NAVIGATING MIFID II: WINNING IN THE NEW REGULATORY ENVIRONMENT

With only eight months until the Markets in Financial Instruments Directive (MiFID II) comes into effect on 3 January 2018, everyone across the industry has their heads down working hard on solutions to the challenges and opportunities presented by the new regulation. MiFID II will be felt across all asset classes and impact nearly every aspect of trading.

As with the first MiFID, MiFID II is designed to bring more transparency to the market, which is a good thing for investors. But unlike ever before, the buy-side community has been pulled into the thick of this regulation, which has placed increasing pressure on firms already dealing with other marketplace challenges.

As the largest stock market operator and trade reporting venue in Europe, Bats, now a CBOE Holdings company, has been working closely over the past couple of years with its customers to ensure our systems are ready to support the industry through MiFID II. We have listened closely to market participants to understand their biggest challenges as they prepare for MiFID II and have worked closely with them to establish new, easy-to-use services to manage the impact of the new regulation on their trading strategies and business practices.

With new data reporting requirements, caps on trading in dark pools, the emergence of new liquidity pools and trading services, and amended best execution regulations, the marketplace is fundamentally changing for everyone – particularly the buy-side.

As we enter the final stretch of preparation and firms work to establish the framework for managing their businesses in a MiFID II world, I have outlined some of the key areas of impact as it relates to buy-side trading and how firms can work to successfully adapt their strategies to work within the new regulatory environment.

Dark Pool Caps

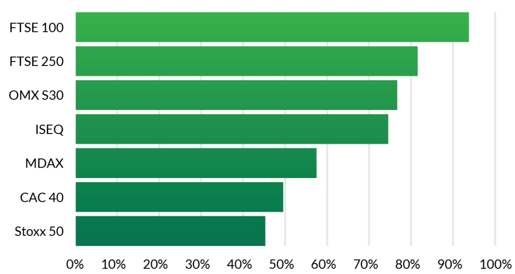
One of the most talked about elements in MiFID II on the trading side is the imposition of caps on the use of the Reference Price and Negotiated Transaction pre-trade transparency waivers, the so-called double volume cap mechanism. These caps will limit the amount of business that can be transacted away from lit order books. For buy-side participants who rely upon dark pools to trade without signalling to the market, the volume caps will have a significant impact on how they execute their trading strategies.

Both MiFID and MiFID II require trading venues to publish details of available orders and quotes. The various pre-trade transparency waivers allow order information to be kept hidden until execution occurs, minimising information leakages and any associated market impact.

The double volume cap imposed by MiFID II will limit the usage of the Reference Price and Negotiated Transaction pre-trade transparency waivers to 4% of the total volume in any stock on any particular venue and 8% market-wide in any 12-month rolling period. If a waiver cap is reached, the stock will be suspended from trading in the dark book(s). The caps are calculated at month end and all suspensions will take effect within seven working days of the end of the month and will last for six months.

Our analysis on the potential impact of the dark pool caps indicates that many stocks would almost immediately breach the 8% market-wide limit. Once the caps are in place, and if there is no alternative, we would anticipate a sizable disruption to trading across the market in a significant number of stocks.

Figure 1: Percentage of Stocks Hitting 8% Cap
Excluding OTC Trades



Source: Bats Europe, February 2017 data

Empirical data evidences the fact that large orders are negotiated bilaterally rather than executed through lit venues. MiFID II will not change this, but its cap rule will force institutional investors to seek alternatives even for smaller-sized orders. If new liquidity pools are not found then one of the main aims of MiFID II, namely to move more volume onto exchanges, is unlikely to be achieved as this sort of activity is much more likely to move into Systematic Internalisers.

New Liquidity Pools

Buy-side firms know better than anyone that being able to trade without signalling is a vital part of the market and dark pools have been an important place for this type of trading. Once the double volume caps come into play, buy-side traders will need new tools and services to enable them to trade without market impact.

What we're seeing is an increase in initiatives across the industry designed to provide alternatives to trading under the Reference Price and Negotiated Trade waivers, including two of our own initiatives – our Periodic Auctions book and Bats LIS (Large in Scale), which have been designed with customers to give investors new tools to find liquidity, trade large quantities of stock and achieve best execution without the associated market impact.

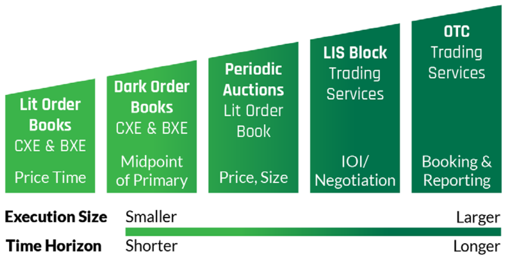
Bats' Periodic Auctions book matches orders on a price/size priority and only executes at or within the European Best Bid and Offer (EBBO) to ensure orderly markets and provide certainty around execution price range. Since the indicative price and size of each auction is published, pre and post execution, it is a lit order book and not subject to double volume caps.

Furthermore, because of the nature of the auction, information leakage is minimised and size of orders is prioritised over time of order arrival so larger order size is encouraged. The frequency of each auction depends on the underlying liquidity of the stock, with many being triggered many times a second. Bats' Periodic Auctions book is available to all its participants and is gaining volume, an encouraging sign as we move towards MiFID II as market participants need to retain the ability to achieve such price improvement. Additionally, for times when a block trade isn't viable or traders want to tranche an order and work it on different markets, Bats' Periodic Auctions book can help facilitate those trades.

When it comes to trading blocks or large in scale, Bats has partnered with BIDS, the largest block trading ATS in the US, to launch Bats LIS, a new block trading service for the European equity market. An indications of interest (IOI) negotiation and execution platform, Bats LIS allows market participants to negotiate large blocks without revealing their intentions to the wider market. Bats LIS provides the buy-side with IOI protection tools and full control over their IOI until execution via a designated broker model to protect against information leakage.

By partnering with BIDS, Bats can immediately offer buy-side firms the opportunity to reach their peers and easily integrate Bats LIS, via the BIDS Trader front-end user management system (GUI), to their own Order Management Systems (OMS) and Execution Management Systems (EMS). Minimising technical impact on customers is crucial to optimise adoption in what is a very busy period for everyone.

Figure 2: Bats Europe Trading Services Overview



Best Execution

One of the other key areas of MiFID II impacting buy-side trading is regulations governing best execution, which are set to become more prescriptive under MiFID II. The overarching MiFID I best execution obligation requires investment firms to take all reasonable steps to obtain, when executing orders, the best possible result for their clients. Firms need to take into account the execution factors – price, cost, speed, likelihood of execution and settlement, size and nature of the order or any other consideration relevant to the execution of the order. This responsibility has been upgraded under MiFID II to "all necessary" steps.

The investment firm's best execution policy must also be signed by the client and reviewed annually. The policy must include information on the execution venues and the factors affecting their choice and with all orders executed on behalf of clients potentially challengeable by clients.

Under MiFID II, the investment firm is required, when executing a client order, to consider each venue listed in its execution policy in order to assess the most favourable terms for execution. In addition, they are now required annually to make public their top five execution venues in terms of trading volumes and the quality of execution obtained.

MiFID II's Best Execution regulations (RTS 27) also require trading venues to provide best execution reports, free of charge and downloadable in a machine readable format. Bats will provide such reports in CSV format that will include intraday and daily data (e.g. the average prices and total values transacted in financial instruments for the two minutes after four specific points in time in the trading day, and daily high, low and average prices achieved). Bats will also supplement these with more straightforward reports that look at the likelihood of execution, order book and spread analytics.

Whilst such exchange-based reports will help firms meet their best execution responsibilities, significant amounts of business, particularly for larger trades, will continue to be transacted bilaterally away from multilateral venues. As such, when transacting large in scale or portfolio trades, for example, firms will need to satisfy themselves, their clients and their regulator that they have met their best execution requirements.

The use of services like Bats LIS will help firms meet this requirement with an audit trail, as well as transparency requirements. All MiFID symbols will also move to a prescribed tick size regime from January 2018, and as the tick size requirement will apply to limit prices on orders and not to executions, such bilateral trades done on systematic internalisers can and will be executed at fractional tick prices.

Trade Reporting

One of the main tenets of MiFID II is to extend the existing pre- and post-trade transparency framework into a much broader set of venues and asset classes. One of the mechanisms by which MiFID II seeks to achieve this is to mandate a trade publication obligation on all MiFID investment firms when they transact on an OTC (i.e. off venue) basis.

The investment firm category includes buy-side firms, who under MiFID II cannot delegate formal regulatory responsibility to their counterparties (unlike now). Therefore, unless a firm is dealing with a systematic internaliser, the selling firm is responsible for the report. In practice for the buy-side this is likely to give rise to trade reporting obligation in the following OTC trading scenarios:

➤ When a buy-side firm is trading with a counterparty from outside the EEA;

➤ When a buy-side firm is selling to another investment firm that is not a systematic internaliser in the instrument in question;

➤ When a buy-side firm is trading between different funds that it manages and cannot take advantage of the exemption available to UCITS or AIF management companies.

Recognising that these new reporting obligations will present buy-side firms with a range of operational, technical, financial and regulatory challenges, Bats has already implemented a solution to address all of these. Bats operates the largest equities trade reporting facility in Europe (BXTR) covering nearly 13,000 European equities and exchange-traded products and has adapted this service to meet buy-side trade reporting needs.

The solution is simple as Bats' "assisted reporting" model allows buy-side firms to enable their brokers to submit trade reports on their behalf using the broker's existing connectivity to Bats Europe. With no technical or operational impact, no delay and under a simple and in expensive licence, the buy-side firm can continue to operate as normal.

Benchmark Regulations

While not an aspect of MiFID II, another important area of regulations coming into force next year relates to benchmark indices. The European Benchmark Regulation will come into effect on 1 January 2018.

These regulations introduce a common framework and consistent approach to benchmark regulation across the EU. Largely based on existing IOSCO Principles, they aim to ensure benchmarks are robust and reliable, and to minimise conflicts of interest and introduce greater transparency.

We've long advocated for more transparency in the benchmark index market and last year we launched an indices business to bring competition, choice and transparency to this segment of the market through our high-quality, real-time, low-cost indices. Since Bats introduced its own series of UK and European benchmark equity indices, it has provided full transparency of its common set of Rules and Methodology used to construct and manage all the indices, its licences and its tariffs. We'll continue to do all we can to help drive down costs and bring innovation to this segment of the market.

Final Countdown

Since the beginning of the MiFID II process, we have been working closely with our clients and the buy-side community to design products and services to meet their new needs and have been a go-to resource for MiFID II information via our dedicated MiFID II microsite (bats.com/mifid). We have listened to the challenges market participants face and worked together with them to develop solutions that are right for the market, innovative, easy-to-use, and address the specific concerns raised by them.

As with any fundamental marketplace change, there will be winners and losers. The winners will be the firms that successfully navigate this new regulatory landscape and we want to help ensure that all market participants have the keys to success. As we gear up for these final months of preparation, working together we can navigate these challenges to ensure we are all meeting the necessary regulatory requirements.

By Mark Hemsley, CEO, Bats Europe, the largest stock exchange and trade reporting venue in Europe.