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Capital
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Association

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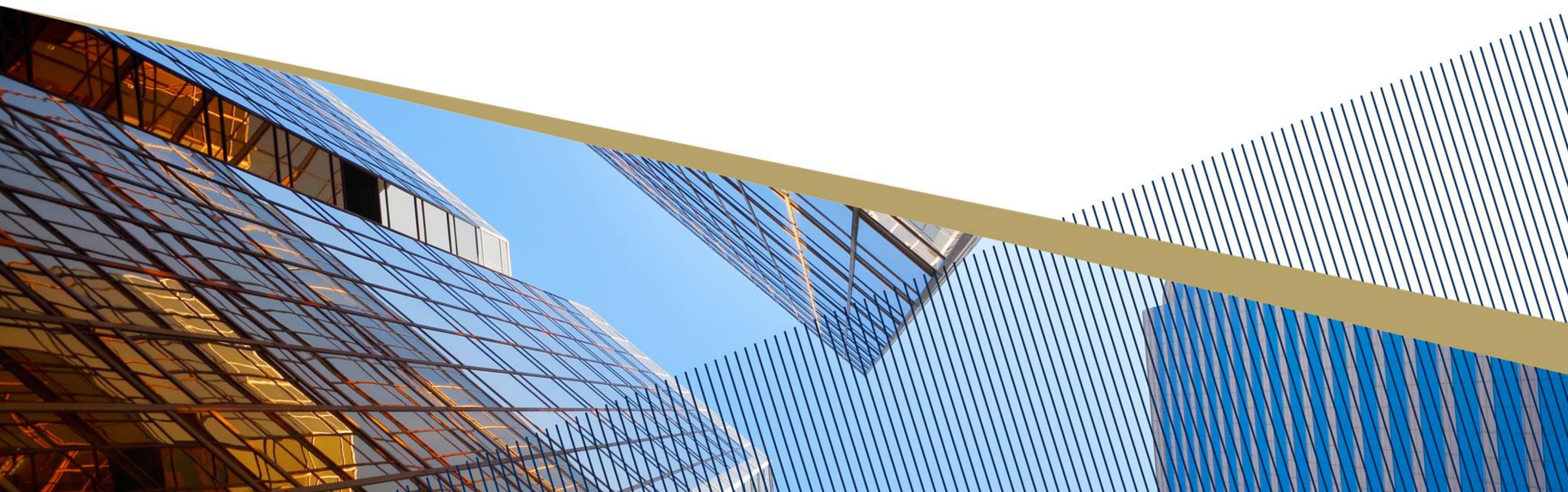

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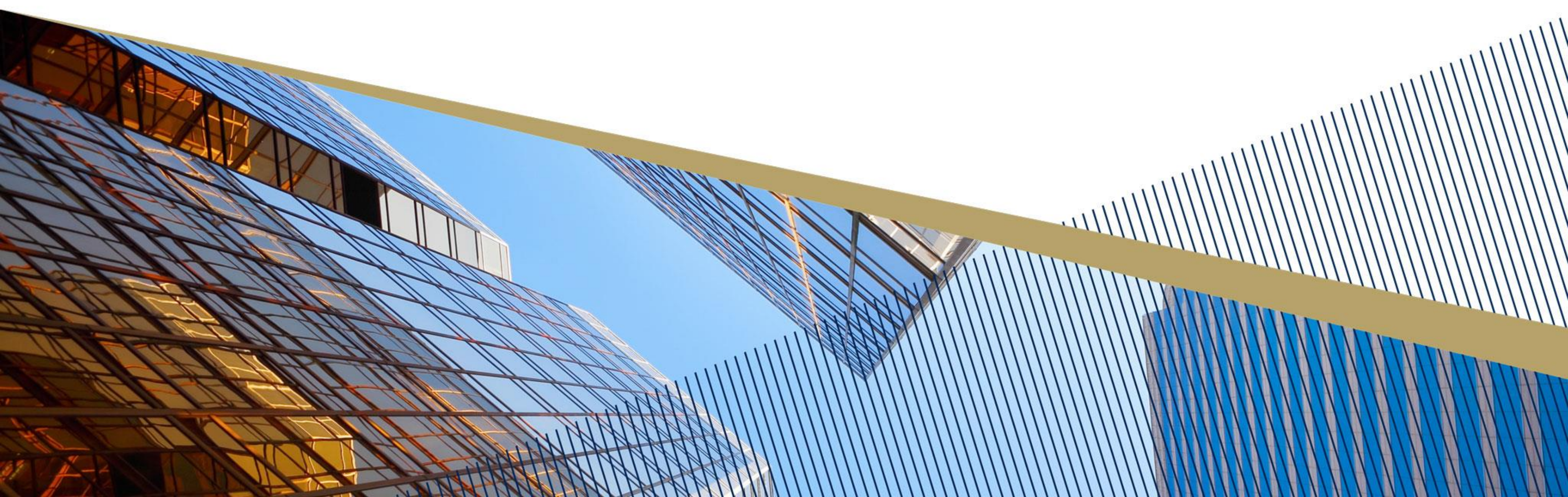
MiFID II, Liquidity & Electronic Trading



Agenda:

1. MiFID II Consultation Paper - Summary

2. MiFID II Consultation Paper & Liquidity – Unintended Consequences

3. MiFID II Consultation Paper & Liquidity – Bond Transparency: Pre – Trade & Post Trade

4. Electronic Trading – Synergies, Evolution & Darwin

In summary:

ICMA's Working group members: buy-side heads of dealing desks, sell-side heads of trading desks as well as market structure heads

- Focus: Orderly functioning of the market
- Concentration: Liquidity related questions in the consultation paper

MiFID II - extends equity transparency obligations into fixed income instruments:

- Liquidity Determination: ESMA wants ease of monitoring and simplicity – less focused on accuracy… Chose Class by Class (COFIA) liquidity determination model.
  - E.g. Subordinated Corporate bonds could be liquid w/transparency requirements and Senior corporate bonds or non-EU Sovereign bonds might be illiquid…
- ESMA's own data analysis: 42% to 74% false positives (inaccurate classification of instruments as liquid, when in fact they are illiquid)
  - Corporates and Covereds are the worst hit
- ESMA currently has no dynamic (or market responsive) method to change liquidity classification (e.g. liquid to illiquid based on market conditions). ESMA has to change the Regulatory Technical Standard (RTS) and then publish.
- Most traders indicated, the only way to calibrate liquidity properly, is daily average spread – instrument by instrument (IBIA) trading behaviour.
- ICMA proposed two liquidity classification models to ESMA. First and our preferred: 1. Hybrid model which has an element of IBIA, along with an improved granular COFIA table and 2. Second, our reserve: COFIA model – COFIA only but with modified and tiered Size Specific to the Instrument (SSTI) and Large in Scale (LIS) thresholds.
- Deferrals: ICMA also suggested longer than 4 weeks for the supplementary deferral regime. 12 weeks or more was deemed the optimal deferral period.
- ESMA had left out 'Package Transactions' (transactions that are combinations of asset classes or combination within asset classes) in the Consultation Paper. ESMA in the Open Hearing in Paris last month acknowledged this. It is anticipated it will be added to the Level II documentation at some point. ICMA believes these 'Package Transactions' should be illiquid if package contains liquid and illiquid components.

Unintended Consequences:

False Positives (inaccurate classification of instruments as liquid, when in fact they are illiquid):

1. Investment manager receives client instructions to liquidate a percentage of their portfolios in cases of adverse risk conditions.

- Contractually agreed between asset manager and client (pension fund, insurance company or large corporate, for example)

Unintended Consequence - Two-fold:

I. They may not be able to liquidate at all, particularly now in a shrunken balance sheet environment.

II. The price may be so disadvantageous that it corrupts the funds' performance.

Unintended Consequences:

False Positives (inaccurate classification of instruments as liquid, when in fact they are illiquid):

2. Public Funds are increasingly collateralised with bonds E.g. Bond ETFs. Collateralisation is a daily and sometimes intraday process.

- If the collateral is advertised as liquid but is in fact, illiquid then this could put the underlying client at risk.

Unintended Consequences:

I. Create balance sheet problems for the client (e.g. pension scheme, insurance company or even a bank treasury).

II. Create forced behaviour such as untimely buying/selling of bonds, resulting in further illiquidity.

Unintended Consequences:

False Positives (inaccurate classification of instruments as liquid, when in fact they are illiquid):

3. Investment Managers - Liquidity scorings for UCITs Funds:

- Senior portfolio managers at an investment manager must sign off on liquidity scores (process of ascertaining the relative liquidity of individual ISINs as the constituents of the UCITs fund) of a given fund.
  - The portfolio manager then discusses with the client what they are holding and why and how the client can liquidate certain 'liquid' portions at the client's request.

Unintended Consequences:

I. Can create the appearance the asset manager is mis-managing client funds.
II. European client (Pension Fund, State Treasury etc.)may have made decision to invest €100 million based on liquidity scoring and informed discussions with the portfolio manager. This information and resulting decision is now incorrect. The end client is punished for the mis-calibration or 'false positive' liquidity classification.

Bond Transparency:

Pre – Trade:

- Bonds are complex with moving parts:
  - Maturity Dates
  - Coupons
  - Interest rate
  - Credit Rating
  - Currency
  - Cyclicality
- Only way to properly calibrate liquidity in pre-trade space is daily trading behaviour, using average spreads.

Post -Trade:

- Deferrals - Supplementary deferral regime:
  - In order to hedge and trade-out a tricky large illiquid trade, banks often need longer than 4 weeks. 12 weeks or longer is recommended by ICMA. Otherwise, the resulting market impact on pricing is a disincentive to market makers.

Lack of standardised structure, not conducive to electronic trading: Often the new bond trades actively for three days and then goes off the run to trade sparsely or sometimes never to be heard from again…

Bond Transparency

1. Does this mean you shouldn't trade bonds electronically?

No, electronic trading is necessary to meet Regulatory obligations and increase efficiency, automation and effectiveness.

2. Are there no synergies between equities and fixed income electronic trading?

No, synergies exist but with market structure and not instruments.

- Equity Instruments – 9000 listed equities, on average trade 400 per day.
- Fixed Income Instruments – 300,000 bonds, on average trade 1.5 times per day. (Academic study 2007)

3. The evolution of electronic trading is happening now in fixed income. However, electronic trading advancement will be quite unlike that experienced in equities.

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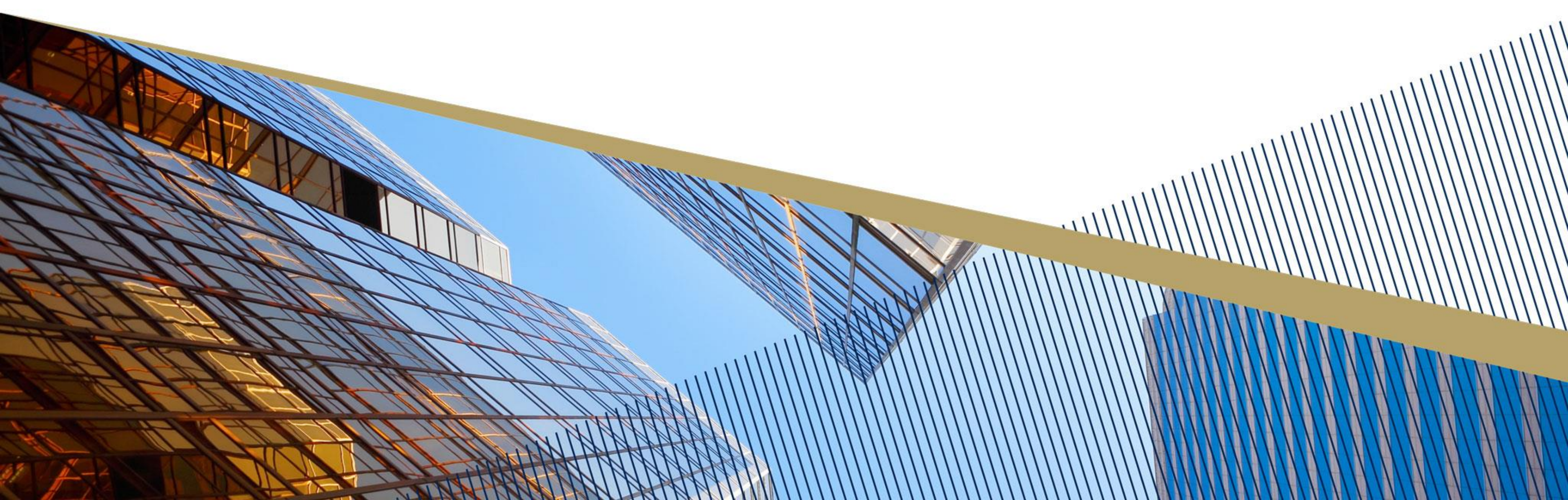
Bond Electronic Trading
Synergies, Evolution & Darwin



Electronic Trading – Synergies between equities & fixed income:

Electronic Trading – Drivers:

1998 – Equities

- Buy-side control – Informed decisions, performance and evidence based execution
- Technology – Advancements led to the beginnings of STP and the start of electronic trading
  - Order Management Systems & Execution Management Systems
  - FIX Protocol (buy-side & sell-side common language and standards for cross border electronic trading)

2015 – 2017 and beyond - Fixed Income

- Regulations – Market crisis
  - Prevent another 'Liquidity Crisis', as in 2008/09 (Political Agenda)
- Regulations – MiFID II
  - In order to meet obligations, have to have some form of electronic trading for 'evidence' purposes
- Regulations – Balance Sheet shrinkage (e.g. Basel III: Liquidity Coverage Ratio, Leverage Ratio, NSFR)
  - Investment Banks no longer can hold large inventories, causing liquidity fragmentation. Need electronic methods of 'sourcing' liquidity across a fragmented landscape

MiFID II – Market Structure 'Standardisation' NOT "equitisation" of fixed income markets.
Market Structure categories: RM, MTF, OTF & SI*

Sourcing Liquidity:

"All to All"
Platforms

Market Axess
Tradeweb
Bloomberg
MTS.com (FIX 4.4 API)

Dark Pools or Anonymous Trading

Liquidnet
ITG
Electronifie
Broker Crossing Networks*

Actionable IOIs, using Algo & SOR logic to aggregate and facilitate

Bondcube
Project Neptune
Algomi

*More detail in subsequent slides

Electronic Trading – Synergies between equities & fixed income:

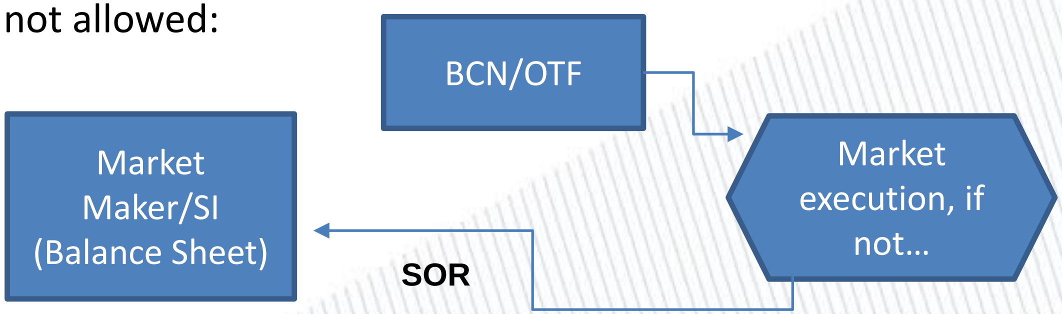
*Broker Crossing Networks, what the regulation states:

MiFID II states, in 2017:

- Member States shall **not allow the operation of an OTF and of a systematic internaliser to take place within the same legal entity.** An OTF shall not connect with a systematic internaliser in a way which enables orders in an OTF and orders or quotes in a systematic internaliser to interact. An OTF shall not connect with another OTF in a way which enables orders in different OTFs to interact.

- Investment firm and a market operator operating an OTF **establishes arrangements preventing the execution of client orders in an OTF against the proprietary capital** of the investment firm or market operator operating the OTF **or from any entity that is part of the same group or legal person** as the investment firm or market operator.

Scenario not allowed:



Electronic Trading – Evolution

***Systematic internaliser obligations:**

- Investment firms shall make public firm quotes in respect of bonds for which they are systematic internalisers and for which there is a liquid market when the following conditions are fulfilled:

(a) They are prompted for a quote by a client of the systematic internaliser;

(b) They agree to provide a quote.

…

- Systematic internalisers may update their quotes at any time. They may withdraw their quotes under exceptional market conditions.

Electronic Trading – Evolution

- Fixed Income is not equities
- Transparency does not equal liquidity
- Electronic trading does not create liquidity

- Electronic trading will stimulate innovation. From innovation, additional liquidity can materialise. E.g. HFTs are liquidity providers in equities market

Darwinian approach to Market Structure in **Equities**…

- 2002

Equities – Execution or Liquidity Venues (21):

Nyfix Euro – Millennium, Pipeline, Liquidnet, Pulse Trading, Chi-X, Posit, BATS, Turquoise, Baikal, Plus Pool, Smartpool, SwissBlock, Sigma X, Tradepoint, BlocSec, LIQUIFI, Cross Finder, E-Crossnet, BlockCross, IOInet, Jiway, Lehman Live

- 2015

Equities – Surviving Execution or Liquidity Venues (8):

Liquidnet, BATS Chi-X, Posit, Smartpool, *Sigma X, BlocSec, LIQUIFI, CrossFinder*

Darwinian approach to Market Structure in **Fixed Income**?

- 2015

Fixed Income – Execution or Liquidity Venues (32 – at last count…):

Some of which include: Liquidnet, ITG (Dark Pool), GFI, Creditex, Bondcube, Algomi, Trumid, Electronifie, Bonds.com,Delphx, ITB, Trading Screen…

Similar (but definitely not exact)to the equities experience, Fixed Income electronic trading is maturing due to a confluence of **market structure standardisation**, **regulation** and **technology**.

Leading to a Darwinian approach to:

- Liquidity sourcing venues/Execution
- Technology
- Front office skill-sets