SYSTEMATIC INTERNALISATION UNDER MIFID II: WHAT’S NEEDED NOW
INTRODUCTION

From September 1, MiFID II-regulated firms breaching certain volume thresholds for internal matching of client orders will be required to register as systematic internalisers (SIs).

SIs were created by regulators under the original MiFID directive a decade ago, and applied to equities, where the approach had only modest uptake. Today, regulators are using SIs to enhance transparency across the wider financial markets, including fixed income and OTC derivatives. Regulators are hoping that SIs will shift liquidity from opaque dark pools and broker crossing networks (BCNs) to the more transparent SI platforms. As such, SIs will be required to report their quotes and trades to the marketplace across all instruments through a new framework of pre- and post-trade reporting created by MiFID II.

This new SI regime effectively rounds out the reconfigured execution venue landscape under MiFID II for Equities and Fixed Income, with wide-ranging repercussions both for sell-side firms facing mandatory registration as SIs and an evolving competitive landscape, and for trading firms seeking to understand which SIs they should be doing business with. In a last-minute reprieve, the SI regime for Derivatives has been pushed back to next spring.

This paper will explore the impact that the SI regime is having on financial services firms as they prepare for the September 1 deadline. Firms deciding on SI registration need answers to crucial questions, such as:

- Does the firm need to become an SI due to existing or expected trade volumes?
- Does the firm need to become an SI in order to become or remain competitive?
- What does the firm need to do from an operational workflow, technology and data perspective to implement the infrastructure needed to become an SI?

Additionally, the paper will look at how trading firms that could find themselves doing business with an SI should navigate the new execution venue landscape. For example, how do they deal with the growing complexity of liquidity in the marketplace and the greater need for transparency around counterparties? How do firms understand who the SIs are in the marketplace, and what the competitive implications are for a particular instrument or instrument group?
THE NEW SYSTEMATIC INTERNALISER REGIME

The new SI regime is potentially transformative for the markets for financial instruments, as well as for financial services firms themselves. Both sell-side and buy-side trading firms need to make sure that they fully understand the implications of the SI structure, as well as the evolving competitive landscape.

Deciding whether or not to become a systematic internaliser – or how to cope with being one automatically – requires strategic thinking. The rules around SI activity are nuanced, and the role that SIs will play in the marketplace is evolving. Firms considering whether or not to become an SI need to understand the answers to a number of questions:

What is a Systematic Internaliser?

While the term ‘systematic internaliser’ has been around for a while – it originated in MiFID I – it’s a good idea to revisit the definition briefly as a starting point. MiFID II and the associated MiFIR regulation have defined a systematic internaliser as an investment firm which, on an organised, frequent, systematic and substantial basis, deals on its own account when executing client orders outside a Regulated Market (RM), Multilateral Trading Facility (MTF), or Organised Trading Facility (OTF).

The regulators created the SI regime for equities – and are expanding it to include bonds, structured finance products, emission allowances and derivatives – to improve transparency around the trading of instruments over-the-counter (OTC) for the markets as a whole. (A last-minute reprieve, announced by ESMA in July, has pushed back the implementation date by six months to March 1, 2019, for a range of instruments, including exchange-traded commodities, exchange-traded notes, securitised futures products, securitised derivatives and emissions allowances and derivatives.)

The shift toward SIs also will help the regulators to better understand and manage systemic risk, through the transparency created by trade reporting. Third, the SIs will help to ensure that the internalisation of order flow by financial services firms does not undermine price formation on trading venues.

Post-financial crisis, global regulators had concerns about all of these areas. In bond trading, supervisors are hoping that this new degree of transparency will eliminate off-venue trading practices that they worried were disrupting price formation. For OTC derivatives – which were a big cause for concern in the financial crisis – the new transparency is openly designed to push much of this market out into the light, helping improve price competition and also reducing systemic risk.
Why Become an SI?

Firms can become SIs in two ways – either because ESMA has told them they must do so, or because the firm has decided it wishes to voluntarily do so, for competitive reasons.

Firms are required to become an SI when the volume they trade (numerator) in a particular instrument (or collection of instruments) exceeds a threshold set and published by ESMA. This threshold is based on the total number of transactions in the particular instrument or group (denominator).

ESMA is publishing the first set of SI calculations, setting the thresholds, by August 1, 2018. This covers a period from January 3, 2018, to June 30, 2018. Financial services firms will then need to decide if they must become an SI, if their trading volumes in a specific instrument exceed the ESMA threshold. If a firm must become an SI, it will need to comply with all of the SI obligations by September 1, 2018. For the reprieved asset classes (e.g. derivatives), initial publication – covering the period July 1 to December 31, 2018 – is now scheduled for February 1, 2019, and SIs will have to comply with their regulatory obligations from March 1, 2019.

Going forward, ESMA will publish the SI thresholds within a month of the end of each assessment period – so on the first calendar day of February, May, August, and November. Firms that breach the SI thresholds going forward – and who are therefore required to become an SI – must do so within two weeks of the publication of the threshold data, and notify their regulator of their new status. Many firms will be monitoring their trading volumes for instruments and groups, so that they can determine in advance whether they are approaching the SI thresholds in instruments for which they were previously not an SI. This is important, as the transition window of two weeks is simply too little time for most organisations to prepare to meet their regulatory obligations.

More information about the calculations involved in becoming an SI – such as which transactions count and how to engage with clients when an SI – is available here: https://www.esma.europa.eu/system/files_force/library/esma70-872942901-35_qas_transparency_issues.pdf.

A firm may also decide that, for competitive reasons, it wishes to become an SI. This could be because many of its main competitors in the market are SIs, and the firm feels that it therefore should also become an SI. By becoming an SI for a particular instrument, the firm must meet certain compliance obligations, which makes it a more attractive trading counterparty, particularly for buy-side firms. While the deadlines do not apply, it must also comply with all of the other SI requirements, including notifying the regulator of its SI status.

What Are SIs’ Reporting Obligations Under MiFID II?

Becoming an SI entails significant compliance obligations and therefore will
naturally increase costs. Firms should take these additional requirements, and the associated resources needed to fulfil them, into account when choosing whether or not to be an SI. Firms who find themselves required to become an SI but find it is not economically viable for them to continue in this status should reflect on ways to improve the efficiency of their compliance processes before deciding how they plan to disengage with clients to reduce trade volumes around the particular instrument that has attracted the SI status.

MiFID II charges SIs with a range of obligations, among them the ability to match client orders, to monitor transactions against a published best execution policy and to report to the market and to regulators in a variety of ways. This latter reporting obligation is perhaps the most challenging for SIs.

For a start, SIs must publish pre-trade quotes to the marketplace. Post-trade, under most circumstances SIs are responsible for fulfilling trade reporting obligations, which under MiFID II require one of the counterparties to report the trade to the marketplace within 15 minutes (five minutes after 2020). Finally, for transaction-reporting, all counterparties – including SIs – need to report transactions to trade repositories clearly identifying what was traded and the parties involved in the trade.

These requirements are significant, and so organisations should ensure they are prepared to fulfil them if they are considering becoming an SI, or are trading close to the SI threshold limits. In each case, the required data needs to be structured and validated before delivery into the chosen reporting mechanism. This requires data managers to understand the formats, frequencies and other nuances of how the recipient accepts reported information.

**What Kind of Investment is Involved in Becoming an SI?**

Becoming an SI comes with costs for firms – each firm should investigate the impact of these costs on its overall business strategy. Key areas where investment is required include:

**Compliance costs** – The significant compliance costs associated with becoming an SI could impact the competitiveness with which the firm is active in the marketplace.

**Data management** – To physically undertake the various regulatory reporting obligations, a firm requires a robust approach to data management. In particular, SIs need to ensure they have a strong approach to reference data as they have a daily regulatory reporting obligation for this.

**Pre-trade quoting and post-trade reporting technology** – While this is costly and comes with a range of compliance obligations, post-trade reporting in particular is an attractive marketing asset. Trading firms may select to do business with an SI over a competitor that is not an SI so that it can avoid having to undertake this obligation itself.
Once a firm has decided to become an SI – or is required by the regulator to become one – it needs to put in place a practical approach to ensure it can meet both its regulatory obligations and the needs of the business. For many, a key challenge will be identifying and sourcing the reference data they need to meet MiFID II’s transparency requirements; particularly around pre-trade quotes, and trade and transaction reporting.

Firms need to modify their workflows in order to ingest the requisite reference data to support publication of pre-trade quotes and generate trade and transaction reports. This process change necessarily involves a rules engine that can support the decision trees needed to ascertain on a per-instrument or per-segment basis how the firm needs to treat each tradeable product. In short, firms need this reference data to determine whether they need to publish any quote or report any trade, and it needs to be readily accessible at the right stage in the decision process.

To address these issues, firms will need to modify their trading workflow to ensure they can:

**Publish Pre-Trade Quotes** – All prices quoted by an SI must comply with the SI’s best execution obligations under Article 27 of MiFID II. The quote must also reflect the market conditions at the time, with particular reference to trading venues. Normally the SI would provide a quote to a client on request. The quote is then made public through one or more Approved Publication Arrangements (APAs). The SI can also publish the quote on its website – all publications of the quote must be simultaneous. The SI may also make the quote available to other clients of the SI – the SI has the discretion to select which categories of clients receive the quote. SIs are also able to limit the number of transactions a client may enter into. Both the sharing of the quote and the limiting of the number of transactions must be part of a formal commercial policy of the SI.

To achieve this, SIs need a quote engine to generate and send pre-trade quotes to an appropriate APA and respond to requests for quotes. The quote engine must link to the parts of the trading systems that support SI-required market-making and quoting functions. In addition, to execute on the quoting and reporting requirements of the SI rules effectively, SIs need to ensure their client order management function is integrated enough to ensure all necessary information is captured for reconciliation purposes. As well, SI solutions need speed and accuracy to publish and adjust quotes in fast-moving market conditions. All of these activities must be supported by a good source of reference data, which can be applied at all of the relevant points in the process.

**Complete Post-Trade Reporting in Close to Real Time** – Under MiFID II, one of the two counterparties to a transaction is required to report the trade within 15 minutes (five minutes after 2020) of execution either directly to market or through an APA. MiFID
II rules dictate that under most circumstances, the SI is responsible for fulfilling trade reporting obligations (for example, in OTC transactions, including when the SI is the buyer). The SI also has to inform its counterparty that it is undertaking this reporting, so that the trade is not reported twice.

This requires SIs to operate internal reporting mechanisms with easy access to all required data sets, including details of the trade, as well as high-quality reference data describing the assets and counterparties involved in the transaction. Reference data is needed to determine who reports the trade for the specific instrument involved, which may depend on counterparty, instrument, buyer or seller, or whether it qualifies for deferral. An APA helps deliver post-trade reports to the marketplace, but the SI remains the regulated entity and many SIs are not comfortable relying solely on their selected APA to perform this function. SIs will need to be sure that both their technology and their approach to reference data is up to this significant task.

**File Transaction Reports Within 24 Hours** – All counterparties need to report transactions clearly identifying what was traded and the parties involved in the trade, either directly or through an Approved Reporting Mechanism (ARM). Transaction reporting under MiFID II/MiFIR requires price, volume, time of trade and reference characteristics of all data points, as well as reference data codes mandated by MiFID II for instruments and entities (RTS 1, 2, 22 and 23). The data needs to be structured and validated before it is delivered to an ARM for onward reporting to regulators, or for direct reporting to regulators.

Finally, MiFID II requires that firms put in place a control framework to ensure that reports are complete and accurate. This should include mechanisms for identifying errors and omissions, duplicates or over-reporting when there is no obligation. A robust control framework would also include regular testing of processes, regular reconciliation of front-office trading records with external trade reports, and an independent source of reference data.

**Key Challenges for SIs**

All of these reporting activities require significant changes to the trading workflow, supported by a robust source of reference data that is readily accessible. A Reference-Data-as-a-Service (RDaaS or Utility) model removes the complexity involved in sourcing the MiFID II data, providing a complete data service that meets the toughest of regulatory expectations. This allows the firm to focus on its trading operations, automating the trade workflow and ensuring customer satisfaction, reducing cost and improving profitability of the SI for the organisation.

Firms that are monitoring their trading volumes to ensure that they understand whether they are close to the SI mandatory limits need to be able to understand how to measure their volumes and how those trades are bucketed into groups. This requires a good understanding of RTS 2 and access to data that accurately reflects the asset classifications of the products traded relative to the RTS 2 definitions.
Trading firms – whether they are SIs or not – also need to keep on top of the rapidly evolving SI landscape. As the number of SIs within the EU continues to increase, and the amount traded on them rises, it will be important for trading firms to know who they are doing business with. SI status determines a number of compliance activities, including trade reporting. Indeed, for trading firms – particularly those on the buy-side – doing business with an SI may be a good way of eliminating the compliance costs associated with trade reporting.

Investment firms who have significant best execution obligations to their clients also need to understand who is an SI for which instruments. It will become increasingly difficult to claim that best execution has been achieved, if an investment firm does not know who are the most significant brokers or market makers (SIs) for the instruments traded.

ESMA does not provide a list of which firms are SIs, by instrument. As a result, the financial services industry is taking a centralised utility approach, coming together to create a registry of SIs by instrument. This list enables all subscribers to immediately see the SI landscape across the EU, helping trading firms to better understand who they should be trading with.

LOOKING AHEAD: THE SI LANDSCAPE IN 12 MONTHS’ TIME

The SI concept is having a far greater impact on the capital markets under MiFID II than it did under MiFID I, where it was restricted to only equities. Trading volumes under SIs have been much greater since the January go-live date of MiFID II, and continue to trend higher.

Many large financial services firms opted to become SIs at the January 3 date, and others have opted to become SIs subsequently, but it is clear that the number will continue to rise, driven either by competitive momentum or ESMA mandate. As a result, the SI landscape is becoming more complex and it is increasingly difficult to understand who is an SI in what, making it even more important to have access to a registry of SI services by instrument.
CONCLUSION – SMARTSTREAM SI SOLUTIONS

SmartStream’s Reference Data Utility (RDU) can help by providing the essential reference data that firms need to navigate the MiFID II regulations. For systematic internalisers, the RDU delivers of all of the reference data needed to complete the wide range of MiFID II compliance requirements, including regulatory reporting. This makes being an SI easier to accomplish. For trading firms seeking to better understand the SI landscape in advance of a transaction, the RDU provides clarity in what is a relatively opaque area of the MiFID II landscape – just who the SIs for a particular instrument are.

Reference Data for SIs

The SmartStream RDU offers a complete set of data for all MiFID II requirements, aggregated and enriched for easy data integration. The RDU allows a choice of distribution methods, either file-based or through a cloud-based API. The RDU MiFID II file-based service offers daily file drops via SFTP, full files at weekend, and deltas during the week – synchronized with ESMA publication. The cloud-based API service offers RDaaS through a set of request / retrieve REST APIs that allow easy integration into your trade workflow. The service provides full support for all asset classes, pre and post-trade flags and thresholds, intra-day OTC Derivatives, Traded on a Trading Venue (ToTV and uToTV) determination, ANNA integration and all with easy counterparty role identification built in.

The SmartStream RDU also offers all of the data that you need to be able to monitor how close to the SI mandatory thresholds you are with the volumes that you are trading. No-one wants to be surprised by receiving notification of a mandatory requirement for SI status from ESMA and only have two weeks to comply.

The SI Registry – A View of the SI Landscape

The SI Registry is available from the SmartStream RDU and offers a comprehensive record of which SI is providing SI services in which instruments. A collaboration between the SmartStream RDU, the APA community and their SI customers, the SI Registry allows SIs to register the financial instruments for which they are providing SI services through their APA, resulting in a comprehensive listing of the services offered.

The SI Registry is operated by the SmartStream RDU and open to all APAs with collaboration; including Deutsche Börse, Bloomberg, Nasdaq, NEX Regulatory Reporting, TRADEcho, Tradeweb and Trax. The registry is also open to all SIs and more than 60 have signed up so far, a number that continues to increase as the September 1 date approaches.
The SI Registry data is essential for SIs to meet their post-trade transparency obligations, but the SI Registry data is available to all market participants, including traders that are not SIs and investment firms.

Trading firms can more simply meet their post-trade transparency obligations if they can identify upfront whether they or their selected brokers will be required to report a trade. By making broker selections based on whether the broker is an SI, trading firms can reduce the costs and complexity of some of MiFID II’s reporting obligations.

Investment firms can much more reliably meet their best execution obligations if they understand the SI landscape and which brokers trade which instruments as SIs and therefore probably at volume.

In conclusion, while the SI landscape is rapidly evolving, SIs, trading firms and investment firms can benefit from joining the SmartStream RDU – which delivers the reference data they need to complete regulatory reporting under MiFID II, monitor their SI mandatory status and maintain a good picture of the overall SI landscape.
ABOUT SMARTSTREAM RDU

The SmartStream Reference Data Utility (RDU) is a managed service that delivers complete, accurate and timely reference data for use in critical regulatory reporting, trade processing and risk management operations, dramatically simplifying and reducing unnecessary costs for financial institutions.

The RDU acts as a processing agent for its participants selected data sources; sourcing, validating and cross-referencing data using market best practises so that these processes do not need to be duplicated in every financial institution. An experienced global team, who operate under the compliance frameworks of their customers, deliver data that is fit-for-purpose, consistent and in a format that is specific to the financial institutions’ needs.

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