EVIA
European Venues & Intermediaries Association

The Matched Principal Broking Model
Merits of the Model

Most wholesale transactions in sovereign, agency and corporate bonds arranged across multilateral venues are transacted under the matched principal broking model, as specified under MiFID2. This typically involves an investment firm operating an OTF and is treated for economic purposes as a single transaction although it is, in practice, a discrete chain of transactions: a seller-client sells the bonds to the intermediary and the intermediary sells the bonds to a buyer-client.

OTFs are allowed to engage in matched principal trading in bonds, structured finance products, emission allowances, and derivatives that have not been declared subject to the clearing obligation under Article 5 of EMIR, provided the client consents.

- *"Matched principal trading" is defined as "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 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."*
- *The operator of an OTF must provide the relevant competent authority with information explaining its use of matched principal trading.*
- *The competent authority will monitor the OTF operator's engagement in matched principal trading to ensure that it complies with the definition and to ensure that it does not give rise to conflicts of interest between the OTF operator and its client.*

That matched principal broking is an important and long-established feature of the wholesale securities markets in the European Union was acknowledged when it was codified into MiFID2/MiFIR. Virtually all non-cleared multilateral liquidity pools are arranged under this market protocol. Interdealer brokers support anonymous trading by market participants inside OTFs and arrange similar transactions for submission to other trading venues.

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:

   - 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.

The Benefits of Matched Principal over Name Give Up for the Fixed Income Markets

By acting as the intermediary between buyers and sellers for matched principal transactions, interdealer brokers. It offers the following advantages over the 'name give up' model more usual employed in the venue arrangement of derivatives markets:

- 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. Serves to stabilise pricing of securities, by removing counterparty-specific pricing considerations.
- Anonymity; dealers will still require anonymity, most especially in peripheral sovereign and other non-benchmark bond issues.
- Liquidity - Enhance market liquidity, by simplifying credit risk decision-making. 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. Facilitates the matching together of dealers and other market participants on a non-discriminatory (anonymous) basis.
- Basis and Spread Trading; Cash – Derivative, Butterfly and other spreads are able to be worked as consolidated trade units.
- Safe and Efficient Settlements; Provide organised trading venue compliant requirements and rulebooks. 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]

Under the matched principal model, the investment firm acts as the buyer to the seller and the seller to the buyer. By working to arrange transactions between market participants, interdealer brokers make it easier for component trades to be done under pertaining rules and protocols, which brings a level of organisation to markets that promotes orderly trading. More details concerning the benefits of the matched principal model are available on the EVIA website .