

EDMA Europe

The Value of RFQ

Executive summary

In the ongoing search for liquidity and delivering value to their clients, institutional market participants use a variety of trading protocols for their execution activity, typically depending on the asset class and trade type.

In this context, the Request for Quote (RFQ) protocol is a long-established execution mechanism that allows firms to request prices from liquidity providers that they specify, resulting in “committed liquidity” for their specific trading interest whilst limiting potentially harmful information leakage. The RFQ protocol is most commonly used in the fixed income and derivatives markets where the number of instruments is large, the trade frequency is low, and many transactions are large in size. As such, where the operator of the RFQ is a trading venue as defined by MiFID II, it facilitates the transition of execution from bilateral, over-the-counter activity to transparent on-venue trading and, once sufficient two-way liquidity has gathered on such venues, further to central limit order books (CLOBs). MiFID II explicitly recognises a variety of trading protocols across asset classes and trading interests, including Request-for-Quote (RFQ). Several of its requirements have been tailored to reflect the mechanics of the RFQ protocol and protect its functioning.

EDMA strongly encourages European regulators and policy makers to secure the availability of a broad choice of execution mechanisms as basis for the liquidity and robustness of European financial markets. The functioning of existing protocols, including RFQ, should be protected, with justified differences being reflected in the regulatory framework. This will be essential to achieve the policy objectives of MiFID II, including the further transfer of trading onto transparent, regulated trading venues, whilst securing ongoing liquidity provision in the fixed income and derivatives markets.

Introduction

Given the ongoing changes in financial markets, many of which are triggered by regulatory activity, market participants need to continuously re-assess their approach to executing their trading interests in the most effective way. Having the flexibility to execute in a variety of ways is critical for market participants’ varying liquidity needs – depending on asset class, size, liquidity and market conditions, among other considerations.

In the non-equity markets, available types of execution can broadly be categorised into over-the-counter (OTC) / bilateral and on-venue. For on-venue execution, various trading protocols are available, including the Central Limit Order Book (CLOB), Request-for-quote (RFQ), auctions, Dark Pools, voice and quote driven protocols. In this context, the RFQ mechanism is a long established, transparent and effective trading protocol, providing liquidity and a point-in-time price. It is particularly well suited to execution in asset classes with a large number of instruments that trade infrequently and in larger size, where it enables firms to maximise the likelihood of accessing the best price whilst limiting detrimental market impact. The RFQ protocol complements other trading protocols, allowing market participants to choose the most appropriate manner of execution on an asset-class-by-asset-class, and often on a trade-by-trade, basis. The RFQ protocol is explicitly recognised in the regulatory framework with MiFIR transparency requirements tailored to the RFQ specifics whilst ensuring it supports overall policy objectives.

The role of the RFQ protocol

Using an electronic RFQ protocol on a trading venue allows participants to trade financial instruments with multiple other participants. Liquidity takers (clients) can either individually request executable quotes from multiple liquidity providers that they select or, for the more liquid instruments, have access to real-time electronic streaming of live prices, for example in form of “request for stream”.

- Most suitable trade types and asset classes

The RFQ protocol is particularly well suited for execution in asset classes with a large number of instruments, a limited trade frequency and/or a larger trade size. This is because there will rarely be an end investor who wants to buy the same instrument, at the same time, in the same size as an end investor wants to sell. Institutional clients have historically relied on market makers or “liquidity providers” to, on request, immediately make a price and provide liquidity by taking the opposing side. ‘Requesters’ – typically buy side firms, such as asset managers, pension funds and insurance companies – receive immediacy of execution and price certainty, typically for the full size of their request, as ‘liquidity providers’ act in a principal capacity filling the request and taking the risk onto their own book to hedge. In this regard, the execution risk immediately passes from the requester to the liquidity provider.

As RFQ is a request driven protocol, the requester can direct its enquiry at those firms that are most likely to be competitive liquidity providers for this transaction. By doing so, it will limit potentially harmful information leakage and increase the likelihood of execution. The RFQ mechanism allows participants to retain existing relationships, should they choose to do so, or transact with other firms that provide competitive pricing on the venue.

- The relevance of information leakage

To achieve best execution for larger trades and/or in asset classes that are less liquid, it is important to limit information leakage about the trading interest. This is because, where information about a significant trading interest leaks into the market place before a trade takes place, market participants, whether they are taking part in the negotiation or not, will be able to predict the trading intentions of the buy side requester and the pricing or hedging need that will arise for the winning liquidity provider. This increases the risk of adverse market movements – potentially as a result of predatory behaviour – before a hedging position can be located, in turn reducing the willingness of liquidity providers to provide a competitive, firm price.

By allowing the requester to choose the parties whom he informs about his trading interest, the RFQ mechanism provides the liquidity provider who wins the trade with sufficient time to redistribute the risk without other market participants interfering or trading against them. Whilst RFQ trading venues do not limit the number of firms that can be asked, buy side requesters might decide to put in competition a limited number of liquidity providers, namely those that are most likely to provide a competitive price (based on historical performance and/or ‘axes’ or other indications of interest) for the trading interest of the requester. By not revealing their trading interest more broadly firms minimise market impact and can achieve better execution, to the benefit of their end investors.

- Use of RFQ in practice

Given their advantages, electronic multi-dealer RFQ platforms have become a prevalent form of execution in the dealer-to-institutional client market for non-equity instruments in recent years, often replacing bilateral dealer-to-client trading on the phone with a more efficient and transparent execution on a regulated marketplace. Post-crisis regulatory reforms have increased the level of electronic trading of these instruments significantly, with MiFIR’s trading obligation for liquid derivatives triggering migration onto regulated venues, also for derivatives that are not subject to the trading obligation. As of today, an estimated two thirds of the dealer-to-institutional client market in EU government bonds (by volume) and more than half of the cash credit market trades electronically – predominantly by RFQ.

The benefits of RFQ

In addition to the direct benefits for liquidity provision for certain trading interests as described above, electronic multi-dealer RFQ platforms enable clients and dealers to reap all the benefits of the electronic workflow while still being able to benefit from a high-touch, relationship-driven trading:

- **Liquidity access** – Electronic RFQ allows buy-side firms to send requests simultaneously to multiple liquidity providing dealers. The availability of a range of liquidity providers on most RFQ platforms broadens firms' access to liquidity, it results in execution at better prices, it reduces the time to execution and lowers the resulting execution risk.
- **Price transparency** – 'Pricing screens' that display composite indicative pricing-level information, or 'axes' to indicate strong buyer or seller interest are often provided as part of execution platforms. This ensures efficient and auditable price discovery.
- **Operational efficiency** – RFQ offers a seamless, standardised, automated process that captures every stage in the transaction lifecycle from pre-trade to clearing and reporting. It thus ensures smooth workflows and creates an electronic audit trail that supports compliance monitoring and compliance with best execution requirements.
- **Best execution / Transaction Cost Analysis (TCA)** – Investment managers are required to show their best execution practices across instrument, broker and order type. RFQ supports electronic audit trails, referenceable prices, and time stamps, thus helping to quantify trading risk and costs, on a scalable and trade-by-trade basis. This information will also be used by firms to decide which brokers to send RFQ requests to for new trades.
- **Seamless integration** – As a well-established trading protocol in multiple asset classes, electronic multi-dealer RFQ can be seamlessly integrated into an institutional investor's order management system, taking advantage of connectivity standards, such as FIX.
- **Surveillance** – As regulated multilateral trading venues, RFQ platforms will perform comprehensive surveillance activity to identify potential market abuse and insider trading on their platforms.

Compliance with MiFID II / MiFIR

European policymakers explicitly defined "Request for Quote" as an acceptable trading system within the relevant technical standards of MiFID II¹ and tailored several provisions, including the pre- and post-trade transparency requirements, to reflect the specificities of the RFQ protocol.² By doing so, they ensured the continued functioning of the RFQ protocol in a manner that fully supports the Directive's objectives.

Transparency

Transactions executed via an RFQ protocol on a European Trading Venue are made pre- and post-trade transparent according to MiFIR requirements in accordance with RTS1 and RTS2 respectively. This includes the use of a "collection window".

¹ See RTS2 Annex 1: Description of "Request-for-quote trading system": "A trading system where a quote or quotes are provided in response to a request for a quote submitted by one or more other members of participants. The quote is executable exclusively by the requesting member of market participant. The requesting member or participant may conclude a transaction by accepting the quote or quotes provided to it on request."

² "The requirements should be calibrated for different types of trading, including order-book and quote driven systems such as request for quotes ...". See MiFIR Recital 16.

- The collection window

Timely responses by liquidity providers to an RFQ are essential for the proper functioning of the protocol. However, if the first responses to an RFQ were to be published to the wider market whilst others were still outstanding, it would give the late responders an advantage, allowing them to adjust their quote in response to the published quotes. As such, firms receiving an RFQ would be incentivised to wait or initially simply not respond, which would undermine the viability of RFQ protocols.

To prevent such effects of a “winner’s curse”, MiFID II introduced the concept of a “collection window” for RFQs. Specifically, all quotes that are provided in response to an RFQ shall be published only at a specific point in time, i.e. when they become executable. On that basis, the RFQ protocol under MiFID II / MiFIR functions as follows:

- The requester sends an RFQ for a specified financial instrument, size and direction to several liquidity providers. It herewith opens the “collection window”.
- The liquidity providers that receive the RFQ respond by sending their quotes. Whilst this should happen quite quickly following receipt of the request, in reality it will be at different points in time.
- Once the requester has received a sufficient number of responses from liquidity providers, it decides to close the collection window.
- At this point in time, the RFQ trading venue publishes the appropriate pre-trade transparency. This will consist of
 - All individual executable quotes (for a liquid financial instrument with a requested notional size below the pre-trade SSTI threshold),
 - The simple average of all executable quotes (for a liquid instrument with a requested notional size between pre-trade SSTI and LIS thresholds), or
 - No pre-trade transparency where a relevant waiver (LIS, illiquid, or package) applies.
- The requester executes the transaction with the chosen liquidity provider.
- Post-trade transparency is published by RFQ trading venue (either real time or deferred, depending on the size of the transaction and the nature of the instrument).

- Pre-trade transparency for RFQ

In the run-up to MiFID II, providers of RFQ trading platforms had extensive discussions with ESMA, NCAs and policymakers about the most appropriate approach to pre-trade transparency for RFQ protocols. Based on these discussions, RFQ trading venues designed their pre-trade transparency protocols so that they comply with regulatory expectations, including clarifications provided via recent ESMA Q&As.³ Specifically, pre-trade transparency as per above is published also in situations where no transaction takes place.

Best execution

To comply with the enhanced best execution obligations under MiFID II, firms have moved significant amounts of their execution activity from bilateral to on-venue RFQ. This is largely because the RFQ electronic audit trail simplifies the trading process and enables firms to demonstrate compliance with their best execution obligations.

Further, RFQ platforms provide firms with access to the whole range of liquidity providers. Specifically, consistent with ESMA Q&As,⁴ there is no cap on the number of counterparties that can be asked in an RFQ. Also, for centrally cleared products, there is no “enablement” mechanism.

³ See Q&A 7, General Q&As on transparency topics, “When should an operator of an RFQ system provide pre-trade transparency?”, ESMA Questions and Answers “On MiFID II and MiFIR transparency topics”, page 22.

⁴ See Q&A 3 (d), Multilateral and bilateral systems, “Trading venues should not impose restrictions on the number of participants that a participant can interact with.”, ESMA Questions and Answers “On MiFID II and MiFIR market structure topics”, page 35.

Reporting obligations

Trading on venue helps firms to satisfy the order record keeping and transaction reporting obligations that were introduced with MiFID II. As such, there has been significant growth in activity on RFQ trading venues in asset classes that previously did not trade electronically, for example securities finance and convertible bonds. Also, the portion of trading activity that is executed on electronic trading venues has risen across asset classes, often driven by the ease to comply with reporting and order record keeping obligations.

The value of choice

MiFID II aims to provide market participants with effective, robust access to liquidity at a low cost. To this end, it explicitly recognises that, given differences between asset classes, order types and financial instruments,⁵ various execution methods are suitable for effective execution, and it allows firms to choose the execution method that they believe is best suited to their objectives. At the same time, it establishes a level playing field between various forms of execution by regulating all comparable activities similarly, whilst also reflecting differences between trading protocols by tailoring certain requirements.⁶ Whilst some have interpreted its rules as an effort to bring trading “on exchange” for price formation purposes, MiFID II does support market integrity through common requirements across multiple execution channels.⁷

Market participants generally use RFQ protocols concurrently with other trading protocols, not as a substitute, where they see fit, for example for executing trades in larger size and/or less liquid instruments. Importantly, given their design and characteristics, RFQ often represents the initial step for the migration of execution from over-the-counter, bilateral trading onto regulated trading venues. Thereafter, by allowing products to gather sufficient liquidity and way participation in an RFQ context, they can also facilitate migration of execution to an order book.

Conclusion

The availability of a range of execution mechanisms is essential to secure the liquidity and the robustness of European financial markets. Policy makers and regulators should protect the functioning of existing protocols and not force them to converge towards one single, preferred model.

Without RFQ protocols that deliver the desired functionality to users, trading activity that is currently conducted on transparent, regulated RFQ trading venues would most likely retreat “into the dark”, i.e. return to trading bilaterally OTC. Also, RFQ platforms could not facilitate any migration to CLOB style trading at a later stage.

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⁵ See RTS2, ANNEX I, listing and defining different types of “systems”, including Continuous auction order book trading system, Quote-driven trading system, Periodic auction trading system, Request-for quote trading system, Voice trading system, and Trading systems that are not covered.

⁶ “The requirements should be calibrated for different types of trading, including order-book and quote driven systems such as request for quotes ...”. See MiFIR Recital 16.

⁷ For example, its trading obligation for equities is designed to ensure that “more trading takes place on regulated trading venue and systematic internalisers”, not just on exchange. See MiFIR Recital 11.

About EDMA Europe

Electronic Debt Markets Association represents the interests of companies whose primary business is the operation of regulated electronic fixed income multilateral trading facilities in Europe (regulated markets and/or trading venues) and act as a source of consultation between the members in their roles as operators of such venues in order to project collective views on regulatory, compliance and market structure topics for the benefit of the electronic fixed income markets.

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