ICMA Workshop: MiFID II - Practical Implications for Fixed Income Trading

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Summary notes

Panel 1: Trading workflow and the impact of MiFID II implementation

How will MiFID II impact trading workflow from your perspective?

- The provisions will make it very challenging from the perspective of 'voice trading'. Firstly, meeting the pre-trade transparency obligations will be technically and structurally difficult, and it is likely that systematic internalisers (SIs) will have a preference to provide quotes via electronic RFQs (request-for-quotes). Secondly, best execution reporting requirements under RTS 27 require firms to log every client query, the time to execution, etc. This will demand more structure and systems for sales desks to capture these data points.

- Buy-side firms will want to trade more frequently in sizes that are above the SSTI (size specific to the instrument) and LIS (large in scale) thresholds, as well as to move more business on venue. It will become more difficult to communicate with dealers via phone. Ideally, we need to move to a hybrid system where buy-sides can communicate and negotiate with their banks via electronic 'chat' or phone, but then go on venue to transact.

- It will be easier to negotiate bond trades electronically as they have ISINs, but it becomes more complicated in the case of derivatives.

- Some firms will want to keep all communications electronic and to transact everything on venue in order to support the requisite record keeping and reporting requirements.

- Trading protocols are unlikely to change much. However, dealers are likely to spend less time on the phone, with systems in place to process more trading electronically. However, you will still need 'voice' for less liquid and more complex instruments.

- There is still the SI dilemma to resolve. There are very few advantages for banks becoming SIs, and most large buy-side firms will use platforms or have their own APAs (Authorized Publication Agreements). However, being an SI could provide some value to smaller buy-side firms.

- In the case of sell-sides with many small clients, such as agent banks, it will be necessary to become an SI as their clients will rely on them for the reporting obligations.

What are the implications of post-trade transparency for market-making, particularly the potential for different post-trade deferrals across the EU?

- This could be very difficult. For instance, you could trade with an Italian bank in a UK regulated platform, and benefit from a potential four-week deferral. But if that bank subsequently starts offlaying the position with Italian regulated clients, those transactions, could be reported after just two days. This information leakage would then undermine the benefits of the original transaction's deferral position and put you at risk.

- Splitting orders only destabilizes market-makers – there is a term, 'getting run-over', which relates to dealers who transact part of an order but are unaware of the clients' full size. Normally it is considered bad market practice for buy-sides to do this, but if banks are not able to transact the full size then buy-side firms will have little choice.

- Clearly dealers always prefer to see a client's full-size, and clients may want to think more about ensuring that they are above the transparency deferral thresholds. Meanwhile, banks will need to become more prescriptive about how they work their client orders.

- If clients want to show more 'on the follow' or leave an order, will banks be interested? They will if the size is above the LIS/SSTI thresholds. They will also need to consider the applicable deferral period for the counterparty they are transacting with. These will become integral factors for salespeople when talking to their clients.

- The sales role is likely to change, with salespeople moving away from ticket entry and more toward an advisory function. There will need to be a retraining of salespeople.

- There is also an important impact with respect to cost incurred by the buy-side. Prices will need to factor in considerations such as whether or not you are an SI, the deferral regimes, or whether it is a riskless or risk trade. Also, counterparties will become fewer, which will again drive up the costs of trading. Maybe in time the availability of new market data will help to improve price formation and liquidity, but this needs to be analyzed against the potential negative impacts of increased transparency.

- If you are dealing in illiquid markets, you will probably need more counterparties rather than fewer. The biggest worry is the risk of banks becoming 'accidental SIs'. From a risk perspective banks currently want to see your full size and so trade bigger blocks, but this could go the other way as they try to avoid becoming SIs.

How do you manage your trading with respect to the potential delineation between risk and risk-less trading for SIs?

- It seems to be clear that SIs are expected to take risk, and that there can be no multilateral trading and no execution of contingent trades. They are allowed to cross trades on an occasional basis, but many may not want to.

- Some firms will try to put as much distance as possible between being an SI and running a multilateral system.

- It will be interesting to see how banks interpret the guidelines, but is likely that there will be a 'risk price' and a 'riskless price', and we will begin to see the true cost of dealers' capital.

Will the market be able to trade large in scale (LIS) tickets without market impact?

- At first it is unlikely that we will see much impact, since most bonds will be classified as illiquid, and the thresholds for LIS and SSTI are likely to be quite low. The real concern is what will happen over time as the thresholds are adjusted.

- Key to this will be the different deferral regimes adopted by the various NCAs. If we are talking about a 4-week deferral, and weekly aggregated trades, then this is fine. But if some NCAs go with 'T+2' transparency, with published volumes, then we have a problem.

- A harmonized deferral regime will reduce client concerns. It will also be part of any best execution consideration. Even where the price is the best available, if the deferral regime is disadvantageous then you will not want to trade on it.

Panel 2: Market structure and MiFID II/R

When will we see real innovation? Or are we not investing in new technologies at the moment?

- We will probably see more innovation in the next 12-to-18 months, once we have pre- and post-trade transparency and there is more data available. It will come as we find new pockets of liquidity, and as we have more information to reference prices and to support improved levels of best execution. But it is going to take a while to reach everybody.

- At the moment, the whole scale of MiFID II, in terms of breadth and cost, is crushing people. Also, there is a lot of uncertainty around the rules, interpretation, and enforcement, and it remains unclear as to where to invest.

- We have a seen a lot of new platforms in the run-up to MiFID II, including all-to-all platforms, but it is not clear whether MiFID II is driving innovation or actually preventing it.

- We are expecting new liquidity providers and more systematic collation and analysis of data, and so platforms are already starting to position for this. However, while we see a lot of solution providers, they are struggling to get people to sign up to them.

- We need to ask how we define innovation. At a very high level it is difficult to get investment for true innovation. What the platforms are more focused on is compliance with the new rules, such as the deferral waivers for trade reporting, and on ensuring that they are as user friendly as possible for their members. So, what we are seeing is more practical than innovative.

- We are seeing a lot of EMS (execution management system) vendors moving into the fixed income space. We expect this to accelerate.

Why would an entity choose to become an OTF? And how will other venues interact with OTFs?

- It is more a case of the regulation forcing entities to become OTFs, rather than entities choosing to do so. If your business model is based on brining counterparties together to trade, then you are obliged to become an OTF, with discretion being the key difference. But ultimately it does not change anything, other than firms requiring an OTF license.

Is it possible that some banks could actually qualify as OTFs?

- Banks could certainly become accidental systematic internalisers, but it is not clear as to whether they could become OTFs. It really depends on the underlying business model.

- If you are running multiple businesses under a single entity then you need to become an SI. But ultimately, entities need to be able to work with OTFs and SIs to avoid market fragmentation. This requires looking at the various models and seeing what works best for your clients.

- As an MTF, you will need to create a separately capitalized legal entity to support open-access all-to-all trading. It would be much better for liquidity if it were possible for entities to support multiple business models.

A helpful tool that many participants have suggested is the ability to negotiate trades off-venue, and then to be able to execute them on a platform – sometimes called 'negotiated trades' or 'processed trades'. Do you see this happening?

- For less liquid markets in larger sizes there has to be a place for this form of functionality, given the reporting and record keeping requirements of MiFID II. Whether there will be innovation to support this or the market will find ways to work within the current protocols and functionality, we will have to wait to see.

- This is nothing new. Already it is normal practice to agree trades OTC and then execute them on a platform via an RFQ-for-one. This is mainly to benefit from straight through processing (STP).

- The problem is that one will need to be careful about the language used when negotiating the trade. If the trade is agreed by phone on or 'chat', and then put through the platform, you could find that you are technically transacting twice.

- One proposal is for a '15 minute rule', which is being discussed with market participants. This would allow participants 15 minutes between agreeing a trade and executing it through the venue. But this is already done today, just not so systematically.

- This form of functionality would help a lot in terms of managing your SI thresholds, as well as managing transaction and trade reporting, best execution reporting, order record keeping, etc.

- Negotiated trade protocols already exist for repo transactions, with an established fee structure. This is likely to be the same model for outright trades going forward.

Are we seeing new entrants competing, or are the incumbents creating barriers?

- Both. There is definitely room for new entrants in some areas, but the challenges of competing with established incumbents makes entry difficult.

- The increase in data arising from MiFID II will make the market more democratic and bring in new competitors. This will help bring in new liquidity providers, and allow buy-side firms to become price makers, which will help to disrupt the traditional market model, and which is a positive for everybody. However, there is also a negative impact of regulation which is that compliance with the requirements makes the barriers to entry much higher.

- MiFID II is trying to raise the bar for entry and to drive out smaller players; for example, the capital requirements for OTFs. Eliminating the marginal players could be viewed as a positive, but perhaps it could be done more subtly.

- Capital markets technology is an incredibly difficult space to get into. If you look at the recent start-ups, very few have been successful without consortium backing. Maybe if you are filling a niche need, then you can survive as a stand-alone. Also, competition is good, but many new platforms are not particularly open and are quite selective in terms of who they connect with.

Panel 3: Research consumption and distribution

How is the market approaching the unbundling requirements?

- It is now broadly understood that the cost of research is not embedded in fixed income pricing, and that bid-ask spreads will not decrease as a consequence of unbundling.

- One solution is to devise an evaluation methodology for research, assessing what is used by whom, and what value it provides. Then you need to assign a budget for research, assuming that firms pay from their own account and do not charge it to their clients. Meanwhile, banks will need to provide different options and pricing structures, particularly as they are keen to keep providing research to their customers.

- There is a need to educate (buy-side) traders, to ensure that they know what changes are taking place from January 2018, and for them to think about what research they actually want. Again, this requires developing a model to assess the value of research. But this is difficult, particularly with respect to quantifying the value of macro research.

- This is going to be very difficult for the sell-side. The starting point is establishing the cost of research, and disaggregating this from the overall customer consumption of multiple services. Also, it is very difficult to draw up one single client list, as these can be very different with respect to rates, credits, commodities, foreign exchange, etc. How do you determine the different value that research provides to different customers across various markets and asset classes? Previously clients did not pay for research, so there was no limit on what different clients could receive. Now banks will have to look at their customer lists and think about who should be getting what, in what quantities, and how much they should pay for it.

Are there lessons that can be learned from equity research unbundling?

- Evaluation models for research are already common in equities, and firms are able to assess the value of various research. But also, it is about putting controls in place to ensure that firms only receive research that is paid for, as well as identifying what is research, even if it is called something else, such as 'desk notes'.

- Larger firms will already have solid teams of internal analysts, so they are less concerned about being 'switched off'.

- It is also important for firms to be aware of the commercial value of the research they are receiving, and to ensure that they are paying the right amount. If they feel that the price is too low, they need to say so and to pay more if necessary, in order to ensure compliance with the rules.

- There will be pressure on banks to classify their research, and to establish what actually constitutes research. For example, would a trader's comments on IB chat count as research?

- The value of internal research should increase significantly, which is good news for buy-side analysts.

Why won't bid-ask spreads reduce?

- There is no transmission mechanism from research to dealer spreads. Ultimately, all business costs, including research, are paid for by the firm's clients, in one form or another, but these are not directly embedded into the prices that firms quote for securities. So, this actually introduces an additional direct cost that will be borne by the buy-side; at least those based in Europe.

- It is definitely introduces an additional cost. As for dealers' prices, these are determined by the desire to take risk, cost of balance sheet, financing costs, etc. If a client decides to trade based on a research recommendation, this does not result in a different price. This additional cost will be particularly detrimental for smaller asset managers.

What will be the impact on dealer research provision?

- There is currently a lot of research available, but the expectation is that over time we will see a lot less FICC research.

- It is incredible how much economic research is available, given that this is free. This is likely to reduce significantly once firms have to pay for it.

- Ultimately this will depend on how many clients are able and willing to pay for research, but there is likely to be significant consolidation in terms of their research providers.

What is likely to be the impact on corporates, especially SMEs?

- All liquid instruments or issuers have significant coverage. For example, there are 104 different analysts covering Apple stock. Conversely, the less liquid the instrument or issuer, the less research coverage there is. Ultimately, we are likely to move to an alpha-based model. There is clearly very little alpha being provided by Apple research, so what we should see is a move in coverage toward less liquid mid-caps.

Could the European unbundling rules eventually be applied more globally?

- In the US, firms are not able to accept payment for research, so it is not clear how this could be applied there. However, the understanding is that there is currently a request with the SEC to provide a carve-out with respect to the MiFID rules; otherwise, US firms would inadvertently become investment advisors.

- There is a question of whether asset managers set up operations outside of Europe to avoid research costs. This seems unlikely. However, they may do this to avoid MiFID II more broadly. But the research issue is likely to remain a problem for the larger global asset managers.

- We may see this with respect to equities, but it is unlikely that the rules will be harmonized for FICC.

Panel: Trading Workflow & the impact of MiFID II implementation
Moderator:
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Panellists:
Ricky Goddard, Head of European Fixed Income Trading, Schroders
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Panel: Market Structure & MiFID II: Innovative incumbents & Adaptive new entrants
Moderator:
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Panellists:
Mark Goodman, Head of Electronic Trading, FRC, UBS
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Gareth Coltman, Electronic Trading - Head of Product Management, MarketAxess
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A Conversation on research consumption and distribution
Moderator:
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