MiFID/MiFIR: The OTF and SI regime for OTC derivatives

The International Swaps and Derivatives Association (ISDA) would like to take this opportunity to set out its views on the elements of European Commission's MiFIR/MiFID2 proposals that impact on OTC derivatives markets, particularly proposals covering market structure and transparency.

This paper considers the European Commission's legislative proposals regarding the Organised Trading Facility (OTF) and the Systematic Internaliser (SI) regime. In this paper, we make the following points:

- We endorse the European Commission's approach that the trading obligation should only capture clearing eligible and sufficiently liquid contracts; we believe that the **drafting covering the derivatives trading obligation would benefit from further refinement to ensure it captures the appropriate contracts**, taking into account appropriate phasing in and whether a contract is likely to be sufficiently liquid over the course of a whole economic cycle.

- **We welcome the establishment of the OTF category** (and the discretion afforded to the operator of an OTF), but do have reservations about the fact that the derivatives trading obligation promotes multilateral trading systems above bilateral ones, even when the latter offer equivalent levels of transparency. We believe that a firm operating as an SI and providing electronic client access should be eligible for fulfilling the trading obligation.

- We believe that **clarity is necessary as to the relative roles of regulated trading venues, systematic internalisation and pure bilateral OTC trading** and make suggestions that would promote consistency, particularly in terms of transparency, across the three.

- We believe that the **treatment of block trades in derivatives is crucial** and that it is appropriate, and in many cases necessary, for such transactions to occur on a bilateral basis, which currently does not appear to be possible under the MiFID 2 proposals.

- The **SI regime for 'non-equities' should operate at the level of liquid instrument** to ensure consistency with the approach to pre- and post-trade transparency and the approach to the equities regime. This will also ensure that liquidity in non-equity markets is not compromised.

- More broadly, the Commission's approach to 'non-equities' markets poses a challenge given the differences between asset classes within the non-equities category, such as derivatives and fixed income, with significant differences between them in terms of quoting practice, pricing conventions and levels of automation of trading.

Reform of OTC derivatives markets: Global context and effective prioritization

The OTF category is linked to the September 2009 G-20 commitment to move trading in standardised derivatives to exchange or electronic trading venues where appropriate, reflected in MiFIR in the 'trading obligation' (Articles 24-27).

The OTF category reflects the G-20 commitment to exchange and electronic trading

The commitment to exchange and electronic trading, where appropriate, was part of a package of reforms of OTC derivatives markets at the G-20 level, covering central clearing, reporting to trade repositories and capital treatment of uncleared transactions: "All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements."

This is part of a wider package of reform

The various elements of this package of reforms are being handled through distinct pieces

Being delivered in the EU through different pieces of legislation of legislation at the European level, with EMIR dealing with clearing and trade repositories, and CRD IV dealing with capital requirements for uncleared transactions.

This creates a challenge in terms of achieving the necessary level of coherence and consistency across the different pieces of legislation, but in terms of the sequencing of reform, the European Commission's approach greatly enhances the possibility of smooth reform implementation: In particular, we think it was sensible to deal with clearing and repositories ahead of exchange and electronic trading, given that central clearing and trade repositories are fundamentally matters of systemic risk mitigation. It is appropriate that priority is given to these areas. Exchange and electronic trading, on the other hand, relates to matters of transparency, integrity and efficiency. While these are themselves important objectives, they relate first and foremost to competition in OTC derivatives markets; an issue that is less clear-cut or pressing than mitigation of systemic risk, and in all likelihood much harder to address given the inevitable trade-offs that must be made between transparency and liquidity and between different participants in the market.

We support the prioritisation of clearing and trade repositories over exchange and electronic trading

In what follows, we set out our views on how to approach matters of market structure and transparency in a way that will benefit the OTC derivatives market at large, reflecting ISDA's broad membership base of sell-side firms, buy-side firms, corporate and sovereign treasuries and commodity firms.

The trading obligation: scope

The trading obligation is probably the area where the important dependencies between MiFIR and EMIR are most pronounced, given that the MiFIR trading obligation applies to non-intra group transactions in clearing eligible and sufficiently liquid contracts when traded by counterparties subject to clearing under EMIR (MiFIR Article 24(1)).

MiFIR is dependent on EMIR, notably as regards the trading obligation

We think that the link to clearing status is an appropriate starting point for the trading obligation and strongly support the principle that the trading obligation should be limited to sufficiently liquid contracts, i.e. a particular subset of contracts that can be cleared. This in effect implies a double liquidity test – one under EMIR for the purposes of clearing (taking into account other factors as well, notably standardization) and a second under MiFIR for the purposes of the trading obligation. This is a very important feature of the European Commission's proposals, as it recognises that liquidity for the purposes of central clearing, where the focus is on establishing market values for the purposes of margin calls, is distinct from the notion of liquidity in the context of determining whether a contract is suitable for trading on a particular type of venue. We have previously made a comparison with futures markets to illustrate this point – despite high levels of contract standardisation, many new futures contracts fail to attract liquidity and ultimately fail.[1]

We think the trading obligation takes the right starting point with 'clearing eligible and sufficiently liquid' contracts

While we endorse the European Commission's approach that the trading obligation should only capture clearing eligible and sufficiently liquid contracts, we believe that the drafting covering the trading obligation would benefit from further refinement to address a number of important considerations:

Further criteria should also be built into the process for determining sufficient liquidity

- Make sure that only clearing eligible contracts can be made subject to the trading obligation.
- **Prospective liquidity:** ESMA should consider the potential for the liquidity of a contract to vary *over time* in considering whether an instrument is 'sufficiently liquid'.
- **Market infrastructure capacity:** The number of venues available for trading the class of derivatives or subsets thereof and the expected volume of trading on those

[1] http://www2.isda.org/attachment/Mzk4Mw%3D%3D/ISDA%2520MiFID%2520Position%2520Paper%2520-%252023%2520Nov%25202011.pdf

venues is an important aspect of liquidity; it helps assess whether there is a necessary commercial impetus to support exchange or electronic trading.

- **Phasing in** of the trading obligation for a class of derivatives, or subsets thereof, or for particular client types, in line with the approach under EMIR.
- **Block trade exemption:** In making a class of derivatives or subset thereof subject to the trading obligation, ESMA should determine specific and carefully calibrated size thresholds above which pre-trade transparency requirements and the trading obligation under Article 24(1) of MiFIR would not apply for that class of contracts.
- **Consultation process:** The views of market participants in respect of whether the trading obligation should apply to particular classes of derivatives or subsets thereof.
- **Suspension of the trading obligation:** There may well be conditions under which the trading obligation should be suspended or removed, particularly if liquidity levels have fallen to an extent that it becomes impossible to manage risk through products traded on venues. Ideally, ESMA could establish criteria for the automatic suspension of the trading obligation; the alternative would be creating a mechanism for lifting the trading obligation after an assessment by ESMA, although this approach might be less responsive.

None of these points would fundamentally change the coverage of the trading obligation, but they would help ensure that the appropriate contracts are made subject to the obligation. We believe that such criteria could be built into Article 26 through targeted changes to the drafting.

This would not change the nature of the trading obligation

The trading obligation: eligible venues

The trading obligation states that relevant counterparties shall conclude relevant transactions only on regulated markets, MTFs, OTFs or third country trading venues (subject to equivalence and reciprocity considerations).

The trading obligation requires certain transactions to occur on venues

We welcome the establishment of the OTF category, and the discretion afforded to the operator of an OTF. Interdealer brokers currently use matching discretion to good effect to facilitate trading in OTC derivatives markets, which are characterised by episodic, non-continuous activity. They typically mix voice-broking with electronic price screens, creating 'hybrid' systems that are well suited to the thinly traded OTC derivatives markets.

We support the creation of the OTF venue

We also believe it is vital to explicitly recognise the role of voice-broking in derivatives markets. As explained previously[2], we believe that transparency rules should be crafted in a way that doesn't unduly promote or undermine particular trading methodologies, something that is particularly important in the context of OTC derivatives markets, for which organised trading is in its infancy and untested. We return to questions of transparency later in this paper.

We do not believe the rules should promote a particular trading methodology

On a separate issue, we also have reservations about the fact that the trading obligation promotes multilateral trading systems above the platforms operated by individual investment firms: as it stands, single-dealer platforms would appear to fall under the SI rules, rather than the OTF rules, and would therefore not be eligible for satisfying the trading obligation.

Single-dealer platforms will not be eligible for satisfying the trading obligation

To some degree this is driven by the belief that the existing multilateral equities trading environment offers a template on which other markets, notably bond markets and the OTC derivatives market could be remodelled. As we have previously explained at length[3], OTC

We question the promotion of multilateral platforms

[2] See http://www2.isda.org/attachment/NDAxMw==/MiFIDMiFIRandtransparency20120214.pdf

[3] See http://www2.isda.org/attachment/MzExMw==/SEF-FinalVersion.pdf

derivatives markets are structurally different to exchange-based markets and serve a different purpose, such that aggressive convergence with the equities model would almost certainly be detrimental to those who rely on OTC derivatives to manage risk. In looking at whether trading venues should provide multilateral access, IOSCO was not able to reach a unanimous position, illustrating that this is not a straightforward issue.[4] We believe single-dealer platforms offer their users many benefits that might not be available via multilateral trading systems, including benefits relating to trading hours, contract selection, execution possibilities, and the possibility to use related services, such as investment research.

Single-dealer platforms currently play a significant role

Favouring multilateral systems will also imply a relocation of existing trading activity – which could detract from the existing efficiency of the market.[5] Today a modest amount of trading activity in interest rate swaps, the largest segment of the OTC derivatives market by notional size, already occurs on organised trading platforms – somewhere in the region of 10% of the total activity. Of this, single-dealer platforms account for about 50% of this activity, with multilateral platforms accounting for 40% and inter-dealer platforms about 10%.[6]

The G-20 commitment did not preclude single-dealer platforms

Hence our view remains that there is nothing in the G-20 commitment that rules out a role for single-dealer electronic trading platforms, and we would be supportive of changes to the trading obligation that would make it possible to fulfil the trading obligation by executing relevant transactions through an SI operating an electronic trading platform. Naturally, appropriate levels of pre-trade transparency should apply regardless of the venue of execution. This would also ensure that clients who do not have access to a regulated venue would be able to access relevant contracts.

We do not support the ban on the use of proprietary capital by the operator of an OTF

We also question provisions that would prevent an OTF operator from executing client orders against its proprietary capital. While we understand that the intention is to ensure the neutrality of the firm operating the OTF platform and draw a clear delineation between agency and principal trading, we would highlight that the distinction between agency and principal activity is not a straightforward issue, particularly in the context of derivatives markets where *all* client transactions involve banks deploying their own capital and managing the risk associated with a client-facing transaction over time.

Relationship between the SI regime and OTF concept for OTC derivatives

The SI regime would benefit from greater clarity as to its purpose for OTC derivatives

As currently framed, the likely application of the SI regime remains unclear for OTC derivatives. In part, this lack of clarity stems from uncertainty as to whether foreign exchange derivatives will be deemed to be clearing eligible under EMIR – if they are not made subject to clearing, then activity in foreign exchange derivatives could fall under the SI rules as currently written if it is taking place in a systematic fashion (assuming the relevant contracts are also voluntarily traded on a regulated venue). For other contracts that are likely to be clearing eligible, such as certain interest rate swaps, those that are sufficiently liquid will, on account of the trading obligation as currently drafted, largely be required to trade via OTFs, MTFs or regulated markets.

Changing the trading obligation as we suggest above (such that it can be satisfied by trading through an electronic SI) would therefore create a far clearer purpose for the Systematic Internalisation regime as it applies to OTC derivatives, with transparency obligations linked to contracts subject to the trading obligation.

[4] See www.iosco.org/library/pubdocs/pdf/IOSCOPD345.pdf
[5] See http://www2.isda.org/attachment/Mjg3NA==/press110910[1].html
[6] See http://www2.isda.org/attachment/NDAxMw==/MiFIDMiFIRandtransparency20120214.pdf

In the absence of such a change, we would at the very least suggest that the scope of the SI pre-trade transparency regime be clarified along the following lines, such that it sets pre-trade transparency rules for a very clearly defined set of instruments:

- that are clearing eligible;
- and that are admitted to trading on a regulated market or are traded on an MTF or an OTF;
- for which there is a liquid market (paralleling the Article 26 liquidity criteria);
- when being traded in a non-block size.

Ensuring consistency of approach for contracts trading OTC and on regulated venues

This would make for a workable SI regime for OTC derivatives that would ensure that liquid contracts traded both on regulated venues and OTC under the SI regime would benefit from comparable levels of transparency, taking into account any relevant waivers. This would ensure a level playing field and efficiency of price formation. In concrete terms, this would mean that an SI would be obliged to publish price data (e.g. responses to Request-For-Quotes) for such contracts when it has been prompted for and has agreed to provide a quote to a client.

The idea that the SI regime operates by 'sub asset class' is at odds with calibrating transparency by instrument

Some interpretations of the European Commission's text have suggested that an SI should be recognised at 'sub asset class' level – say for example interest rate derivatives. We believe this would be at odds with the desire to construct a pre-trade transparency regime that applies to specific instruments (or, perhaps more accurately in the case of derivatives, a very narrowly defined set of contracts with shared key characteristics). Taking the example of interest rate derivatives, there will inevitably be instruments within the 'sub asset class' that cannot support pre-trade transparency – such as an exotic interest rate option – versus those that can, such as the most liquid benchmark interest rate swaps. A firm should only be an SI for a particular, liquid instrument.

It is not feasible for the price made for one client to be made available to all clients

The extent to which other clients of the SI can transact on such prices is a separate question. We do not believe that it is feasible to require an SI to enter into transactions with other clients on the basis of a price made for one client, simply because the price made for one client will legitimately reflect factors that are specific to that client, notably its credit risk status, as well as factors that are specific to the transaction, which might entail tailored provisions. This outcome would contradict one of the key aims of financial reforms introduced since the financial crisis – namely that the price of a transaction should reflect the real risks associated with that transaction.

We would instead suggest that SIs establish Quoting Policies

However, we believe that there would be merit in requiring Systematic Internalisers to put in place a Quoting Policy, setting out the factors that inform the quotes that a given client receives. This would establish greater transparency around the factors that investment firms take into account in providing quotes, while nevertheless protecting the ability of market makers to quote in light of a particular client's circumstances, rather than trying to force a 'one size fits all' approach. The quoting policy could also have a broader application that publication of quotes, covering contracts that are not available on venues but which are nevertheless traded systematically by an SI.

All activity will be subject to post-trade transparency

It is also important to stress that the MiFIR post-trade reporting regime will apply to any OTC derivative reported to a trade repository. In other words, even if certain OTC derivatives contracts are not pre-trade transparent, there will essentially be no instruments that are exempt from transparency per se, given the indiscriminate scope of the post-trade regime. In this context, defining appropriate post-trade reporting delays and volume masking is an important consideration. We would therefore suggest that this be dealt with through technical standards from ESMA, rather than delegated acts.

We summarize this framework in Annex 1.

Pre-trade transparency

Pre-trade transparency rules should not favour a particular execution method

In our previous paper on Pre-Trade Transparency[7] we explained in detail the importance of framing the pre-trade transparency requirement in a way that doesn't pre-judge a specific execution method. We made the following observations:

- Different trading models are appropriate for different instruments.
- Pre-trade transparency differs according to the nature of a given trading model.
- Pre-trade transparency should be calibrated by trading model and should adequately accommodate Request for Quote trading systems.

We support an approach that reduces reliance on waivers

In terms of drafting suggestions, we believe that the SI regime could be improved as outlined above, while Article 7 could be remodelled to explicitly allow greater variety in terms of execution methodologies, and without giving rise to any need to place such a heavy reliance on the waiver process.[8]

Waivers are required for block trades

Pre-trade transparency requirements are particularly important in the context of large transactions, or 'block trades'. As noted above, we believe that the trading obligation procedure should also entail determination of the block size for a given contract, above which size pre-trade transparency and the trading obligation would not apply, regardless of whether the contract is being traded on a regulated venue or under the SI regime.

Bilateral block trades should be allowed

In practice, this will mean that block transactions could still be negotiated and executed on a bilateral basis, if the parties to the transaction so choose. They would still be subject to clearing, as appropriate, and to post-trade reporting.

Treatment of block trades is being discussed in the US

This point is also being discussed in the US in the context of Dodd-Frank Act rulemakings. In January 2011, the CFTC published its proposed rulemaking on Core Principles and Other Requirements for Swap Execution Facilities[9]. This includes a distinction between 'Required Transactions' and 'Permitted Transactions' [Permitted Transactions including block trades], with differing requirements for each category when it comes to execution. In ISDA's response to the CFTC, we note that there is no need to require or suggest specific execution methods for transactions that are not subject to the "trading requirement" under Dodd-Frank Act.[10] Similarly, in the context of MiFIR, we do not believe that block trades should necessarily be executed on an OTF, MTF or regulated market, which are first and foremost vehicles for transparency.

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[7] See http://www2.isda.org/attachment/NDAxMw==/MiFIDMiFIRandtransparency20120214.pdf
[8] Ibid.
[9] See http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-32358a.pdf
[10] See http://www2.isda.org/attachment/MjUxNQ==/CFTC-SEF-Letter.pdf

Annex 1: Summary of regulatory framework

Instrument traded on regulated venues as well as bilaterally in a systematic fashion	**Ensuring a level playing field and supporting price formation** • Equivalent scope and detail of pre-trade transparency rules, with equivalent waivers • Harmonized post-trade transparency • Off-venue activity subject to the investment firm's Quoting Policy • Best execution applies when a client order is executed • Activity subject to the investment firm's Quoting Policy
Instruments not available on a regulated venue and where trading is not systematic	**Ensuring all instruments fall within the scope of MiFID protections** • Best execution applies when a client order is executed • Post-trade transparency applies