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Understanding the role of the MiFID2/MiFIR 'OTC' category

Summary

- **MiFIR includes an obligation to trade certain classes of derivatives exclusively on trading venues. ESMA is to make the determination of which classes of derivatives fall under this mandate, subject to their being clearing-eligible and sufficiently liquid. This requirement applies only to derivatives; there is no equivalent requirement for securities (i.e. bonds and shares). Indeed, one of the explicit aims of MiFID1 was to abolish the so-called 'concentration rule', whereby, in certain cases, shares had to be traded exclusively on the exchange of listing.**
- **Where a firm deals OTC on a frequent and systematic basis, the 'systematic internaliser' (SI) regime will apply in respect of liquid instruments.**
- **All trading – whether OTC or on venue – will be subject to post-trade reporting.**
- **In light of this framework, it is therefore unnecessary – and counterproductive – to seek exhaustively to define the scope of 'OTC' trading in legislation. The focus should be on defining venues, the scope of the derivatives trading requirement, and the scope of the SI regime, and doing so in a way that means that only sufficiently liquid instruments are covered by the regime. ISDA notes that the definition of a 'liquid market' proposed in recent Council texts seems to be helpful in that regard.**

Analysis

The MiFID2/MiFIR framework distinguishes between trading activity on 'organised trading venues' and 'OTC' activity.

There are three types of organised trading venue under the MiFID2/MiFIR framework, all with identical pre- and post-trade transparency requirements: regulated market, Multilateral Trading Facility, Organised Trading Facility [new]. We believe that having three separate venue categories is important, as it will maximise regulators' ability to regulate the various types of different trading systems that exist today – and which might emerge in the future.

For derivatives, there will be a requirement (MiFIR Article 24) to trade clearing eligible and sufficiently liquid contracts on an organised trading venue. In other words, the more standardised and liquid part of what we currently refer to as the 'OTC' derivatives market will in future no longer trade on a purely OTC basis and will instead move to a trading venue. As noted above, all trading venues will have to apply identical pre-trade transparency provisions.

The only derivatives contracts that will in future continue to trade OTC are those that do not meet the test of being 'clearing eligible and sufficiently liquid'. Where a firm is trading liquid instruments OTC on a frequent and systematic basis, it will be covered by the systematic internalisation rules.

For all OTC transactions (whether under the SI regime or not), post-trade transparency will apply, just as it does for venue-traded instruments. Likewise, investment firms will be obliged to provide best execution and to follow other conduct of business requirements, regardless of where the trade takes place

To summarize: the MiFID framework requires clearing eligible and sufficiently liquid derivatives to trade on a trading venue, a requirement that does not exist for other instruments (such as bonds or equities). Where a firm trades liquid instruments OTC on a frequent and systematic basis, the 'systematic internaliser' (SI) regime will apply. In all cases, post-trade reporting rules will apply.

In light of this framework, it is therefore unnecessary – and counterproductive – to seek to narrowly define 'OTC' trading in MiFID. The focus should be on defining venues, the scope of the derivatives trading requirement, and the scope of the Systematic Internalisation regime, and doing so in a way that means that only appropriately liquid instruments are covered by the regime. ISDA notes that the definition of a 'liquid market' proposed in recent Council texts seems to be helpful in that regard.

Likewise, it makes no sense to stipulate that OTC trading <u>must</u> take place under the Systematic Internalisation rules [cf. ECON position] or to stipulate that trading that doesn't exactly meet a new definition of OTC can only take place on venue or via an SI [cf. Presidency compromise].

The SI regime and derivatives trading obligation already provide for their scope of application, and any separate requirements relating to OTC activity can only serve to at best duplicate or at worst contradict other elements of the MiFID market structure framework.

The risks associated with further constraining OTC activity for derivatives (in a way that goes beyond the existing derivatives trading obligation) are clear:

- This goes well beyond the G-20 mandate to exchange and electronic trading of derivatives, where appropriate, and would put the EU out of sync with other jurisdictions, notably the US.
- This introduces a material risk that customised hedging transactions, which are vital to the needs of corporate users and investors, are disallowed, because there might be cases where they don't precisely meet the definition of OTC, yet cannot be executed in any other fashion.
- Defining OTC too narrowly – or seeking to stipulate where OTC transactions can take place – would undermine the separate derivatives trading obligation test ("clearing eligible and sufficiently liquid"), potentially pushing illiquid instruments towards venues when they are ill suited to venue trading.

ISDA therefore encourages the Council to focus first and foremost on the scope of the SI regime and trading obligation, rather than seeking to fundamentally re-engineer the 'OTC' category, which should be maintained as a residual category within the framework.

If there is to be an OTC definition in MiFID, it should be consistent with that in Article 2(7) of EMIR (see below). Using the EMIR definition would also ensure consistency between the EMIR and MiFID texts.[i]

Contact: Adam Jacobs, ajacobs@isda.org

[i] The OTC derivative definition found in EMIR Art. 2 (7) is as follows:

> (7) ‘OTC derivative’ or ‘OTC derivative contract’ means a derivative contract the execution of which does not take place on a regulated market as within the meaning of Article 4(1)(14) of Directive 2004/39/EC or on a third- country market considered as equivalent to a regulated market in accordance with Article 19(6) of Directive 2004/39/EC;

It is also referenced specifically in MiFIR Recital 31:

> (31) Regulation [EMIR] sets out the criteria according to which classes of OTC derivatives should be subject to the clearing obligation. It also prevents competitive distortions by requiring non-discriminatory access to central counterparties (CCPs) offering clearing of OTC derivatives to trading venues and non-discriminatory access to the trade feeds of trading venues to CCPs offering clearing of OTC derivatives. As OTC derivatives are defined as derivatives contracts whose execution does not take place on a regulated market, there is a need to introduce similar requirements for regulated markets under this Regulation. Provided that ESMA has declared them subject to it, derivatives traded on regulated markets should also be subject to a clearing obligation.