

MiFID II/R: The Benefits of Matched Principal over Name Give Up for the Fixed Income Markets

- i. In cash settled European Government bonds and corporate bonds wholesale inter-dealer markets are entirely traded using the IDB Matched Principal Model, whereby the IDB takes no principal positions and employs no risk capital other than operational risk. This has been the modus for several decades and therefore has been tested by several sets of crises and found to be robust.
- ii. The Matched Principal Model of broking is not 'Trade Facilitation' as commonly interpreted by the media and by market observers. Instead it needs to be recognised as a market model. As such all inherent risks are transparent, supervised and are explicitly recognised in Pillar 3 disclosures. Neither does it employ proprietary capital or facilitate proprietary trading as also interpreted by MiFID. Rather, it requires specific recognition as a market model away from these terms.
- iii. EVIA believes that safe, efficient and liquid markets lead to better-priced markets for investors and issuers, including and especially both sovereigns and corporate firms when they issue debt. Further we understand that more corporate access to debt markets will help achieve G20 growth ambitions by replacing the shrinking size of banking system balance sheets.
- iv. In order for those markets to work in the best manner possible, we would urge the Commission and Member States to retain the Matched Principal model of broking specifically in MiFIR as has been the case in all the Danish and Cypriot texts.
- v. This method of transacting is particularly important in sovereign debt markets across Europe, where the market makers prefer to manage their risk and positions anonymously during government debt auctions and interactions with the wholesale client base, in order to provide competitive and efficient pricing absent the 'winners curse'. We also note the adverse impact of TRACE in the US from 2002 in undermining the corporate bond market liquidity and acting as a catalyst for wholesale risk transfer in the US to have transitioned across to the CDS product family.
- vi. In 2013 the [European Sovereign Debt Markets Sub-Committee](#) of the EFC wrote to the European Commission requesting that MiFID II/R enable Inter Dealer Brokers to undertake MPT in the sovereign bond markets:
 - o IDBs play an important role in the distribution of sovereign debt and MPT is an essential part of the mechanism by which they support price discovery, redistribution of market risk and ultimately liquidity. With regard to the primary markets and more in particular the auctions, it is clear that trading with IDB's in the pre-auction window facilitates the price discovery for the primary dealers and in the aftermath of the auctions, it allows the dealers to smoothly and efficiently adjust their risk positions without the need to reveal those positions to competitors.
 - o These features affect the primary dealers' willingness to, and the price at which, they take on auction risk. Similarly, in the secondary market the ability to redistribute risk across the market via the IDBs rather than directly with their competitors will affect the price at which dealers are prepared to transact with investors, and ultimately will lead to tighter bid-offer spreads.
 - o The role of MPT provided via the IDBs is, therefore, intrinsic to sovereign bond market functioning. It increases liquidity and helps to tighten bid-offer spreads

even in larger bond markets. Any restriction on MPT in OTFs would be detrimental to the IDB model and the ESDM considers that the potential impact of this on borrowing costs could be significant.

- Moreover, ESDM members consider it doubtful that a quick replacement of matched principal trading, e.g. through a reversal to an agency model of brokering, would be feasible. Reporting statistics, for instance for gilts and German federal paper, suggest that as much as one third of total turnover in the secondary market is transacted through an IDB.
- **Matched Principal broking offers the following advantages over the 'name give up' model more usual employed in derivatives:**
 - **Discovery of Liquidity:** Arranging transactions to compose sets of trades in order to discover liquidity. These may be spreads, basis and repo transactions in order to create matching liquidity pools where and when desired.
 - **The 'netting' of trades** and sets of trades against each other, aiding the building of market liquidity.
 - **Building of a liquidity pool** wherein multiple buyers and sellers join both sides of an initiated transaction
 - **Anonymity;** dealers will still require anonymity, most especially in peripheral sovereign and other non-benchmark bond issues.
 - **Liquidity** - Dealers are able to transact wholesale client trades without compromising market pricing, liquidity, their inventories or client interests – clients in fixed income markets are predominantly governments, central banks, pension funds and insurance funds.
 - **Block Trading;** Orders are able to be "built" upon to facilitate larger trades with fewer counterparties at single prices
 - **Basis and Spread Trading;** Cash – Derivative, Butterfly and other spreads are able to be worked as consolidated trade units
 - **Safe and Efficient Settlements;** MP benefits counterparties since the IDB **settlements** departments. manage the post-trade process in a real time environment [in an NGU market this would move to the clients' responsibility]
- **Name Passing Brokerage [NGU] is the alternative and this is the usual method that IDBs employ to arrange trades in derivatives and very liquid markets such as FX. Both models should freely compete under MiFID2/R**
 - IDBs operate NGU for the majority of their businesses especially derivatives
 - However, we note that a purely NGU market would not enable cash bond markets to be in any way liquid beyond a very few benchmarks
 - This is because liquidity is derived from portfolios that are each able to passively offer basis trades, contingent switches, securities lending and block trades; but in all these case each transaction is comprised of sets of contingent trades.
 - A purely NGU market in the 2008/2011 credit crisis would have resulted in fractured debt markets with greatly reduced **liquidity** with most dealers refusing to take other members names
 - Electronic platforms offering fixed income offer each of the MP, NGU or CCP cleared model. Those platforms offering NGU and Cleared trades include several of those operated by WMBA member firms including ICAP's 'BrokerTec' and BGC Partner's 'e-Speed'. Critical here is to offer the best model for the requirements of each market segment.

- These market tools mean that markets can be kept efficient, can help minimize transaction costs in often illiquid securities
- It has been suggested, for example, that this type of trading be allowed to continue through the 'Systematic Internaliser' route rather than through 'Organised Trading Facilities' (OTFs). We do not support this argument.
 - OTFs will exist to ensure that trading takes place as transparently and with as much liquidity as is possible. It is the intention of the majority of member states via MiFID/R to move trading onto organized venues with conduct and reporting requirements and responsibilities. Commensurately it remains vital to enable the right amount of transparency to ensure that markets continue to function in the most efficient way possible.
 - Many of the defining features around systematic internalisers would have to change to accommodate such trading and the exercise would be very complicated and unwieldy. It is not clear value a regime change would bring, or that it would be welcomed by the markets.¹
- The proposals in the EP text to mandate CCP clearing for cash bond markets is unwelcome because:
 - Many wholesale participants are non-financial counterparties not suited to clearing
 - The re-plumbing settlement systems [CSDs] into clearing systems [CCPs] adds a great amount of moral and systemic hazard
 - The collateral squeeze would be exacerbated. Collateral would not be able to be recycled nor rehypothecated.
 - Repo markets would decline in efficiency and accessibility
 - Transaction costs would rise greatly
 - Liquidity would be fragmented, linkages and contingent trades disabled and the depth of markets therefore destroyed
 - Fixed Income markets would become regional – raising the costs of debt issuance
 - Many systems are already able to offer the choice of clearing currently

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- ¹ **The proposed rule set denies IDBs operating their businesses as SIs because:**
 - It is the very reason for an IDB bring together third party buying and selling interests in functionally the same was as a regulated market, MTF. This is forbidden by the SI rules
 - It is the very reason for an IDB bring together liquidity from OTC and OTF risk sets and match into more standardized and generic RM and MTF risk pools
 - Its is utterly against the business model of the IDB to take positions and trade against customers for whom they are arranging trades or acting as agent and are therefore an insider. IDBs have neither permissions nor capital to take positions and therefore cannot execute against its own proprietary capital.
 - SI publishing and transparency rules would act against the interests of fixed income market liquidity
 - IDBs cannot comply with the price making rules under Sis since their indications are not their own
 - IDBs cannot comply with the SI conditions for price improvements
 - Arranging a transaction through an IDB will normally consist of a set of inter-related trades against multiple counterparties. SI rules do not cater for complex arrangements.
 - Arranging trades through an IDB does not always mean a counterparty has another single counterparty as per SI rules

Technical Notes: Annex on Broking Models and Venues

The main business of an inter-dealer broker (IDB) is to provide access to over-the counter (OTC), MTF (Multilateral Trading Facility) and/or exchange traded pools of liquidity, across a full range of asset classes and their associated derivatives. Typically, brokerage activity takes place in the wholesale financial markets, which includes cash deposits, financial derivatives, securities, equities, commodities, energy and credit.

The primary function of an IDB is to act as an intermediary through which other wholesale market participants can conclude transactions by matching their trading needs with other third party wholesale market participants who have reciprocal interests.

To facilitate this activity IDBs may engage their clients on both a voice and electronic basis and act in a "name passing", "matched principal" or "exchange or agency give up" capacity.

Name Give-Up

The name give-up brokerage model is the traditional model, through which the broker takes on an arranging role in a transaction between two or more counterparties. The broker, through price dissemination, distributes quotes to other market participants showing both price and volume. As outlined above, for voice brokered products these prices and volumes are dependant upon market convention, either firm or indicative levels of interest, and must be confirmed prior to the trade being completed. For electronic products brokered through MTFs, these prices and volumes are typically firm and are traded without further communication.

Once the trade price, volume and terms have been agreed, either through further conversation with the broker or with the direct hit or taking of prices on an MTF, the counterparties' names are disclosed and the broker steps away from the transaction. Bilateral agreements are then enforced between the counterparties and the broker will invoice the brokerage fee on a monthly basis or extract the commission at the point of sale.

Matched Principal

In the matched principal model, the broker facilitates its clients in anonymous trading activity by taking part in a matched transaction as principal, becoming the buyer to the seller and the seller to the buyer. The broker's own credit with its counterparts and the nature of its netting and settlement procedures will determine the amounts that be executed in this manner.

While operating as matched principle the broker will not trade speculatively for a client or for his own book. The trade will only be executed as a result of a firm client order to buy or sell at a set price or size. Once the trade is complete, price, volume and terms are communicated through the broker and back office confirmations.

Similar to the name give-up format, settlement is made between each client based on the market convention with the brokerage fee being either incorporated in the all-in price passed to the client through a disclosed brokerage agreement or through a monthly invoice.

Exchange Give-Up

In addition to name give-up and matched principal brokerage models, brokers can facilitate the trading activity of their clients on derivative exchanges (e.g. LIFFE, Eurex, CME, etc). In this instance the broker may engage in exchange trading in the capacity of an 'Executing Broker' as defined in the FOA's International Uniform Brokerage Execution Services ('Give-Up') Agreement, and give-up the trade to a client's clearer immediately following the execution of the transaction. Under this 'exchange give-up' model the broker is subject to intra-day exposure of this 'agent' position until the trade is accepted by the counterparty. This 'give-up/pick-up' arrangement is standard in all exchange traded products.

Procedurally, upon receiving the relevant price information from the broker, the client will instruct the broker to place an order on the appropriate exchange, either in its own name (if a member of the exchange) or through a third party clearing member or GCM. The broker can provide the client with an indication of the market based on the current price and volume activity on the exchange.

Business models

There are 3 types of business model used by IDB's;

1. Voice Broking

Voice broking is the conventional method of communicating prices between buyers and sellers. Clients maintain regular contact via the telephone, email or Bloomberg, with IDBs, who assess market liquidity, provide indications of interest, and arrange trades between counterparties either in a name passing, matched principal or exchange give up capacity

2. Electronic Broking

Electronic broking is conducted on electronic trading platforms otherwise known as MTFs. Transactions are concluded bi-laterally between trading counterparties without the direct intermediation of a voice IDB. The electronic trading platform is a mechanism which provides participants with efficient and reliable execution and simplified trade process, allowing them to access pre trade transparency from the platform and automatically match their trading requirements with those of other market participants.

3. Hybrid Broking

Hybrid broking is a derivation of voice broking. Following an indication of interest via the telephone, email or Bloomberg the IDB, on behalf of the client, may either access its voice brokered liquidity pools or at the request of an electronic platform participant the electronic liquidity pool within the MTF and arrange trades on behalf of the client either in



a name passing, exchange give up or matched principal capacity. Price and particularly Volume Matching Auctions are distinctive features of Hybrid Broking

Dependant on the business model adopted the IDB has access to three distinct liquidity pools and these are defined below;

Voice Liquidity Pools; The volume created by indications of interest and orders received verbally by the IDB

Electronic Liquidity Pools; The volume created by pending client orders on the IDB's electronic platform

Exchange Liquidity Pools; The volume created by pending client orders on a Regulated Market

Broking Venues

Indications of interest received under the broking models detailed above are matched and arranged using both electronic (MTF and Regulated Markets) or in Over the Counter (via the IDB) venues. The classification criteria for these venues are detailed below;

Non-discretionary Electronic Venues (MTF's and Regulated Markets)

Indications of interest/orders received from the client by the IDB either voice or electronically and which are arranged automatically on the trading platform or executed by the IDB on an exchange and given up to the client. Resultant trades are subject to the rules of the electronic platform or Regulated Market and (for relevant instruments) are subject to the MiFID MTF and Regulated Market rules (including post trade transparency)

Discretionary OTC Venues [prototype OTFs]

Indications of interest/orders received from the client by the IDB either voice or electronically and which are arranged manually by the IDB matching it with other client initiated voice brokered liquidity

The Value of Interdealer Brokers to Market Infrastructure

As outlined above, IDBs are companies that serve as intermediaries which facilitate transactions in the OTC markets between dealers and banks in a variety of financial instruments.

Interdealer Brokers add value to the markets by:

- Enhancing price discovery and transparency
- Increasing pricing confidence
- Protecting clients' interests
- Providing anonymity and confidentiality
- Managing complex trades



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- Facilitating information flow
- Facilitating enhanced liquidity
- Improving market efficiency
- Delivering multi-lateral electronic trading and settlement solutions
- Lowering costs for customers

Annex 3

ESDM Chair's letter to the European Commission on its amendment to the June 2013 compromise text of MiFID on Matched Principal Trading

Dear Mr Faull,

The Council General Approach on MiFID includes permission for Matched Principal Trading (MPT) in bonds for operators of OTFs, a category that includes Inter Dealer Brokers (see Annex). This would allow IDBs to undertake MPT in the sovereign bond markets. However, in the context of the on-going trilogue, the Commission has recently proposed an amended version of Article 20(1a) narrowing the use of matched principal MPT so that it would be permissible only on a temporary basis for illiquid corporate debt (see Annex). ESDM members are very concerned about the possibly harmful effects of the proposed restrictions of matched principal trading on the liquidity of sovereign bonds.

IDBs play an important role in the distribution of sovereign debt and MPT is an essential part of the mechanism by which they support price discovery, redistribution of market risk and ultimately liquidity. With regard to the primary markets and more in particular the auctions, it is clear that trading with IDB's in the pre-auction window facilitates the price discovery for the primary dealers and in the aftermath of the auctions, it allows the dealers to smoothly and efficiently adjust their risk positions without the need to reveal those positions to competitors. These features affect the primary dealers' willingness to, and the price at which, they take on auction risk. Similarly, in the secondary market the ability to redistribute risk across the market via the IDBs rather than directly with their competitors will affect the price at which dealers are prepared to transact with investors, and ultimately will

lead to tighter bid-offer spreads. The role of MPT provided via the IDBs is, therefore, intrinsic to sovereign bond market functioning. It increases liquidity and helps to tighten bid-offer spreads even in larger bond markets. Any restriction on MPT in OTFs would be detrimental to the IDB model and the ESDM considers that the potential impact of this on borrowing costs could be significant.

Moreover, ESDM members consider it doubtful that a quick replacement of matched principal trading, e.g. through a reversal to an agency model of brokering, would be feasible. Reporting statistics, for instance for gilts and German federal paper, suggest that as much as one third of total turnover in the secondary market is transacted through an IDB.

Although the Council Ad hoc working group is engaged in an active debate on all the issues surrounding matched principal trading, I hold it important to raise your awareness of what is at stake for sovereign debt markets, and argue that MPT in bonds for operators of OTFs should remain permissible for sovereign bonds, [as agreed by the Council General Approach of June 2013], while possibly even further defining the scope of own account exposures. [For all of the above reasons, the ESDM would welcome a text closer to the Council General approach.]

[signed]

Anne A. Leclercq

Annex A: Council General Approach on matched principal trading, as included in the June 2013 compromise text

MiFID Article 20 (1a)



1a. Member States shall only permit an investment firm or market operator operating an OTF to engage in matched principal trading in bonds, structured finance products, emission allowances and certain derivatives, and only in cases where the client has been informed of the process.

An investment firm or market operator operating the OTF shall not use matched principal trading to execute client orders in an OTF in derivatives pertaining to a class of derivatives that has been declared subject to the clearing obligation in accordance with Article 5 of Regulation (EU) No 648/2012.

An investment firm or market operator operating an OTF shall establish arrangements ensuring adherence to the definition of 'matched principal' trading in [MiFIR].

1aa. Member States shall permit an investment firm or market operator operating an OTF to engage in dealing on own account other than matched principal trading only with regard to sovereign debt instruments for which there is not a liquid market

MiFIR Article 2 (7aa)

(7aa) 'Matched principal trading' means a transaction where the facilitator interposes between the buyer and seller to the transaction in such a way that it is never exposed to market risk throughout the execution of the transaction, with both sides executed simultaneously or as soon as technically possible and the transaction is concluded at a price where the facilitator makes no profit or loss, other than a previously disclosed commission, fee or charge for the transaction;

Annex B: Alternative text proposed by the Commission

MiFID Article 20 (1a)

1a. Member States may allow investment firms or market operators operating an OTF to engage, for a period of maximum 6 months, in matched principal trading only in corporate bonds where the liquidity in a corporate issuer as measured by the average nominal value of debt instruments issued by that issuer traded monthly relative to the total nominal value of issued debt of that corporate issuer drops significantly.

The investment firm or market operator of an OTF making the request shall provide the competent authority with all the information needed to assess whether this condition is met.

The initial 6 month period can be extended upon request by the OTF operator for additional periods of 6 months if the conditions are fulfilled.

Competent authorities shall take into account the extent to which matched principal trading would alleviate liquidity concerns when deciding to allow matched principal trading and transmit all requests and decisions to allow matched principal trading to ESMA without delay. A competent authority may refer decisions to ESMA where it disagrees with the assessment made by another competent authority. In these situations, ESMA may act in accordance with Article 19 of Regulation (EU) No 1095/2010, without prejudice to the possibility of ESMA acting in accordance with Article 17 of Regulation (EU) No 1095/2010.

An investment firm or market operator operating an OTF shall establish arrangements ensuring adherence to the definition of 'matched principal' trading in [MiFIR].

1a. In order to ensure consistent application of paragraph 1a, ESMA shall develop and submit draft regulatory technical standards to specify the parameters and methods for calculating the threshold of liquidity referred to in paragraph 1a and the percentage change which indicates a significant drop of liquidity. When drafting these regulatory technical standards, ESMA shall take into account at least the following elements:*

(i) the average amount of outstanding issued corporate debt,

(ii) the average size of monthly turnover relative to that issued debt, and



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Power is delegated to the Commission to adopt these regulatory technical standards in

accordance with the procedure laid down in Articles 10 to 14 of Regulation (EU) No 1095/2010.

Annex C: Definition of trading venues

Organised trading facility (OTF)

Any facility or system operated by an investment firm or a market operator that on an organised basis brings together third party buying and selling interests or orders relating to financial instruments. It excludes facilities or systems that are already regulated as a regulated market, MTF or a systematic internaliser. Examples of organised trading facilities would include broker crossing systems and inter-dealer broker systems bringing together third-party interests and orders by way of voice and/or hybrid voice/electronic execution.

Multilateral Trading Facility (MTF)

MiFID introduced the concept of Multilateral Trading Facilities (MTFs) to replace Alternative Trading Systems (ATs) (which had been established prior to MiFID but were not subject to specific European legislation). An MTF is a system, or "venue", which brings together multiple third-party buying and selling interests in financial instruments in a way that results in a contract. MTFs can be operated by investment firms or market operators and are subject to broadly the same overarching regulatory requirements as regulated markets (e.g. fair and orderly trading) and the same detailed transparency requirements as regulated markets; in this sense they are more like a traditional regulated market than a broker crossing network or a systematic internaliser. There are currently 139 MTFs authorised in Europe¹ offering trading on a diverse range of products. The most prominent MTFs are equity platforms, such as Chi-X and BATS Europe however there are a large number of smaller specialist MTFs providing trading in specific instruments examples include GFI's reditmatch, Forexmatch, Marketwatch and Energywatch MTFs.

Regulated Market

A regulated market is a multilateral system, defined by MiFID (article 4), which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments in a way that results in a contract. Examples: the traditional stock exchanges such as the Frankfurt and London Stock Exchanges.

Systematic Internalisers (SI)

Introduced by MiFID in 2007 Systematic Internalisers (SIs) are institutions large enough to match client orders internally, or against their own books (unlike a broker crossing network, which may route orders between a number of institutions). They are defined in MiFID as

an investment firm which, "on an organised, frequent and systematic basis, deals on own account by executing client orders outside a regulated market or an MTF". A firm does not need specific authorisation from its competent authority to carry out systematic internalisation; however similar to MTFs and RMs, they are required to conform to some transparency requirements, such as providing public quotes. Only a few (generally large) firms have set up SIs and, currently, there are 12 registered.