ISDA Safe, Efficient Markets

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ISDA commentary on Presidency MiFID2/MiFIR compromise texts as published on 31.08.2012[1]

This paper has been produced by the International Swaps and Derivatives Association (ISDA) in order to help inform on-going European Council discussions on MiFID2/MiFIR. Some of these points will be familiar from previous ISDA commentaries; new points are therefore shaded in grey. In summary, we make the following points:

Pre-trade transparency for non-equities trading venues (MiFIR Articles 7 and 8)

- We strongly welcome the clear link that is now made between the scope of transparency requirements under Article 7 and OTC derivatives contracts that are subject to the derivatives trading obligation.
- We are supportive of the new provisions allowing for suspension of transparency requirements in certain situations.
- There should be a clearer recognition of the importance of Request-For-Quote or voice trading for OTC derivatives markets, in support of the move to exchange and electronic trading.

Systematic internalisation in non-equities instruments (MiFIR Article 17)

- Uncleared OTC derivatives transactions should not be subject to the provisions of Article 17, particularly sharing of quotes with multiple clients, given that uncleared OTC derivatives transactions are priced according to the credit risk of an individual client.
- The purpose of new Article 17.1 language regarding quoting on illiquid instruments is not clear; the new language should therefore be removed.

Derivatives trading obligation (MiFIR recital 21, Articles 24 and 26;)

- We welcome the proposed approach to assessing liquidity, including the reference to "the nature and lifecycle of products within the class of derivatives".
- Transactions that are large in scale should not be subject to the trading obligation.

Organised Trading Facility (MiFIR Recital 8; MiFID Article 20)

- The ban on use by the OTF operator of its proprietary capital should be removed or, alternatively, allowance should be made for client facilitation.
- Rules governing the interaction of an OTF and SI within the same firm are overly restrictive and should be amended.

Mechanism to avoid duplicative or conflicting rules (MiFIR Article 26a)

- We support the intention of this new Article, which allows for the adoption of equivalence assessments by the European Commission; however, we stress the importance of an approach to 'equivalence' based on regulatory outcomes and not detailed correspondence of respective jurisdictions' rules. We also believe the provision could be usefully amended to deal with a wider range of potential conflicts.

[1] http://register.consilium.europa.eu/pdf/en/12/st13/st13287.en12.pdf and http://register.consilium.europa.eu/pdf/en/12/st13/st13286.en12.pdf

Pre-trade transparency for non-equities trading venues (MiFIR Articles 7 and 8)

The latest Presidency compromise text on MiFIR maintains a re-worked waiver framework for non-equity instruments under Article 8, including waivers for:

(a) orders that are large in scale compared with normal market size and orders held in an order management facility of the trading venue pending disclosure;
(b) indications of interest in request-for-quote and voice trading systems that are above a size specific to the instrument, which does not expose liquidity providers to undue risk and takes into account whether the relevant market participants are retail or wholesale investors;
(c) markets with trading restricted to professional participants;
(d) derivatives which are not subject to the trading obligation specified by Article 24 of this Regulation and other financial instruments for which there is not a liquid market;

The latest Presidency text also maintains changes to Article 7 stipulating that indicative pre-trade prices must be published where a waiver is granted in accordance with point (b) or (c).[2]

We note that point (d) above has been reworked, notably through the addition of an explicit waiver for "derivatives which are not subject to the trading obligation". ISDA strongly endorses this change. As previously explained, we anticipate that some OTC derivatives contracts will be traded on trading venues on a purely voluntarily basis, including contracts that are not cleared and which are illiquid. This is particularly likely to be the case for Request-For-Quote trading systems, where a price in an instrument is made following the client's expression of interest. Extending pre-trade transparency requirements to such transactions would, paradoxically, have created a strong disincentive to venue trading for such instruments, which would not be in keeping with the spirit of the MiFID revision. The proposed drafting from the Presidency under Article 8(1)d effectively deals with this concern.

The latest Presidency text also departs from the earlier Danish text in that it allows for the temporary suspension of Article 7 pre-trade transparency requirements where the liquidity of a class of instruments falls below a defined threshold, granting ESMA a review role in this regard.

We believe that this is a helpful addition and will allow for a more dynamic approach to transparency provisions that is able to respond to changing market conditions and which takes better account of the systemic implications of transparency rules.

We do, however, re-iterate our concerns regarding provisions that would require indicative pre-trade price transparency for activity that takes place under a waiver [Article 7(3)]. Where indicative price transparency is possible, and demanded by users of a trading system, it is likely to be provided, although not necessarily on an instrument by instrument basis given the potentially limitless number of non-equities instruments. For this reason, seeking to *mandate* such provision of pre-trade price data on a broadly defined basis would not be in keeping with market functioning or with encouraging the move to organised trading.

In addition to this, we also believe that there is a need for a clearer **recognition of the importance of Request-For-Quote or voice trading for OTC derivatives markets**. In the case of cleared, liquid OTC derivatives, some policymakers have a tendency to envisage the possibility of equities-like exchange trading on platforms based on an order book. While such trading systems do exist for a limited range of contracts, they are only part of the solution. This reflects the fact that even liquid OTC derivatives contracts trade infrequently; for example, the most actively traded contract, the 10-year USD Interest Rate Swap contract, trades only 200 times per day on average. For this reason, RFQ trading will continue to play an important role in OTC derivatives markets, even after the move of cleared, liquid contracts to trading venues.

[2] Note there is a reference error under Article 7(3), which cross-refers to Article 8(1)(ii-iii), despite the fact that this has now been recast as Article 8(1)(b-c)

One solution would be to refine the Article 8 waiver provision for RFQ and voice trading as follows:

> (b) indications of interest in request-for-quote and voice trading systems ~~that are above a size specific to the instrument, which does not expose liquidity providers to undue risk and takes into account whether the relevant market participants are retail or wholesale investors~~;

This is not to suggest that all RFQ or voice activity should be subject to a waiver; it would, however, strengthen the ability of competent authorities to calibrate pre-trade transparency according to the nature of a given trading system.

Systematic internalisation in non-equities instruments (MiFIR Article 17)

We are broadly supportive of the direction of travel in the context of the Article 17 rules on systematic internalisation (which define when an investment firm must provide a firm quote to its client for an internalised trade and which also require that this quote be provided to the firms' client base more broadly). Specifically, we support the new language that makes clear that the rules apply in the case of instruments for which firms "…are systematic internalisers and for which there is a liquid market…" and the supporting elaborations under Article 2(3) and Article 2(7a). We also support the addition of 'commercial policy' provisions allowing firms greater control over how they share quotes with clients.

There is, however, an additional point that we believe should be addressed in the drafting. Specifically, it is important to clarify that uncleared OTC derivatives transactions should not be subject to the provisions of Article 17, notably the requirement that a firm provide one client's quote to other clients (subject to a size threshold), allowing them to transact on it.

When a client enters into an uncleared OTC derivatives contract with its bank, this establishes a credit relationship between the client and bank that lasts over the life of the contract, potentially many years. This risk is managed in many ways, including through the exchange of collateral, and through pricing the contract relative to the credit risk associated with the client. Thus a bank will provide different quotes to different clients based on the specific characteristics of an uncleared OTC derivatives transaction, including a price adjustment to reflect an individual client's credit standing. It follows that it would be extremely undesirable from a risk management perspective if a bank were required to provide the same price to all clients for uncleared OTC derivatives transactions.

This point could easily be addressed by a small change to the scope of Article 17 as follows:

> Investment firms shall publish a firm quote in those bonds, structured finance products, emission allowances and derivatives which are clearing eligible and traded on a trading venue and for which they are systematic internalisers and for which there is a liquid market as defined in article 7 of this Regulation when the following conditions are fulfilled: […]

We also note the additional paragraph under Article 17(1) that states that:

> "In [the] case of bonds, structured financial products, emission allowances and derivatives which are traded on a trading venue and for which there is not a liquid market, systematic internalisers shall disclose quotes to their clients on request."

We understand that this seeks to replicate the Article 13 distinction between liquid equity instruments, for which firm quotes must be published, and illiquid instruments, for which an SI must disclose a quote to clients on request. However, given the difference in structure between Article 13 and Article 17 (notably the fact that Article 17 requirements are all triggered by a client's RFQ), the additional language risks creating confusion about the scope of requirements under Article 17 and, specifically,

the extent to which illiquid instruments are subject to those requirements (which clearly they should not be). In the interests of clarity, we suggest removal of the new provision.

Derivatives trading obligation (MIFIR Articles 24 and 26)

We are generally supportive of the drafting of Articles 24 and 26, which cover the obligation to trade particular OTC derivatives on an organised trading venue (OTF, MTF or regulated market). Specifically, we believe it is appropriate to limit this to contracts that are subject to the EMIR clearing obligation and which are also sufficiently liquid, as the text does. We also welcome the fact that the latest text refers to an assessment of liquidity "having regard to the nature and lifecycle of products within the class of derivatives", as well as the additional text under recital 21:

> "A liquid market in a product class will be characterised by a high number of active market participants, including a suitable mix of liquidity providers and liquidity takers, relative to the number of traded products, which execute trades frequently in those products in sizes below a size that is large in scale. Such market activity should be indicated by a high number of resting bids and offers in the relevant derivative leading to a narrow spread for a transaction of normal market size. The assessment of sufficient liquidity should recognize that the liquidity of a derivative can vary significantly according to market conditions and its life cycle."

These helpful changes will allow ESMA to take account of all relevant data and information in determining the application of the trading obligation, ensuring that only appropriate contracts are subject to the obligation and preserving the ability of end users to manage risk through the use of tailored contracts.

We do, however, see a need for a more explicit exemption from the obligation for transactions which are large in scale, and which therefore would not be suited to the sort of transparency associated with trading venues. This could be addressed by amending Article 24 as follows:

> Financial counterparties as defined in Article 2(6) and non financial counterparties that meet the conditions referred to in Article [5(1b)] of Regulation [ ] (EMIR) shall conclude transactions which are not intragroup transactions as defined in Article [2a] of Regulation [ ] (EMIR) with other financial counterparties as defined in Article 2(6) or non financial counterparties that meet the conditions referred to in Article [5(1b)} of Regulation [ ] (EMIR) in derivatives pertaining to a class of derivatives that has been declared subject to the trading obligation in accordance with the procedure set out in Article 26 and listed in the register referred to in Article 27 only on:
>
> […]
>
> This obligation shall not apply to transactions that are large in scale.

Alternatively, Article 26(1) could be amended as follows:

> ESMA shall develop draft implementing technical standards to determine the following:
>
> (a) which of the class of derivatives declared subject to the clearing obligation in accordance with Article 4 paragraphs 2 and 4 of Regulation [ ] (EMIR) or a relevant subset thereof shall be traded on the venues referred to in Article 24(1);
>
> (aa) the size of transaction for a class of derivatives or subset thereof above which the trading obligation under Article 24 does not apply;
>
> […]

Organised Trading Facility (MiFIR Recital 8; MiFID Article 20)

We have previously expressed our support for the creation of the Organised Trading Facility, noting however that the ban on use of proprietary capital by the OTF operator is likely to limit its usefulness. We therefore believe that the move by the Council to permit 'matched principal' activity under the OTF rules is helpful, particularly for trading in equities. We do, however, remain of the view that the operator capital ban should be removed completely in the interests of allowing a diverse range of platforms to operate under the OTF category, supporting client choice and the implementation of the trading obligation.

In derivatives markets, client transactions necessarily involve firms employing their own capital and managing the risk associated with client-facing transactions over time. As the carve-out for 'matched principal' activity is unlikely to capture this form of client facilitation (since buying and selling interests rarely perfectly coincide), the proposals would interfere with the way the markets have naturally developed over time (to assist that need for liquidity by the mechanism of firms using their own capital to take the risk on a short term basis, or 'warehouse' it). This could mean a significant withdrawal of liquidity in such markets. That would in turn entail a risk that commercial counterparties would find it more difficult to hedge their risks at the right time or at the right price. Reduced liquidity would also make it more expensive to hedge risks. Allowing an OTF operator to use its own capital for client facilitation purposes would render trading more efficient and less costly for the client and any related end beneficiaries of trades. Clients are protected in such a structure by comprehensive conduct-of-business rules, which ensure that client trades are treated appropriately. In particular, neutrality and fair and orderly trading conditions can be ensured by requiring OTF operators to have in place proper conflicts-of-interest management processes.

Being able to use operator capital to facilitate client trades is particularly important if the OTF cannot find a matching interest on the other side of the trade and the client wants to get the trade done at a certain time and at a certain price.

In the absence of a complete removal of the ban on use of operator capital, we would at least suggest that the exemption for matched principal trading is re-drafted to cover client facilitation activities more generally (with the consent of clients). Recital 8 of MiFIR should explicitly recognise that matched principal transactions are only a small subset of a much wider range of customer-facilitation activity that plays an important role in generating liquidity in line with the needs of clients.

Finally, we remain of the view that changes to MiFIR Recital 8 on rerouting of orders ("if an order is retracted it may only be rerouted to a regulated market or an MTF, or an SI platform not owned by the OTF operator in question, even when this is partly prejudicial to the obligation of best execution") and to MiFID Article 20(1) are not in the best interests of market functioning or investors. We believe that conflicts of interest rules could adequately deal with the interaction between an SI and OTF, without prejudicing best execution. The same is true of the new MiFID Article 20(3) that states that "Member States shall not allow the operation of an OTF and systematic internalisation to take place within the same legal entity." Requiring subsidiarisation is unnecessary, when conflicts of interest rules already address the potential conflicts that arise from having both activities in the same entity. Requiring such restructuring would create additional costs for clients without providing any additional benefits.

Mechanism to avoid duplicative or conflicting rules (MiFIR Article 26a)

ISDA welcomes the introduction of a mechanism to avoid duplicative and/or conflicting rules on derivatives trading for parties which may be subject to both MiFIR and non-EU derivative trading regimes. From the point of view of successful implementation of this provision, it will be essential to adopt an approach to equivalence based on regulatory outcomes and not detailed correspondence of respective jurisdictions' rules.

We also believe that the current drafting does not fully address the range of situations in which a conflict between different jurisdictions' rules could arise.

MiFIR Article 26a(3) states that where counterparties enter into a transaction subject to MiFIR, they shall be deemed to be in compliance with the obligations of MiFIR where: (i) an equivalence decision has been made in accordance with paragraph 2; and (ii) at least one of the counterparties is established in the third country which has been deemed equivalent.

We believe that this provision does not take account of the fact that, in certain circumstances, two EU counterparties that trade and are subject to MiFIR may also be subject to a third country's regime due to the nature of the derivative contracts they trade or other factors that mean that the parties will have obligations under the third country's regime. For example, Section 722(d) of the US Dodd-Frank Act states that non-US counterparties may be subject to the provision of the US Commodities Exchange Act, where their activities:

- have a direct and significant connection with activities in, or effect on, commerce of the United States; or
- contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of this Act.

We believe that, if an equivalence decision has been made on a third country regime and the parties are subject to both MiFIR and that third country regime, the EU counterparties should be deemed to have met their obligations under MiFIR if they are in compliance with the equivalent third country regime.

As such, we would propose the following wording for Article 26a(3):

> (3) An implementing act on equivalence as referred to in paragraph 2 shall have the effect that counterparties entering into a transaction subject to this Regulation shall be deemed to have fulfilled the obligation contained in Article 24 and 25 where ~~at least one of the counterparties is established in that third country and~~ the counterparties are in compliance with those legal, supervisory and enforcement arrangements of the relevant third country.

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