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MiFID II – Microstructure and trading obligations

Microstructure – RM/MTF/OTF/SI

MiFID II introduces a new category of trading venue called an Organised Trading Facility (OTF) that will sit alongside Regulated Markets (RMs), Multilateral Trading Facilities (MTFs) and the amended scope of Systematic Internalisers (SIs). Only non-equity instruments, namely bonds, derivatives, emission allowances or structured finance products, will be eligible for trading on an OTF. Whilst firms are unable to operate both an OTF and act as an SI, the operator of an OTF may also operate a RM or MTF. Additionally, operators of OTFs will be prohibited from allowing the interaction of orders between two separate OTFs.

Consistency of application

To ensure consistency amongst the different types of trading venues, MiFID II extends the requirements that were previously applied to RMs and MTFs to OTFs. For instance, operators of an MTF or OTF are required to establish transparent rules regarding the criteria for determining which financial instruments can be traded under their platform, as well as ensuring fair and orderly trading with objective criteria for the efficient execution of client orders. Furthermore, MiFID II imposes a number of requirements upon trading venues that largely mirror those imposed upon investment firms, namely relating to governance and accountability, staff competency and training.

Market abuse and surveillance

Operators of an MTF and OTF are required to immediately inform the regulator of any instances of significant infringements of its rules, disorderly trading conditions or conduct issues that may indicate potential market abuse. Firms must ensure that they have sufficiently effective monitoring arrangements in place to assess and record any potential instances of market abuse. Furthermore, should a trading venue remove or suspend a particular instrument due to suspected market abuse, it must make its decision to do so public and other trading venues must also remove or suspend this instrument (unless doing so would likely cause significant damage to investors or the orderly functioning of markets).

Robustness of operation

Significant technological advances in the way financial instruments are traded have occurred since the implementation of the original MiFID legislation in 2007. MiFID II aims to ensure that firms operating trading venues have in place appropriate and effective systems and controls to ensure orderly trading conditions are maintained under times of severe market stress, particularly via the use of effective business continuity procedures.

Additionally, to help ensure that orderly trading conditions are maintained, regulated markets are required to have in place processes to reject orders that exceed pre-determined volume and price thresholds, or orders that are clearly erroneous, as well as halting or constraining trading if there are significant price movements in financial instruments in a short period of time. There are also new requirements relating to the standardisation of tick sizes for certain financial instruments, as well as the synchronisation of business clocks.

Trading obligations - derivatives

MiFID II introduces a requirement that specific in-scope OTC derivative contracts must be traded on a RM, MTF, OTF or equivalent third-country trading venue, and not executed on a bilateral basis. This requirement applies to financial and non-financial counterparties that are subject to the clearing obligation under EMIR. ESMA's Regulatory Technical Standard 4 provides further details to those outlined within MiFID on which derivatives are subject to these new trading obligations. It should be noted that any intragroup transactions are exempt from this trading obligation. In summary, there are three conditions that, if all are met, will determine whether a derivative is subject to the trading obligation. These are:

- the derivative, or subset thereof, must be admitted to trading on at least one trading venue;
- the derivative or subset thereof, is considered sufficiently liquid (determined by frequency and size of trades, the number of market participants and the average size of spreads); and
- ESMA has deemed the contract in question subject to the clearing obligation, as outlined under EMIR.

Equities

In order to ensure more trading takes place on regulated trading venues, a trading obligation for shares admitted to trading on a regulated market or trading venue is being introduced. This obligation will require investment firms to undertake all trades, including trades dealt on own account and trades dealt when executing client orders, on a RM, MTF or SI (or equivalent third-country trading venue). There are, however, exclusions from this obligation that can be applied when there are "legitimate reasons". These reasons are where trades are non-systematic, ad-hoc, irregular and infrequent, or are technical trades such as give-up trades which do not contribute to the price discovery process. Such an exclusion from the trading obligation should not be used by firms to circumvent the restrictions introduced on the use of the reference price waiver and the negotiated price waiver, or to operate a broker crossing network or other crossing system.

Pre-trade transparency

The financial crisis exposed weaknesses in the way information on trading opportunities and the pricing of financial instruments (other than shares) is available to market participants, namely in terms of timing, granularity, equal access, and reliability. MiFID II brings into force pre- and post-trade transparency rules that aim to address these issues. In order to provide a sound transparency framework for all relevant financial instruments, these requirements have been extended from just equity instruments and will now apply to bonds, structured finance products, emission allowances and derivatives which are traded on a trading venue. Whilst some pre-trade transparency exemptions do exist, these are only available in a specific number of pre-defined cases (outlined below).

The transparency requirements will be calibrated for different types of trading systems, including order-book, quote-driven, hybrid and periodic auction systems. Furthermore, in order to ensure conditions are uniform between trading venues, the same pre and post trade transparency requirements will apply to different types of venues. The transparency requirements will also be calibrated for different types of financial instruments, including equities, bonds, and derivatives, and take into account the interests of investors and issuers, including government bond issuers, and market liquidity.

Specific requirements

Market operators and investment firms operating a trading venue are required to make public current bid and offer prices, and the depth of trading interest at those prices, which are advertised through their systems for shares, depositary receipts, ETFs, certificates and other similar financial instruments traded on that venue. This requirement will also apply to actionable indication of interests (IoIs). Market operators and investment firms operating a trading venue will need to make this information available to the public on a continuous basis during normal trading hours. Furthermore, this information is to be made public in a manner that is easily accessible to other market participants on a reasonable commercial basis. MiFID II extends these requirements to non-equity instruments including bonds, structured finance products, emission allowances and derivatives traded on a trading venue.

Competent authorities will have discretion to waive these obligations if certain criteria are met. These include block trades (trades that are large in scale compared to normal market size), actionable IoIs in request-for-quote and voice trading systems that are above a size threshold specific to that instrument which would expose liquidity providers to undue risk, derivatives not subject to the trading obligations and other financial instruments for which there is no liquid market.

Contact

If you would like to discuss any element of MiFID II please do not hesitate to call your usual Grant Thornton contact.

Nimah Meenan
Partner, Financial Services Audit
T +353 (0)1 680 5614
E niamh.meenan@ie.gt.com

Sheila Duignan
Partner, Business Risk Services
T +353 (0)1 680 5620
E sheila.duignan@ie.gt.com

Dwayne Price
Partner, Regulatory Advisory Services
T +353 (0)1 436 6494
E dwayne.price@ie.gt.com

24-26 City Quay, Dublin 2, D02 NY19

Over 1000 people operating from offices in Dublin, Belfast, Cork, Galway, Kildare, Limerick and Longford.

@GrantThorntonIE

www.grantthornton.ie