

Q1. What is MIFID II and MIFIR?

The Markets in Financial Instruments Directive (MiFID) is a European Union law that provides harmonized regulation for investment services across the 31 member states of the European Economic Area. The Directive's main objectives are to increase competition and consumer protection in investment services. MiFID became effective in November 2007, and is primarily related to equities markets. MiFID II (along with the Markets in Financial Instruments Regulation – MiFIR), replaces MiFID, and broadens its scope to non-equities, including bonds. Among the key aspects of MiFID II/R are provisions covering: transaction reporting, market structure, pre- and post-trade transparency requirements, and conduct of business rules. MiFID II/R entered into force in July 2014. Most 'Level 2' regulatory technical standards (RTS) and implementing technical standards (ITS) were submitted to the European Commission by ESMA in September 2015. Following approval by the Commission, Council, and Parliament, MiFID II/R is expected to be implemented in January 2017.

Q2. What are the pertinent elements of MIFID II/R for repo?

The key aspects of the regulation that impact repo markets are **transparency obligations both pre- and post-trade, best execution reporting obligations** and, to a limited extent, **transaction reporting**.

Q3. What are the MiFID II/R obligations for pre- trade transparency?

Trading venues (Regulated Markets, Multilateral Trading Facilities, and Organized Trading Facilities) will need to make information about executable trading interests publicly available. In other words, trading venues are obliged to make publically available all actionable trading interests per security. This extends to request for quotes (RFQs).

Exemptions exist for pre-trade transparency obligations in the cases where:

- (i) The security is classified as illiquid (as determined by the regulation's liquidity calibration criteria);
- (ii) The interest is part of an order management facility;
- (iii) The order size meets the large in scale (LIS) waiver criteria – i.e. it is above a threshold calibrated by the regulation to determine 'normal market size' for the relevant instrument.
- (iv) The order size meets the size specific to instrument (SSTI) waiver criteria – i.e. it is above a threshold calibrated by the regulation to determine a size of transaction that would expose liquidity providers to undue risk.

Q4. What are the MiFID II/R obligations for post-trade transparency?

Trading venues (Regulated Markets, Multilateral Trading Facilities, and Organized Trading Facilities) will need to make details of transactions executed on the venue publically available in close to real-time. Information will include instrument identifier, unit price, quantity, venue, date and time, and transaction identifier. Details will be made available via an approved publication arrangement (APA).

To protect market liquidity, the possibility for a deferral of two business days for post-trade transparency is available in cases where:

- (i) The security is classified as illiquid (as determined by the regulation's liquidity calibration criteria);
- (ii) The trade size meets the large in scale (LIS) waiver criteria
- (iii) The trade size meets the size specific to instrument (SSTI) waiver criteria.

A further protection of market liquidity is the country by country 'Supplementary deferral regime at the discretion of the NCA' (National Competent Authority) proposed by ESMA:

- (iv) An extended deferral period of 4 weeks can be granted under certain circumstances and at the discretion of NCAs.

Q5. Are repos (and other SFTs) in scope of MiFID II/R pre- and post-trade transparency obligations?

In the case of repo and SFT interests or transactions **executed on trading venues**, it seems clear that these are in scope of the pre- and post-trade transparency obligations whether involving equity or non-equity collateral. In fact, in its Final Report published in September 2015, ESMA explicitly states that in respect of transactions 'involving the use of financial instruments for collateral, lending or other purposes' it is not empowered by the level 1 text to exclude such transactions for on-venue trades, and therefore these transactions '**will have to comply with the general post-trade transparency obligations**' (p.46).

In the case of post-trade transparency, the RTS do, however, acknowledge that SFTs are non-price forming trades, and accordingly **SFTs will be flagged as 'non-price forming'** when reported.

In the case of pre-trade transparency, under some circumstances, transparency obligations can also be waived for trading venues that formalize **negotiated transactions**, including SFTs.

Q6. What are the practical implications of pre- and post-trade transparency for trading venues?

It is clear that trading venues will have to comply with post-trade transparency obligations for SFTs, and, quite likely, also with pre-trade transparency requirements.

In the case of **post-trade transparency** obligations, the waivers specified for outright transactions in the underlying securities are expected to apply (see Q4). While not explicitly stated in the regulation, one would expect the **pre-trade transparency** waivers similarly to apply (see Q3). Given that the LIS and SSTI thresholds are calibrated on average outright market activity in the underlying instrument, these will be relatively low compared to average repo transaction size. Therefore, it seems likely that many, if not most, repo interests will be exempt from pre-trade transparency, and a similarly high proportion of repo trades will qualify for deferral for post-trade transparency.

However, what is not clear is what 'price' the trading venues will have to report (for both pre- and post-trade transparency): is it the **repo rate** of the trade, or the **cash price** applied to the securities underlying the repo transaction? The regulation only specifies *prices*, not rates. And if it is prices, how is this expected to be applied in the case of pre-trade transparency for general collateral (GC) transactions, where the underlying securities are unspecified before the trade? This could also be a problem in the case of near real-time post-trade reporting, where again the securities allocated to a GC trade can be unspecified for a period of time following the execution of the trade.

In the case of triparty transactions, applying 'price' pre- and post-trade transparency, as well as the appropriate waivers, becomes a logistical impossibility.

Q7. What are the pre- and post-trade transparency obligations for off-venue transactions?

To ensure that a significant amount of interests and trading activity are not excluded from the transparency obligations, the regulation aims to capture a proportion of off-venue interests and activity. It does this by expanding the 'systematic internalizer' ('SI') regime to cover non-equities. It defines an SI as 'an investment firm which, on an organised, **frequent and systematic, and substantial** basis, deals on its own account by executing client orders outside a RM, MTF, or OTF'. Furthermore, the regulation specifies quantifiable definitions for 'frequent and systematic', and 'substantial', based on trading volumes. Effectively, where an investment firm trades on a relatively active basis in a particular, liquid security, it is likely to be classified as an SI and will be subject to the same pre- and post-trade transparency obligations with respect to that security as those applicable to trading venues. The SI determination calculation is recalibrated quarterly, based on the previous quarter's activity. Investment firms can also 'opt-in' to become an SI for any security.

What is not clear from the regulation is whether the SI regime is intended to apply to SFTs. In other words, if an investment firm is designated an SI for a particular security, is it also required to meet pre- and post-trade transparency obligations for SFTs in that security? The FCA have expressed a preliminary view that the current text does not require those carrying out repos and SFTs to be subject to transparency (pre- & post-trade) as SIs. However, this is potentially subject to further guidance by ESMA.

There is also an ancillary question as to whether SFT transaction activity in a particular security should be included in calculating the SI calibration. This would of course result in nonsensical unintended

consequences for investment firms engaged in repo activity, and the FCA's preliminary view is that repo transactions will not count towards the SI thresholds, however subject to the same caveat as above.

Q8. What are transaction reporting requirements for repos?

MiFID II/R makes a distinction between trade reporting and **transaction reporting**. Trade reporting relates to the pre- and post-trade transparency obligations of trading venues to make public certain trading interests and transaction details. **Transaction reporting** entails more extensive reporting of trade details (including counterparties) to the relevant regulatory bodies (the national competent authorities – NCAs). Transaction reports are primarily used by regulatory authorities to detect market abuse and the data is not made available to other market participants.

MiFIR provides a specific exclusion for transaction reporting for SFTs where these are already in scope of the transaction reporting requirements under SFTR.

However, as the regulation is framed, the reporting exclusion in SFTR for SFTs transacted with central banks appears to leave these in scope of the transaction reporting requirements of MiFID II/R.

Q9. What are MiFID II/R best execution obligations?

MiFID II/R requires that investment firms take 'all sufficient steps' to achieve the best possible execution for their clients. This requires execution venues (categorized as trading venues, systematic internalisers, market makers, and other liquidity providers) to provide data related to the execution quality obtained, including details about price, costs, speed, and likelihood of execution for individual financial instruments. Additionally, there is a requirement for all investment firms to summarize and make public on an annual basis, for each class of financial instruments, the top five execution venues in terms of trading volumes where they executed client orders in the preceding year, and information on the quality of execution obtained.

While the regulation recognizes that 'order flow in relation to client orders executed solely in respect of Securities Financing Transactions should not be considered in the same way as the general execution of client orders', it does, however, require that **SFTs are separately captured and reported under the best execution obligations.**

Q10. When will these MiFID II/R provisions apply?

The key 'Level 2' regulatory and implementing technical standards were submitted by ESMA to the European Commission in September 2015. These will be discussed (and possibly modified) and approved by the European Commission within 3 months. The European Parliament and the Council then have 2

months to further review and approve the RTS (this can be adjusted down to one month if Parliament & Council decide not to extend the review to the full allotted time period available). MiFID II/R is then expected to be applied in practice in **January 2017**.

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