Move OTC trading onto trading venues** through a trading obligation for non-equities
- **Increase transparency and create a price discovery mechanism**, by expanding pre- and post-trade transparency requirements to non-equity instruments
- **Preserve liquidity** in already challenged markets:
- **Increase available data** (so that market participants are informed as to the true level of potential transactions)
MiFID II Transparency Framework (1) : Pre- versus Post-Trade

- **Pre-trade transparency**
  - A detailed firm (!) quote has to be made available to other market participants
  - Level of disclosure is a function of security, size, and counterparty
  - Quotes need to be published even in absence of trade taking place (i.e. expired quotes)

- **Post-trade transparency**
  - Details of the trade disclosed to the public
  - Timing of disclosure (real time or deferred) is a function of security and size
  - "Large" or illiquid trades made transparent from t+2 up to 4 weeks later
  - Otherwise published within 15 minutes (to be reduced to 5 minutes by 2020)

Waivers and deferrals may not be uniform across the EU as they are determined by each national regulator
MiFID II Transparency Framework (2) : Security Characteristics

- Level of transparency for a trade is a function of three security characteristics:
  
  - **Liquidity** (ISIN-specific) determined by regulator
  
  - **SSTI (Size Specific To Instrument)** threshold (asset class-specific). Size threshold that separates small trades from normal trades.
  
  - **LIS (Large In Scale)** threshold (asset class-specific). Size threshold that separates normal trades from large/block trades.
  
- Relevant fixed income asset classes are:
  - Sovereign bonds
  - Other Public bonds
  - Corporate bonds
  - Covered bonds
  - Convertible bonds
  - IRS grouped by currency and maturity

**Example:** German Bund (deliverable into liquid ‘RX’ Futures) deemed “not liquid”

**Example:** Maltese government bond deemed “liquid”

*Source: Bloomberg*
Transparency and trade publication requirements depend on where/how the transaction was conducted:

- If executing on a venue – **Venue** reports (e.g. Bloomberg, Tradeweb, etc)
- If executing with an SI – **SI** reports (e.g. Goldman Sachs, JPM, etc)
- If executing via OTC – **Seller** reports (“Seller” investment firm)
- If executing with non-EU counterparty – EU party to the trade reports

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**Venue / Multilateral Trading**

- **Regulated Market**
  - Exchange
  - e.g. Euronext, EuroMOT, BondVision, Stock Exchanges

- **Multilateral Trading Facility**
  - MTF
  - e.g. BTEC, iSwap, Tradeweb, MarketAxess, Bloomberg (soon)

- **Organised Trading Facility**
  - OTF
  - non-equities only
  - e.g. IDBs like GEI
  - Broker crossing networks with discretionary order matching

**Bilateral Trading**

- **Systematic Internaliser**
  - SI
  - e.g. active market makers, maybe active Funds
  - Trade own capital

- **Over-the-Counter**
  - OTC
  - The rest
  - Test per instrument: Systematic, Frequent & Substantial; Can opt in

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**Goal:** encourage more venue trading

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Source: ICMA
MiFID II Pre-Trade Decision Tree (1): Trading Venue

RM: Regulated Market (e.g. exchange).
SI: Systematic Internalizer (specialist on a security).
SSTI: Size Specific to Instrument (threshold that separates small trades from normal trades).
LIS: Large in Scale (threshold that separates normal trades from large/block trades).

Source: ICMA
What is "Liquid"?
- If the trade is going to be executed via RM, MTF, OTF, or OTC (via SI), then there is a liquidity test.
- Liquidity is determined and reviewed periodically by the regulator based on pre-defined criteria.
- This is done on the ISIN level.
- Trading venues have to keep track of the latest liquidity determination and the associated transparency requirements.

ISIN-based assessment
Bond = liquid if trades at least:
- 2x a day, on average.
- EUR 100k daily notional, on average.
- 80% of the days.

For new issues, "liquid" depends on bond type and issue size:
- Sovereign. New issue size > EUR 1 bln.

All other bond types on new issue: not deemed liquid.

Pre-Trade Decision Tree:
Step 2
Trading venues
- RM, MTF, OTF?
- Yes
- No
- OTF (from-SQ)?
- Yes
- No
- IS Instrument TOTV?
- ≤ SSI? (for WIG) on ISIN (in USD)?
- Yes
- No
- IS Instrument Liquid?
- No
- SSI?
- Yes
- No
- < SSI?
- Yes
- No
- Trade does not exist
- Step 2

Liquidity information on venue side (Bloomberg):
United States Treasury Note/Bond
- Is Instrument TOTV: Yes
- Is Instrument Liquid: No
- Calibration Date: 07/01/18
- Pre Trade
- SSI: EUR 700,000
- LIS: EUR 6,000,000
- Post Trade
- SSI: EUR 10,000,000
- LIS: EUR 25,000,000
- Currency: USD
- MTIF Currency Rate: 1.199300
- MIFID Pre/Post Trade Reporting Calculator
- Security Name: T 3 02/15/48
- ISIN: US128105479
- Is Instrument Liquid: No
- SSI Pre Trade: USD 839,510
- LIS Pre Trade: USD 7,195,800
- SSI Post Trade: USD 11,993,000
- LIS Post Trade: USD 29,982,500
- Relevant Competent Authority
- Authority: GB
- Identifiers
- FINO Code: US T BONDS/3 DTD 204820215
- Official CIT Code: DBTFR

Source: ICMA
Source: Bloomberg
For illustrative purposes only.
What is the trade size?
- **If** the trade is going to be executed via RM, MTF, OTF, or OTC (via SI), and **if** the security is officially deemed "liquid", then there is a **trade size test**.

- If the trade is "small" ("below SSTI") then there is a **real-time pre-trade transparency requirement**, which includes individual bids and offers.
- If the trade is "medium" (between "SSTI" and "LIS") then there is a **real-time pre-trade transparency requirement**, for the average of the quotes only.
- If it is "large" (i.e. "LIS" and above) then there is no transparency requirement.

- The regulator determines and periodically reviews these thresholds for entire market sectors. German Bunds and Maltese debt are both treated as "sovereign bonds" with the same thresholds.
- Additionally, the **regulator makes no distinction between 1yr or 100yr bonds**.
- The thresholds are expected to go up by a factor of 3 to 5, thus increasing the scope for pre-trade transparency over time.

**Pre-Trade Decision Tree:**

![Pre-Trade Decision Tree](source: ICMA)
MiFID II Post-Trade Decision Tree(s)

Post-Trade Transparency:
- Depending on liquidity and size, the post-trade requirement is either real-time, deferred up to 4 weeks, or waived (at the discretion of NCA).
- Execution data is currently scattered across different trading venues, with no consolidated data source and no common reporting format.
- **Access has not been free of charge**, however, ESMA have recently clarified they expect full machine-readable access without subscription fees.
- In the case of swaps, there is no cap on the reported trade size (unlike Dodd-Frank). This means asset managers using MAC swaps have to change trading behaviour otherwise market participants can infer their total book size.

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**RM**: Regulated Market (e.g., exchange).
**MTF**: Multilateral Trading Facility (electronic platform).
**OTF**: Organized Trading Facility (dealer-only platform).
**SI**: Systematic Internalizer (specialist on a security).
**SSTI**: Size Specific to Instrument (threshold that separates small trades from normal trades).
**LIS**: Large in Scale (threshold that separates normal trades from large/block trades).
**NCA**: National Competent Authority (e.g., Bafin in Germany).

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Source: ICMA

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Source: ICMA
Additional MiFID II Transparency : Public Disclosures

**Top 5 execution venues**
- Asset managers will have to disclose on annual basis its Top 5 execution venues.
- Venues include: platforms, brokers, business entities.
- Disclosure to be broken out by 13 regulatory asset classes and by volume.
- Volume reporting is in gross notional, i.e. not adjusted by risk (e.g. short-duration vs long-duration).

**Account-level costs and charges estimates**
- Asset managers will have to publish:
  - Transaction cost estimates using methodology prescribed by regulator.
  - Explicit costs.

**Disclosure implications**
- Potential news flow, based on disclosure of top trading venues.
- Client questions and comparisons, particularly on reported transaction costs.
Mifid II Transparency : Market and Trading Implications

**Expected Market Implications:**

• Transparency on trade details, both pre and post, will impact the way markets operate and potentially affect liquidity in unintended ways.

• Expect more frequent episodes of illiquid markets where market participants are unable/unwilling to facilitate transfer of risk.

• **Impact may differ across bond market sectors:**
  
  – Limited impact on **illiquid securities** (European Non-Agency RMBS, ABS, certain Corporates). They are “protected” by pre-trade transparency waiver and post-trade reporting deferral.
  
  – **Highly liquid securities** (German bunds) may become more commoditized.
  
  – However: **Securities with liquidity “in-between”** (e.g. Portugal, Greece, EM sovereigns) may see a decline in liquidity and more frequent episodes of illiquidity, due to pre/post-trade reporting obligations.

• **Potential impact for large strategic program trades**, as multi-month execution of non-government bonds (e.g. swaps) is given full post-trade reporting transparency over the life of the program.

• Market functioning will become critically dependent on infrastructure provided by electronic trading venues
## APPENDIX:
### List of MiFID II Acronyms

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>APA</td>
<td>Approved Publication Arrangement</td>
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<tr>
<td>EC</td>
<td>European Commission</td>
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<tr>
<td>EMIR</td>
<td>European Market Infrastructure Regulation</td>
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<tr>
<td>ESMA</td>
<td>European Securities and Markets Authority (&quot;SEC&quot;)</td>
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<tr>
<td>ICMA</td>
<td>International Capital Markets Association (&quot;SIFMA&quot;)</td>
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<tr>
<td>KIDS</td>
<td>Key Information Documents</td>
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<tr>
<td>LIS</td>
<td>Large in scale (&quot;Block Size&quot;)</td>
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<tr>
<td>MiFID</td>
<td>Markets in Financial Instruments Directive (&quot;Dodd Frank&quot;)</td>
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<tr>
<td>MiFIR</td>
<td>Markets in Financial Instruments and Amending Regulation</td>
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<tr>
<td>MTF</td>
<td>Multilateral Trading Facility (e.g. SEF)</td>
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<tr>
<td>NCA</td>
<td>National Competent Authority</td>
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<tr>
<td>PRIIPS</td>
<td>Packaged Retail Investment and Insurance-based Products</td>
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<tr>
<td>OTF</td>
<td>Organized Trading Facility (e.g. Dark Pools)</td>
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<tr>
<td>RM</td>
<td>Regulated Market</td>
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<tr>
<td>RTS</td>
<td>Regulatory Technical Standard</td>
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<tr>
<td>SI</td>
<td>Systematic internalizer (&quot;Authorized Market Maker&quot;)</td>
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<tr>
<td>SSTI</td>
<td>Size specific to instrument</td>
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<tr>
<td>TOTV</td>
<td>Traded on trading venue (&quot;Made Available to Trade&quot;)</td>
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