ISDA Commentary on Pre-Trade Transparency in MIFIR (Huebner report) – 16 September 2022

I. Executive Summary

The European Parliament rapporteur on the MIFID 2/MIFIR revision, Danuta Huebner MEP, supports deletion of pre-trade transparency requirements regarding on-venue non-equity trading using Request for Quote (RFQ) and Voice trading systems in her draft report.

The obligation to publish quotes by liquidity providers regarding non-equity instruments (e.g. bonds and derivatives) currently applies to trading on trading venues *and* trading with liquidity providers acting as Systematic Internalisers (SIs)[1].

Mrs. Huebner has not proposed amendments deleting pre-trade transparency requirements for SIs (detailed in MIFIR Article 18). However, in her justification to amendment 35 (amending MIFIR Article 8 on pre-trade transparency on-venue), Mrs. Huebner supports this principle: '*The removal….will remove an undue burden on market participants without affecting the levels of transparency in the market. Same principle applies for changes to Article 18*'.

ISDA believes that the revised MIFIR should

- create conditions under which EU clients can access optimal prices for derivatives trades for hedging and other commercial purposes.
- provide a safe, efficient framework under which MIFIR liquidity providers can compete with peers from non-EU markets for client business in the EU and globally.

It is for this reason that ISDA agrees that pre-trade transparency should be deleted for derivatives business both for on-venue quotes using RFQ and Voice systems and for SIs. This is particularly urgent for liquidity providers acting as SIs, who face more commercial risk than liquidity providers on trading venues as result of the obligation to publish *attributed* quotes to potential clients (on-venue quotes published are anonymized).

Published SI quotes (particularly for larger trades, if transparency is mis-calibrated), when combined with post-trade transparency information, will reveal the exposures SIs assume when clients trade against these quotes. Predatory market participants will use this information to trade against SIs' interests in the markets they use to offset these risks. Such 'undue' risk will have to be reflected in prices quoted by SIs and client hedging costs will increase. This will be particularly impactful for prices quoted to Small Financial Counterparties (SFCs) and Non-Financial Counterparties below the EMIR clearing threshold (NFCs-) who are exempt from the DTO and therefore able to enter hedging trades with SIs in the more liquid, high-volume derivatives contracts that are otherwise subject to the DTO.

[1] SIs are liquidity providers trading bilaterally with counterparties in derivative products that are insufficiently liquid to support the derivatives trading obligation[1] (DTO) and/or with counterparties that are exempt from the DTO (such as non-financial corporates engaged in limited derivatives trading activity (typically hedging)). The most liquid, high volume derivative contracts, subject to the DTO, and traded between counterparties subject to the DTO, must be traded on-venue.

This impact is compounded by the fact that EU liquidity providers must comply with more intrusive pre-trade transparency rules than those under US rules and that the UK authorities intend deleting pre-trade transparency in fixed income business. This uneven playing field will challenge EU liquidity providers' ability to compete with non-EU peers for clients business.

ESMA (like the UK authorities) has recognized that real economy investors see little value in pre-trade transparency. As ESMA said in their July 2020 'MIFIR report on systematic internalisers in non-equity instruments': *'The overall assessment of the non-equity SI pre-trade transparency framework for liquid instruments attracted negative feedback from most stakeholders based on multiple grounds. A large majority of respondents stressed that there is no demand for SI quotes due to the bespoke nature of each request. Therefore, there is no point in having as a regulatory objective that the quotes are accessed by other clients.'*

ISDA therefore urges MEPs to delete MIFIR pre-trade transparency requirements for on-venue non-equity trading using RFQ and voice systems and for trading with SIs.

2. Pre-Trade Transparency in MIFIR explained

The requirement to publish quotes on a continuous basis during the trading day is first detailed (for trading venues) in MIFIR Article 8 (covering pre-trade transparency in non-equities).

The pre-trade transparency requirement is then detailed for SIs in MIFIR Article 18 ('Obligation for systematic internalisers to make public firm quotes in respect of bonds, structured finance products, emission allowances and derivatives'). SIs must also publish quotes responding to client requests on liquid instruments.

Unlike on-venue quotes, SIs' quotes are attributed i.e. other market participants know which firm is providing the quote.

SIs are limited in the scope of derivatives business they can enter into. Derivatives subject to the DTO, traded between counterparties subject to the DTO (financial counterparties that are not SFCs and Non-Financial Counterparties whose derivatives activity means they exceed the EMIR clearing threshold (NFCs+)) must be traded on-venue. SIs may only trade derivatives contracts which are insufficiently liquid to qualify for the DTO, or – for contracts which are (otherwise) sufficiently liquid to be subject to the DTO, - with DTO-exempt counterparties.

Trading venues and SIs do not have to publish quotes when using RFQ or Voice Systems when these quotes exceed the 'Size Specific To An Instrument (SSTI)' threshold, first mentioned in Article 9.1(b). Trading venues benefit from a waiver granted by National Competent Authorities (NCAs) when RFQ or voice trades exceed the SSTI, which is intended to protect liquidity providers from 'undue risk'. In the case of SIs, the threshold applies automatically: quotes of a size above the SSTI do not have to be disclosed.

ESMA was mandated in Article 9 to decide the SSTI level for different products. To do this, it had to take into account 'undue risk'. The key criterion herein is 'whether, at such sizes, liquidity providers would be able to hedge their risks' if quotes are published.

Liquidity providers on trading venues operating electronic order books (exchange-like systems with less scope for counterparty negotiation) also benefit from a waiver from the requirement to publish quotes – the 'Large-In-Scale' (LIS) waiver.

3. Mis-calibrated pre- and post-trade transparency can combine to create undue risk

MIFIR pre- and post-trade transparency interact to create undue risk if mis-calibrated.

A client wishing to trade may ask several liquidity providers for quotes. Under Article 18, all quotes given to clients in liquid instruments are published, including the name of the quoting SI, if the quotes are of a size below SSTI.

The client is likely to execute against one of these quotes. That trade will be reported to the market on a near real-time basis. While the post-trade report is anonymized, other characteristics of the original quote by the SI are reflected in the post-trade transparency report.

As such, the SSTI has been an important mitigant of undue risk in MIFIR. If larger quotes are published, opportunists in the market could determine (by examining post-trade reports) who had assumed these risks and use this information to move pricing in markets used by SIs to offset risks assumed from clients before SIs have had a chance to do so. This would ultimately result in higher prices quoted by SIs to clients.

If pre-trade transparency is not deleted, re-calibration of the level at which pre-trade transparency either on-venue or for trading with SIs should be evidence-based, given the client-pricing implications of mis-calibration.[2] However, given its limited utility, derivatives pre-trade transparency should be deleted.

4. How does the revised MIFIR proposal change pre- and post-trade transparency affecting EU market participants? How does this create more 'undue risk'?

The EC proposal deletes the SSTI waiver, leaving a waiver from pre-trade transparency only for trades that are illiquid or that are LIS - the latter a waiver that was previously only applied to quotes in trading on electronic order books. Though this is not stated in the EC proposal, ISDA understands that the EC supported replacement of the SSTI threshold with a recalibrated (lower) LIS (as supported by ESMA). The SSTI and LIS refer to trade percentiles (30^{th} and 60^{th}, respectively, for pre-trade quotes), so even if the LIS was recalibrated to the 40^{th} or 50^{th} percentile, it could mean that pre-trade quotes twice or even three times the size of those that don't have to be published, would, after such a change, have to be disclosed.

Under the EC proposal, it appears that the SSTI threshold no longer applies under Article 18, although the drafting is far from clear. While Article 18(10) of the consolidated text (as amended), still states that the the Article 18 transparency regime does not apply where SIs quote sizes above SSTI, the revisions to Article 9 both delete the ESMA mandate to determine the SSTI level *and* link the SSTI to the need to protect liquidity providers from undue risk.

The EC *now* acknowledges that on-venue and SI pre-trade transparency should be deleted.

Under Article 11 (authorisation of deferred publication) the post-trade SSTI[3] threshold is also deleted. ESMA is mandated to decide which trades can benefit from deferral of price information until end-of-day or of volume information for up to a maximum deferral period of 2 weeks (the current maximum deferral period is 4 weeks).

5. Why did the EC propose to delete the SSTI threshold and expand the range of instruments for which a requirement to publish quotes would apply?

[2] In 2015, ISDA shared with regulators analysis showing the level at which 'undue risk' applies in benchmark interest rate derivative markets (by reference to price changes in bund futures, a key market for liquidity providers hedging market making activities in these derivatives sub-classes). To our knowledge, no other analysis has been undertaken to estimate undue risk by any EU authority. We are happy to share this analysis with MEPs on request.

[3] The post-trade SSTI is the trade size above which RFQ/Voice trades may benefit from deferred publication.

The EC proposal and Q&A took the position that greater transparency regarding derivatives should be an objective in itself[4]. However, the concept of 'undue risk' described above - and acknowledged by the co-legislators in MIFIR - shows that there is a trade-off between transparency and liquidity, particularly in episodic, less liquid and less standardized (then equities and futures, for example) markets like OTC derivatives. For trades at a size above SSTI, transparency actually diminishes the availability of liquidity because of 'undue risk'.

The EC Q&A asserts that transparency (and price formation) will be boosted by reducing 'deferrals' in non-equities. 'Deferrals' refers to post-trade transparency only. As mentioned above, if pre-trade and post-trade transparency are mis-calibrated, this creates 'undue risk' for liquidity providers. Poorly calibrated post-trade transparency is damaging by itself, but impacts will be exacerbated if the pre-trade SSTI threshold is replaced by a re-calibrated LIS (between current SSTI and LIS levels).

ESMA supported deletion of the SSTI waiver and SSTI deferral in several reports adopted in 2020 to a) reduce complexity in MIFIR (though this is complexity perceived by ESMA and NCAs and not market participants) and b) to increase transparency (as an end in itself).

ESMA underestimated the importance of the SSTI threshold for SIs while developing its position on revision of MIFIR, citing – in a consultation paper of March 2020 (paragraphs 51 and 72) and final report of September 2020 (paragraph 44) on the transparency regime for non-equity instruments and the trading obligation for derivatives - that requests for the SSTI waiver made up only 6% waiver requests. However ESMA's December 2021 report on use of MIFIR waivers showed that the SSTI is crucial to market participants, and not only in derivatives:

- 49% of total non-equity trading volume waived from transparency was waived under the SSTI waiver.
- 91% of this volume waived under the SSTI waiver comprised sovereign debt business.

ESMA also only looked at the importance of the SSTI waiver *on-venue* in its 2020 reports and inadequately considered the SI perspective. The Article 9 SSTI waiver must be requested by venues, who do not put their own capital at risk. Liquidity providers on-venue are not named in quotes. The SSTI threshold is crucial to SIs' ability to provide liquidity (given that the names of counterparties are published) if pre-trade transparency is not deleted in MIFIR.

ISDA understands that the EC now favours full deletion of pre-trade transparency requirements under MIFIR for trading involving SIs and has made this known to the French and Czech Presidencies (for reasons explained below). If pre-trade transparency for liquidity providers is deleted, no pre-trade SSTI threshold is needed.

6. How does MIFIR pre-trade transparency compare with the US and UK?

[4] ISDA believes that the most effective way to enhance trade transparency in derivatives business would be to overhaul the system of instrument identification used for reporting and transparency requirements. ISINs – which ESMA designated (in MIFID 2/MIFIR) as the identifier for derivatives reporting - are not appropriate for the purpose of transparency in derivatives markets, and obscure whatever benefits could be gained from trade transparency. The use of ISINs undermines derivatives transparency, and will obscure whatever value could be obtained from a CTP. Under the current trade identification system, for example, on occasion two almost identical products (for example, two 5-year IRS, with one being traded one day later than the other) will have different ISINs. The system also generates very large numbers of ISINs.

- *US (CFTC) pre-trade transparency for derivatives is much less intrusive than MIFIR pre-trade transparency for derivatives, and provided to only one counterparty.*

Under CFTC rules, a 'required transaction' i.e. a derivative required to be executed on a Swap Execution Facility (derivatives trading venue under CFTC rules) must be executed on an order book or subject to RFQ-3. The latter means that the client must seek quotes from 3 dealers for a specific trade. As such, there is no requirement to publish firm quotes under the CFTC rules.

Under the MIFIR regime, quotes by dealers must be made available to the entire market. The SSTI threshold partially mitigated this asymmetry, particularly for larger trades involving more exposure for EU liquidity providers.

- *The UK authorities intend to delete pre-trade transparency completely for derivatives and bond business on RFQ and voice systems*

As the UK's 2021 Wholesale Market Review consultation put it, 'available evidence from the….MiFID II transparency regime for bonds and derivatives is that… pre-trade transparency to such markets has not worked effectively… because, order books (which list bids and offers for all instruments), are not widely used by fixed income and derivatives traders. Instead, liquidity is….provided on a request for quote basis, or instruments are traded of bilaterally……. because a lot of fixed income and derivative instruments are bespoke, illiquid and complex'.

The Financial Services and Markets bill will be adopted in Q2 2023, and will empower the UK Financial Conduct Authority to adapt the UK legal framework on this and other issues.

Edwin Schooling Latter, the FCA's Head of Markets and Wholesale Policy and Wholesale Supervision, confirmed at the ISDA AGM in May 2022 (during a panel discussion also featuring Tilman Lueder, Director, Securities in the EC) that the FCA maintains the view that pre-trade transparency should not be required in derivatives or bond markets.

7. The EU should consider the appropriate approach to trade transparency when the EU is (post-Brexit) a much less liquid derivatives jurisdiction than the US and UK

Post-Brexit, the EU's derivatives markets are much less liquid and more fragmented. These markets require a more cautious approach to transparency as liquidity providers are much more exposed to market risk. Increased transparency without safeguards will further damage liquidity and pricing for EU companies wanting to manage risk.

8. ISDA recommendation

ISDA recommends that pre-trade transparency should no longer be required in derivatives business conducted on RFQ and voice systems on trading venues and (most crucially) for trading with and by SIs (because the attributed nature of pre-trade transparency under Article 18 leaves SIs exposed to a particularly elevated level of undue risk.

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About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 960 member institutions from 78 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

Annex: Amendments

Deletion of pre-trade transparency for RFQ and voice trading in non-equities

For ease of reference:

- Consolidated text of MiFIR is available here;
- Commission legislative proposal is here.

Proposal for a Regulation **Recitals – recital (7a) (new)**	
Text proposed by the Commission	*Amendment*
	(7a) Article 8 of Regulation (EU) No 600/2014 requires market operators and investment firms operating a trading venue to make public current bid and offer prices and the depth of trading interests at those prices which are advertised through their systems for bonds, and structured finance products, emission allowances, derivatives traded on a trading venue and package orders. This obligation should only apply to market operators and investment firms operating a trading venue applying a central limit order book or periodic auction system and should not apply to request-for-quote and voice trading systems. To ensure a level playing field, the obligation on systematic internalisers in those instruments to provide pre-trade transparency when they agree to provide a quote in response to a request for a quote should also be removed.

Proposal for a Regulation **Article 1 – paragraph 4a (new)**	
Regulation (EU) No 600/2014 Article 8(2)	

Text proposed by the Commission	*Amendment*
	(4a) Article 8 is amended as follows: ***(a) paragraph 1 is replaced by the following:*** ***'1. Market operators and investment firms operating a trading venue applying a central limit order book or periodic auction system shall make public current bid and offer prices and the depth of trading interests at those prices which are advertised through their systems for bonds, structured finance products, emission allowances, derivatives traded on a trading venue and package orders. Those market operators and investment firms shall make that information available to the public on a continuous basis during normal trading hours. That publication obligation does not apply to those derivatives transactions of non-financial counterparties which are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the non-financial counterparty or of that group.';*** ***(b) paragraph 2 is replaced by the following:*** ***'2. The transparency requirements referred to in paragraph 1 shall be calibrated for different types of trading systems.';***

Explanation: The proposed amendment removes the requirement for venues to provide pre-trade transparency for systems trading bonds, structured finance products, emission allowances and derivatives and package orders other than central limit order book and periodic auction systems. The proposed amendment follows the text of the French Presidency proposed amendment.

Proposal for a Regulation **Article 1 – paragraph 5**	

Regulation (EU) No 600/2014 Article 9	
Text proposed by the Commission	*Amendment*
(5) Article 9 is amended as follows: (a) in paragraph 1, point (b) is deleted; (b) in paragraph 5, point (d) is deleted;	***[No change]***

Explanation: The Commission's amendments already remove the references to request-for request-for-quote and voice trading systems from Article 9.

Proposal for a Regulation **Article 1 – paragraph 9a (new)**	
Regulation (EU) No 600/2014 Article 18	
Text proposed by the Commission	*Amendment*
	(9a) Article 18 is deleted;

Explanation: Article 18 currently imposes pre-trade transparency requirements when systematic internalisers are requested to provide a quote and agree to provide a quote for bonds, structured finance products, emission allowances and derivatives. The proposed amendment removes this requirement in line with the amendments removing the requirements in Article 9 for pre-trade transparency for venues operating request-for-quote and voice trading systems.