

MiFID/MiFIR and transparency for OTC derivatives

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This paper has been produced by the International Swaps and Derivatives Association to describe the nature of trading structure and liquidity formation in OTC derivatives markets and the implications for framing pre-trade transparency obligations under MIFID2/MIFIR. The paper makes the following points:

- *Different trading models exist 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.*

And regarding systematic internalisation:

- *The systematic internalisation regime is inconsistent in respect of different asset classes.*
- *The systematic internalisation regime could undermine liquidity provision.*
- *Effective price formation can be supported through better targeted measures, specifically a requirement that firms establish quoting policies.*

Recommendations:

- *Redraft or replace Article 7 of MiFIR to accommodate trading systems other than order book systems without relying on the waiver process.*
- *Remove the quote-sharing obligation from Article 17 and put in place measures that support competitive pricing.*

1. Introduction: The relationship between market structure and pre-trade transparency

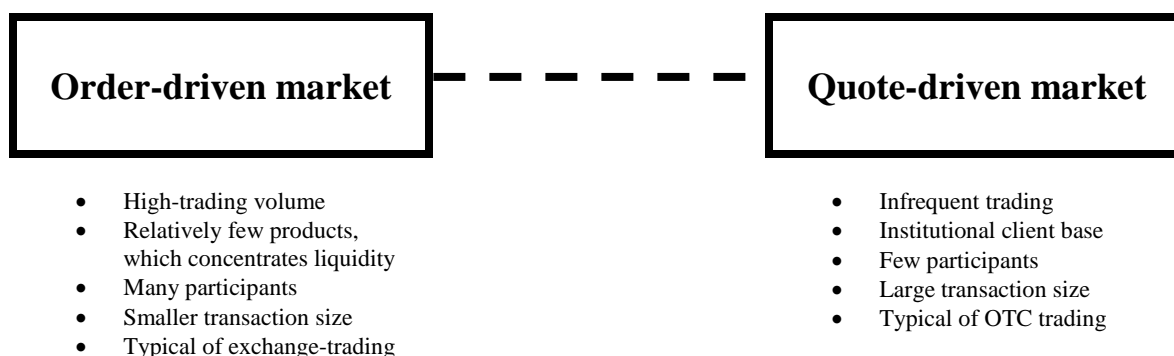
Market structures and trading practices evolve over time, driven by the needs of market participants. Where there is the potential for frequent trading of a financial instrument, with a large number of buyers and sellers, one or more venues will typically emerge to promote such trading. Organised venues facilitate the execution of transactions by standardising commercial terms, developing processes to complete transactions quickly and accurately, and mitigating credit and other risks. Some of these markets evolve into exchanges. Much of the trading in futures contracts and a substantial portion of trading in equities is now done on regulated exchanges, with orders from different clients interacting via an anonymous central order book.

Exchange trading relies on the existence of large number of buyers and sellers

For exchanges to function effectively there must be relatively active order submission by many buyers and sellers, creating high transaction flow and the possibility of matching buy and sell orders. Such ‘order-driven’ trading relies on the willingness of participants to accept ‘execution risk’ – the risk that the trade won’t be executed on the terms the investor seeks.

At the other end of the trading spectrum from order-driven markets sit ‘quote-driven’ markets. In a quote-driven market, the customer faces an intermediary, usually a bank, who makes a price for the customer. In the quote-driven market, it is the intermediary who takes the execution risk in that the intermediary will have to seek to offset the position it takes on from the customer trade through other transactions (as part of managing its risk). Between these poles there exists a wide variety of trading methodologies across different asset classes:

Quote-driven markets protect the client from execution risk



The move from quote-driven markets to order-driven markets is only likely once transaction flow reaches a level at which the customer is willing to accept execution risk. OTC derivatives markets are **not** characterized by high transaction flow. For example, in interest rate products, less than 6,000 trades are executed on an average day globally, all of which are between **wholesale** counterparties. By way of comparison the Deutsche Boerse frequently exceeds 500,000 trades¹ per day, with significant **retail** participation in equities markets. In sovereign CDS markets, even the most actively traded contracts trade on average only 30 times a day, while most corporate CDS contracts trade only once per day (or not even one trade per day) across the entire global market.

OTC derivatives are traded infrequently. Trading is overwhelmingly bilateral

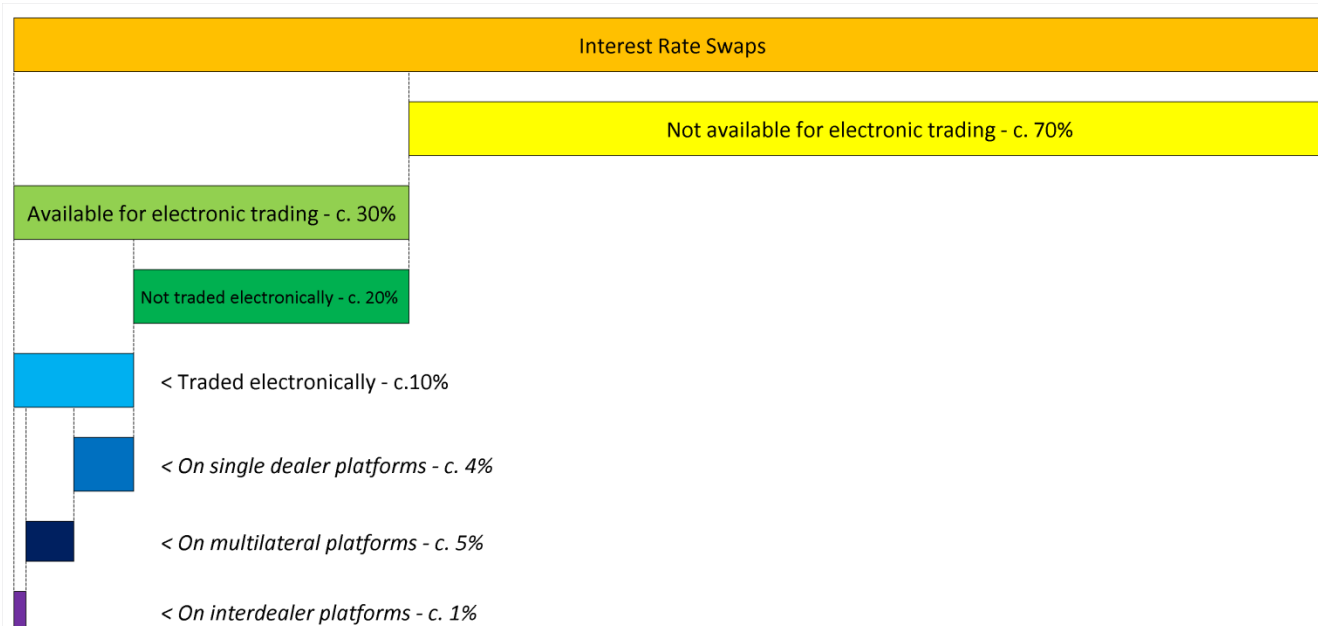
¹ See www.fese.be/en/?id=81&inc=art

At the same, the average size of transactions in OTC derivatives is very large - \$100 million is the average transaction size in interest rate swap markets.

Transaction size is large in OTC derivatives

Because of this, OTC derivatives are still predominantly traded on a **bilateral basis**, i.e. directly between two counterparties rather than via a trading platform. It is largely a **quote-driven market**. The overwhelming majority of derivatives transactions involve a bank acting as principal, either with an end client (c.58%) or with another bank (c. 42%).²

Given these characteristics, exchange and/or electronic trading currently forms only a modest proportion of activity in interest rate swap markets, the largest segment of the market for OTC derivatives, as illustrated by the diagram below:³



Pre-trade transparency – the information available to market participants prior to executing a trade – differs across these different trading models according to the needs of users of the market. For more liquid OTC derivatives contracts, for example, investors have access to many sources of information displaying the exact price at which they will be able to trade: multilateral platforms offer an order book of dealer prices that clients can trade on, just as single dealer platforms offer firm “click and trade” quotes. Both single dealer and multilateral platforms also support Request-For-Quote (RFQ) functionality, where an investor sends an RFQ to the dealer, often on the basis of streamed indicative prices from the dealer, then receiving a firm bid/offer with no obligation to trade if the investor is not happy with the price. Nearly all users of OTC derivatives products have relationships with **multiple** dealers and two or more dealers are typically put into competition for each deal, providing the client with quotes for the specific trade that the client wishes to execute.⁴

Pre-trade transparency differs across trading models. Users of OTC derivatives markets receive multiple quotes

² See www.bis.org/publ/rpfx10b.xls

³ Based on estimates of market participants

⁴ See: <http://www2.isda.org/attachment/Mjg3NQ==/press10141011.html>. 84 percent of surveyed IRS end-users typically get multi-dealer quotes before executing an IRS, reflecting their sophistication and ability to easily access competing price quotes

Additionally, dealers send quotes throughout the day on most of the instruments they trade to their entire client base. Those quotes are most often (but not exclusively) disseminated via Bloomberg messages. In order to deal with the abundance of quotes, clients most often use third-party parsing services (from providers such as, but not limited to, CMA, Bloomberg, Markit, etc) to parse the data and create market-wide quote stacks for any given instrument. The vast availability of quotes versus trades in the CDS markets was evident in the data presented to the ODSG group for its transparency study and referenced in the Federal Reserve Bank of New York's staff report, "An Analysis of CDS Transactions: Implications for Public Reporting."⁵

This leads to very competitive pricing for standard transactions for creditworthy counterparties, resulting in a very narrow difference (the 'spread') between the price at which a dealer will either buy from or sell to a client for the most liquid products: plain vanilla interest rate swaps, many interest rate option products, credit indices and the most liquid single name Credit Default Swaps (CDS). Moreover, OTC derivative users are typically very sophisticated and experienced and are fully capable of executing transactions to their benefit. In fact, end users sometimes "choose not to broadcast their transaction details to multiple participants" in order to have access to efficient and cost effective hedging.⁶ Recent surveys confirm that end users, by and large, are very satisfied with the service, including pricing, they get from dealers.⁷

Pricing is very competitive for liquid products

Illustrative of these points is the blind test sponsored by ISDA in 2010.⁸ In the test, three large investment managers asked groups of three dealers for firm pricing on five interest rate swaps denominated in USD or Euro. Interest rate swaps are quoted in basis points, i.e. hundredths of a percent. The average winning quote for the 15 swaps was a mere one tenth of a basis point over the middle of the market at the time the quotes were sought. In short, there is no evidence of a market failure when it comes to price formation in OTC derivatives markets.

Market tests confirm the competitiveness of pricing

Summary

- Exchange trading relies on the existence of large number of buyers and sellers
- OTC derivatives are traded infrequently. Trading is overwhelmingly bilateral
- Pre-trade transparency differs according to the nature of a given trading model
- Pricing is very competitive for liquid OTC derivatives products

2. Regulation of trading venues under MiFIR – transparency considerations

Despite the bilateral nature of the OTC derivatives marketplace, certain derivatives contracts – plain vanilla interest rate contracts, certain credit indices and nearly 200 CDS single name reference entities – can already be cleared through Central Counterparties (CCPs), with the CCP becoming the counterparty to each side of the transaction and reducing bilateral risk exposures

ISDA supports the move to central clearing

⁵ See http://www.newyorkfed.org/research/staff_reports/sr517.pdf.

⁶ See the Coalition for Derivatives Users letter to the CFTC dated 8 March 2011. Available at: <http://www.chathamfinancial.com/wp-content/uploads/2011/03/Coalition-Comments-Core-Principles-and-Other-Requirements-for-SEFs.pdf>

⁷ See: [http://www2.isda.org/attachment/Mjg3NQ==/press101410\[1\].html](http://www2.isda.org/attachment/Mjg3NQ==/press101410[1].html). 62 percent rate IRS price competitiveness at a 4 or 5, while only 10 percent of IRS end-users rate it at a 1 or 2, on a 5 point scale.

⁸ "Interest Rate Swap Liquidity Test" - a report sponsored by ISDA and conducted by Atrivida Partners in conjunction with market participants in November 2010. Available at: <http://www2.isda.org/attachment/MTY2NQ==/ISDATestReport.pdf>

in the marketplace. The CCP requires both initial margin and variation margin to protect itself and its clearing members. In line with the associated G20 commitment, EMIR will greatly enhance the role of central clearing, something which ISDA supports.

Another limb of the G20 commitment is that, where appropriate, standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms. In order to deliver on this commitment, Article 24 of MiFIR introduces an obligation to trade clearing eligible and sufficiently liquid derivatives contracts on an OTF, MTF or regulated market. What is classed as 'sufficiently liquid' will be defined by ESMA in light of average frequency of trades, the average size of trades, and the number and type of active market participants.

MiFIR will require certain OTC derivatives to be traded on an organized venue

Article 7 of MiFIR defines the pre-trade transparency requirements associated with trading venues in respect of bonds, structured finance products, emission allowances and derivatives. Article 7(1) states:

Pre-trade transparency associated with organised venues

Regulated markets and investment firms and market operators operating an MTF or an OTF based on the trading system operated shall make public prices and the depth of trading interests at those prices for orders or quotes advertised through their systems for bonds and structured finance products admitted to trading on a regulated market or for which a prospectus has been published, emission allowances and for derivatives admitted to trading or which are traded on an MTF or an OTF. This requirement shall also apply to actionable indications of interests. Regulated markets and investment firms and market operators operating an MTF or an OTF shall make this information available to the public on a continuous basis during normal trading hours.

We have significant reservations regarding the drafting of this article. Firstly, we question whether it is appropriate to deal with such a breadth of instruments in a single article. More importantly, we believe that the references to 'continuous' quoting and 'public prices' presuppose a specific execution method, i.e. trading in a central limit order book environment, which is appropriate only for a deeply liquid market with a high number of participants and simultaneously available matching trading interests.

Seeking to impose such a model of transparency on the non-continuous trading that characterizes large segments of the OTC derivatives markets could undermine liquidity in the market by potentially revealing participants' trading interests, encouraging others to trade against them. This could lead to a widening of spreads, i.e. poorer pricing for clients. This is particularly problematic in OTC derivatives markets, where dealers tend to hedge the risk associated with a trade with a client over an extended period of time.⁹

Transparency can reduce liquidity

The drafting of Article 7 is also at odds with the assertion of recital 14 of MiFIR that pre- and post-trade transparency requirements should be calibrated for different types of trading:

Pre-trade transparency should be calibrated by trading model

The transparency requirements should be calibrated for different types of instruments, including equity, bonds, and derivatives, and for different types of trading, including order-book and quote-driven systems as well as hybrid and voice broking systems, and take account of issuance, transaction size and characteristics of national markets.

⁹ See http://www.newyorkfed.org/research/staff_reports/sr517.pdf.

This would suggest that regulators would have to rely heavily on the powers under Article 8 that enable them to grant a waiver from the pre-trade transparency obligation under Article 7 based on “the market model, the specific characteristics of trading activity in a product and the liquidity...”

The pre-trade transparency obligation can be waived

While we fully support the idea that regulators should have the power to waive pre-trade transparency requirements where appropriate, we likewise believe that the pre-trade transparency obligation itself should be amended to recognise trading models beyond the central order book model. This would reduce reliance on waivers, whilst furthering the policy objective of promoting pre-trade transparency. In terms of specific changes to the text, we would highlight the following possibilities:

The pre-trade transparency obligation should be amended

1. Article 7 could be redrafted, removing the references to ‘depth of trading interests’ and ‘on a continuous basis’ or qualifying both by inserting the phrase ‘where appropriate’. This would enable an OTF operator to determine the appropriate pre-trade information to be made available to clients, based on the needs of those clients.
2. Article 7 could be replaced by a mandate for the European Securities and Markets Authority (ESMA) to elaborate what information should be published on a pre-trade basis for particular trading models. While the Delegated Acts referred to under Article 8.4 would address the conditions under which pre-trade disclosure may be waived for particular market models, this would not address our fundamental concern regarding Article 7 as a starting point for the obligation.

Summary

- Pre-trade transparency should be calibrated by trading model
- Request for Quote trading systems should be adequately accommodated

3. Transparency for trading outside of regulated trading venues

While the discussion above has focused on regulated trading venues, the question of pre-trade transparency also arises in the context of the rules that apply to Systematic Internalisers (SIs). Under Article 17 of MiFIR, for **clearing eligible** OTC derivatives contracts SIs would be required to:

The SI rules are also relevant in the context of pre-trade transparency

- provide firm quotes when prompted for a quote by a client and when the SI agrees to quote;
- make all firm quotes available to all clients and available to the public below a certain size; and
- enter into transactions with any other client to whom the quote is made available below a certain size.

Scope

Article 13.1 defines the scope of the systematic internalisation rules for equities and related instruments, making clear that they apply in the case of **instruments for which the firm is a Systematic Internaliser**. On the other hand, Article 17.1, which sets out the systematic internalisation rules for non-equities products, does not make clear that the rules apply only in

The scope of the rules does is not consistent with the way the equities rules operate

the case of instruments for which a firm is an SI – in the case of derivatives it could be read to imply that the obligation covers all clearing eligible instruments that the SI deals in. Furthermore, the requirement for Systematic Internalisers to publish firm quotes in equities only applies to those shares, depositary receipts, exchange-traded funds, certificates, and other similar financial instruments admitted to trading on a regulated market or traded on an MTF or OTF for which the firm is an SI and ‘for which there is a liquid market’. We do not see a clear reason for the difference in approach between equities and non-equity markets.

Quote sharing

Repeating a point made earlier, we believe that the regime as drafted has the potential to decrease the attractiveness of providing market liquidity to the detriment of clients. In particular we would disagree with the requirement for SIs to publish transactable quotes provided to clients when the quoted size is at or below a size specific to the instrument (the threshold) in a manner which is easily accessible to other market participants on a reasonable commercial basis. If firms were compelled to quote the same price to all clients, they would quote based on the profile of the most risky client, and the risk of being asked to enter into numerous transactions. In other words, they would be forced to implement defensive pricing strategies to protect themselves, resulting in widening of spreads and poorer execution for clients.

The SI regime could undermine liquidity provision

The Commission’s objective is to “support market-wide price discovery and protect retail investors”. As highlighted earlier, we do not see any evidence of a market failure when it comes to pricing in OTC derivatives markets. However, we would be supportive of measures designed to reinforce the existing competitiveness of pricing, in particular an obligation for firms to have in place “non-discriminatory quoting policies”, setting out the criteria that inform the quotes firms provide. On the other hand, we believe that obliging SIs to provide any one client with access to the *same* quote as another client is not appropriate, given the range of factors – including counterparty risk – that legitimately influence pricing. Recital 17¹⁰ also overlooks these factors. As mentioned above, forcing firms to make the same price for all clients will lead to prices that do not reflect the risk of an individual transaction.

Competition can be supported through better targeted measures

The size thresholds mentioned under Article 17 also suggest that the Commission is seeking to differentiate between trades of a normal market size and orders that are large in scale. While this sort of differentiation is meaningful in the context of equities trading, it is important to note that OTC derivatives transactions are by their nature very large – the average interest rate swap size is currently \$100 million.

OTC derivatives transactions are by their nature large in size

We therefore support the idea that, rather than being forced to share quotes, firms should be required to establish non-discriminatory quoting policies based on criteria such as those in Article 16 of MiFIR, and others, including:

We would support rules on non-discriminatory quoting

- Counterparty credit risk
- Settlement risk/final settlement of the transaction
- Whether the transaction is clearable or not
- Size of the order
- Portfolio impacts (eg CVA)
- The channel through which a firm quotes (and related connectivity costs, brokerage etc)

¹⁰ “Systematic Internalisers may decide to give access to their quotes only to retail clients, only to professional clients, or to both. They should not be allowed to discriminate within those categories of clients.”

This would be in line with the reference under Article 17.2 to firms' 'commercial policy' regarding quoting and would also help to overcome the various operational challenges that would otherwise arise if SIs were required to communicate a particular quote to all clients, namely:

Quote sharing would be operationally problematic

- What mechanisms would enable firms to communicate to all clients that they are offering firm prices in a specific instrument? Is it expected that the quote sharing obligation would be triggered by a client request or is it presumed that quotes should effectively be streamed?
- What set of clients is the requirement intended to cover, given that a firm that is an SI could have operations covering diverse geographical areas and business segments.
- How long should "live" prices be advertised. This clearly needs to be considered in conjunction with what would be deemed a 'reasonable' amount of time that a client should hold a price, again different by instrument.
- By what mechanism would an SI communicate to its clients that a price is no longer live?

If SIs were forced to make a particular quote available to all clients, then resolving such challenges would undoubtedly serve to complicate the trading environment to the detriment of end users, also implying a system based on streamed prices, which may not be in line with what users of the system want.

Quote sharing could complicate the trading environment for clients

Summary

- The SI regime is inconsistent in respect of different asset classes
- The SI regime could undermine liquidity provision and the quote sharing obligation should be removed
- Effective price formation can be supported through better targeted measures, specifically a requirement that firms establish quoting policies

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Annex 1: OTC Derivatives Markets Statistics

- **5,500:** The average number of transactions in OTC interest rate products on any one day in all currencies
 - **\$100 million:** The average transaction size in interest rate swap markets
 - **30:** The average daily number of trades for the most frequently traded sovereign CDS contracts
 - **2:** The average daily number of trades for the most infrequently traded sovereign CDS contracts
 - **58%** of interest rate swap transactions are between a bank and its client
-