Date: 23 March 2020
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Advice to ESMA

Response to ESMA's Consultation Paper concerning MiFIR report on Systematic Internalisers

This CP is one of a number issued by ESMA (and one from the European Commission) as part of the 2020 review of the MiFID II/R package following its implementation at the beginning of 2018. The SMSG welcomes the opportunity to provide its advice, and overall welcomes that the review is taking place with a view to helping the MiFID II/R package better achieve the objectives for which it was originally conceived.

The scope of this CP is relatively narrow, with specific questions set out in appendix 1 of the CP. The views of SMSG members are noted below. These are largely based on observations relating to the "bond" asset class except where otherwise noted.

In addition, the SMSG also provides some comment on the relationship between pre- and post-trade transparency and comments on the desirability of a post-trade consolidated tape for bonds.

I. General Comments

1. In general, for the bond market, the pre-trade obligations are not felt to have added significantly to the rigour of price formation and the transparency of the market. And the best execution statistics are not at this stage seen to have provided any meaningful value to market participants and are little used.

2. The SMSG considers that the cost to market participants of compliance with the pre trade transparency requirements is not proportionate to the value of the data. The SMSG would welcome an even more fundamental review of this relationship than that addressed by this CP.

3. The SMSG regards accurate, readily available and timely post trade data (including ultimately the creation of a low cost readily available, comprehensive consolidated tape for bonds based on post trade data) as providing significantly more value than pre trade data and accordingly would recommend that ESMA should devote its attention to further improving the integrity,

completeness and availability of such post-trade data and facilitating the development of a post-trade consolidated tape for bonds.

4. As ESMA recognises in this CP the pre trade rules are currently complex (for example para 3.4.2 -47 *"The pre trade transparency regime* applicable *to SIs in relation to non-equity instruments for which there is not a liquid market appears to be overly complex in comparison to the delivered outcome").* Given the limited value of the data it is to be welcomed that ESMA is reviewing the rules and looking at their simplification. In this context the SMSG agrees with ESMA's proposal to simplify the requirements in relation to SI quotes in liquid non-equity (bond) instruments and to delete Articles 18 (6) and 18 (7). ESMA may wish to consider deleting Article 18 (5) in addition.

5. The analysis on the evolution of the EU non-equity market structure suggests that market liquidity in non-equity instruments is discontinuous and often reliant on capital commitment from market-making intermediaries. Non-equity markets with deep pools of high-quality liquidity are a crucial component of healthy ecosystems as well as an important contribution to competitive, transparent and stable EU financial markets. Ensuring robust liquidity and price-discovery in such market requires rules that carefully balance the need for enhanced transparency whilst recognising the nuanced working of such markets. Since MiFID II came into effect, there has been a marked increase in electronic trading, (see ICMA report "MiFID II/R and the bond markets: the second year" Dec 2019), which generally takes place on trading venues, MTFs, OTFs or SIs.

6. When buy side participants are deciding where they believe they will best be served on a particular trade, the SMSG notes that in the bond markets, unlike trading venues, SIs offer a more bespoke service tailored to clients' requirements and provide liquidity by assuming risk positions. Buy side clients find this valuable in the execution of large and/or complex trades.

7. Whether trading on venues, MTFs, OTFs or with SIs, the dominant trading protocol used by market participants remains RFQ.

8. In general, the SMSG considers that market participants are abiding by MiFIR SI pre-trade transparency obligations. This is in line with ESMA's findings that SI firms are meeting their MiFIR SI pre-trade requirements: "the [ESMA] data does not suggest any intention to circumvent the pre-trade transparency obligation via the SSTI threshold (i.e. by quoting 'just beyond' the threshold)". However, ESMA should further work to ensure supervisory convergence and enforcement.

II. Specific Comments

9. Market participants (both buy and sell-side participants) are aware as to what constitutes a 'firm quote' and the SMSG does not consider that more clarification is necessary.

10. In terms of trade execution, buy-side participants assess how they wish to execute a trade based on the current market liquidity, and specific bond liquidity in the context of the size of the desired trade.
11. Where they deem the trade to be large in size and possibly illiquid, they will assess market conditions, and search counterparty axes and runs for indications of interest and activity in

the bond. Only then will they engage directly with a counterparty that they think can offer or bid for the bond, in the size they require. For liquid and illiquid bonds that are small in size buy-side participants will generally use an MTF RFQ protocol to source liquidity at the best possible price.

12. Buy-side participants interact more with vendor published axes and inventory rather than MiFIR based SI pre-trade quotes published on websites.

13. From a sell-side perspective, SIs are generally not asked to disclose quotes in illiquid bond instruments in accordance with MiFIR. Most SIs use a pre-trade waiver with respect to illiquid instruments and trades in illiquid instruments are largely negotiated bilaterally.

14. Similarly, from a buy-side perspective, there is no awareness of MiFIR based quotes being available for illiquid instruments. When trading an illiquid bond, the buy-side will search for axes and inventory and then discuss with a counterparty to trade.

15. The SMSG recommends that MiFIR SI pre-trade transparency obligations should only focus on the transparency element (as it does with multilateral venues) - 'making the information public' as stated in Article 18(1). The SMSG considers that Article 18 currently imposes additional obligations on SIs to make firm quotes available and (unlike for multilateral trading venues) enter into transactions. This creates unnecessary complexity and an unlevel playing field. The SMSG proposes that ESMA remove the second part of the obligation (namely to "enter into transactions") to create consistency.

16. For buy side clients deciding whether to trade on a trading venue or with an SI, it should be noted that in bond markets, SIs do not function simply as an alternative to trading venues. They offer a valuable tailored service based on their clients' requirements, and provide liquidity, by assuming proprietary risk positions, recognising that they will be able to manage that risk. This influences where buy side participants will choose to trade.

17. Accordingly, buy side firms may choose to request quotes bilaterally from an SI rather than access that SI's liquidity through a trading venue when trading in significant size, in order not to reveal their intentions to multiple liquidity provider which might move the market and compromise their ability to execute effectively. Similarly, for complex trades, or series of trades they may prefer to discuss directly with an SI and use its liquidity and risk management/hedging expertise to execute optimally.

18. The CP makes proposals with regard to the waiver arrangements for SIs and the SMSG supports the objective to foster supervisory convergence and simplification. However, in this case we note that the waiver arrangements are well understood and widely used and hence the SMSG doesn't consider a change to the current waiver arrangements is necessary - whilst of course supporting the goal of supervisory convergence more generally.

19. The SMSG also observe that the ESMA liquidity calibration results are used by market participants in determining the appropriate specific transparency arrangements for each security. The calibration of the thresholds and the determination of liquidity are to be the subject of a subsequent CP (see 4.1 para 91), but as commented earlier in this advice there is no evidence of any circumvention of the current regime and the SMSG agrees with ESMA that no change to the relevant legal framework is necessary.

20. As far as the arrangements for publishing quotes are concerned the SMSG would support proposals to inform clients and market participants as to where published SI quotes can be found. However, the SMSG notes that there are elements of Article 13 which relate to equites and are not readily applicable to the bond market. The SMSG recommends that ESMA reviews Article 13 to ensure that its provisions are practicable in respect of the bond markets.

21. As a final point, the SMSG notes that the pre trade transparency regime can only provide value if the quoted prices reflect prevailing market conditions. If the pre trade transparency concept is to be retained then SMSG would advise that ESMA conduct a series of interviews with both SIs and buy side participants to assess their views about pre-trade transparency and how well the quotes reflect prevailing market conditions, focussing on a more qualitative approach rather than purely quantitative.

Adopted on 23 March 2020

[signed]

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