September 30th, 2021

ISDA response to ESMA consultation paper on the review of RTS 2 (non-equity transparency)

1. General comments:

ISDA welcomes the opportunity to provide feedback to ESMA's consultation paper on the review of RTS 2. In line with ISDA's mission to foster safe and efficient derivatives markets, ISDA's response will focus on aspects relevant from a derivatives perspective. As a result, ISDA is not responding to questions relating to RTS 1 (equity transparency).

Whilst ISDA members see the need for targeted amendments to the MiFIR transparency framework for derivatives, both in Level 1 and 2, we believe that the main obstacle to meaningful transparency relates to a few misconceptions with respect to transparency in derivatives markets. Our response should be read with these comments in mind:

- **"Regulatory equitisation"**: As outlined in our paper published in December 2020 [1], ISDA believes that it is counterproductive to assume that concepts from equity markets regulation should be used for the purpose of derivatives regulation. One simple example is the use of ISINs for the identification of derivatives. Another example is the meaning of liquidity in derivatives, which differs significantly from equity or bond markets, as there is neither a finite pool of liquidity nor a single 'issuer' of financial instruments in derivatives markets.
- **Non-equity instruments bucket is not granular enough**: With respect to the structure of MiFIR transparency requirements, i.e. equity vs non-equity instruments, we highlight that bond markets are different from derivatives markets, in terms of objectives, market structure and the above-mentioned notion of liquidity. Furthermore, the differentiation between exchange-traded derivatives (ETDs) and OTC derivatives is sometimes not granular enough. ISDA is of the view that within the 'non-equity' bucket, ESMA should recognise the structural differences between fixed income markets and derivatives markets.
- **The role of Systematic internalisers (SIs) in derivatives market**: As outlined in our paper on 'pre-trade transparency and Systematic internalisers regimes for OTC derivatives'[2], the role SIs in derivatives markets differs significantly from the role of SIs in equity (and bond) markets. In particular, unlike trading venues such as MTFs and OTFs, SIs interact with their own clients to agree bespoke OTC derivatives products on a principal-client basis. And SIs do not compete with Regulated Markets (i.e. historical

[1] https://www.isda.org/a/Q7fTE/MIFID-II-MIFIR-Review-Regulatory-Equitisation.pdf
[2] https://www.isda.org/a/h1MgE/ISDA-Paper-on-Pre-trade-Transparency-and-Systematic-Internalisers-Regime-for-OTC-Derivatives.pdf

exchanges), as bespoke OTC derivatives products traded for the purpose of hedging a client's exposure are different from fully standardised instruments offered by exchanges. Furthermore, the pricing of OTC derivatives largely depends on counterparty risk and contractual relationships with respect to clearing houses and collateral agreements.

ISDA members maintain the view that the review of MIFID 2/ MIFIR should lead to meaningful transparency and useful information provided to end-users on the dynamics in derivatives markets. We have noted the willingness of ESMA to call for simplification of the regime in various review reports. By simplification, however, ESMA means more alignment between the securities and derivatives regimes and between OTC products and exchanged-traded products. One example is the proposal made in certain review reports to 'merge' the 'Large-in-scale' (LIS) and the 'Size specific To the Instrument' (SSTI) thresholds to have only one applied to derivatives instruments.

ISDA members are very concerned that this approach, rather than simplifying MIFID 2/MIFIR, would disincentivise corporates, buy-side firms and generally all end-users of derivatives to appropriately hedge the risks that they are facing in the course of their business with tailored derivatives instruments in the EU.

For corporates in particular, transparency on large transactions or on transactions referring to an illiquid underlying can distort the price formation process to the detriment of the end-user. If the transaction is split up into smaller buckets (which is a common practice for larger and/or illiquid transactions), hedging transactions done at a later stage will become significantly more expensive. The reason for this is that it is unlikely that various corporates have the same hedging need at the same time. For this reason, notably in interest rate derivatives markets, end-users need to customise instruments. Pre-trade transparency then makes it easier to attribute multiple smaller transactions to the same end-user, potentially encouraging predatory behaviour to the detriment of end-users. As a result, prices increase, and it becomes more expensive for end users to manage risk. Both end-users of derivatives and financial institutions providing hedging solutions face undue risk as a result of pre-trade transparency in this context. As such, the suppression of the SSTI threshold would be detrimental to the EU markets and EU end-users of derivatives.

ISDA members note that one of the reasons for the success of central clearing of derivatives is that the level of standardisation required to make an instrument clearable does not prevent counterparties from customising a contract to match it with the hedging needs of the end-user. ISDA published a research paper in June 2020[3] that shows that the ability to customise cleared derivatives is a key element to the success of central clearing. The need for customisation expressed by end-users justifies a cautious approach to transparency.

With all these considerations in mind and with respect to RTS 2, ISDA members believe that it is fundamental - before amending the scope of the transparency regime or the calibration of the thresholds - to remedy the fundamental flaw of the regime which is the use of ISINs for derivatives products.

[3] https://www.isda.org/2020/07/08/interest-rate-swaps-cleared-and-customized/

ISDA (which represents sell- and buy-side firms, corporates, trading venue operators and data providers) continues to believe that the use of ISINs for derivatives undermines reference data and transparency information due to a) an exponentially increasing number of ISINs for derivatives, adding little value and b) the fact that heterogenous derivative contracts with significant differences may share the same ISIN code, while in other instances, homogenous contracts with similar features concluded on several days would be likely to receive different ISINs.

The inadequacy of pre-trade and post-trade transparency implemented through use of ISINs is illustrated by the fact that OTC derivatives with the same ISIN often have very different prices.

ISDA members urge ESMA to address this issue because the transparency regime applied to derivatives will not be meaningful, nor will it add any value for end-users and investors as long as ISINs are used for the identification of derivatives. A qualitative review of transparency and data quality issues should be at the heart of the review.

ISDA generally considers that without such fundamental remedy, any re-calibration of current thresholds or even regulatory reform leading to suppression of thresholds would not bring added value to the regime as it would remain of limited utility for end-users.

We also appreciate that ESMA is reviewing the existing calibration of the two existing thresholds and does not want to pre-empt future level 1 changes. However, ISDA members also note that ESMA is proposing, in review reports on MIFID 2/ MIFIR, to merge the LIS and SSTI thresholds, i.e. that only one threshold applies (which would represent a significant change to MIFID 2/MIFIR Level 1).

ISDA members believe these approaches are inconsistent. ISDA members are concerned about engaging in a long and costly recalibration of the existing thresholds if ESMA intends to completely remove one of them completely in the near future. We are concerned about the prospect of an initial operational change consisting in reviewing the current two thresholds being quickly followed by a second major operational change in the form of the potential suppression of one of these two thresholds.

ISDA members oppose a major overhaul of RTS 2 at this premature stage (the regime has only been applicable since January 2018 and the SI regime has only been in place since September 2020) and believe that the current waiver regime should be maintained.

2. Answers to specific questions:

Pre-Trade Transparency requirements for trading systems

Question 24: Do you agree with the proposed amendments above? If not, please do not reiterate the arguments made under the previous question asked for equity instruments and please rather explain why those amendments are not suitable for non-equity financial instruments.

ISDA does not agree with ESMA's suggestion to merge the relevant table 1 of Annex 1 of RTS 2 with respect to frequent batch auctions (FBAs).

Whilst ISDA refrains from commenting on bond related issues, ISDA would like to highlight that FBAs are not relevant in OTC derivatives markets and such inclusion would not facilitate the application of the table.

ISDA members also believe that the addition of the new definition for Hybrid trading systems as a "catch all" concept seems a little too restrictive and could be argued to be unnecessary given the last definition in the table of "trading systems not covered by the first 7 rows"

Format of the pre-trade transparency information

Question 25: Do you agree with the proposal to specify the fields to be populated for pre-trade transparency purposes? If not, please explain. In case you support the proposal, please comment on the fields proposed, in particular whether you would consider them necessary and/or whether additional information is required

ISDA agrees with ESMA's observation that the readability and usability of information provided under RTS 2 requires improvements. From a derivatives perspective, it is also worth reiterating that derivatives end-users rarely make use of pre-trade transparency information, as acknowledged in ESMA's MiFIR report on systematic internalisers in non-equity instruments of 16 July 2020. Furthermore, ISDA acknowledges ESMA's assessment, articulated in Paragraph 241, that certain fields such as 'Side' do not necessarily make sense from a derivatives perspective.

However, ISDA members are of the view that the main hurdle to meaningful transparency in derivatives markets is the use of ISINs as the instrument identification code for derivative products, as outlined in our general remarks.

LIS and SSTI thresholds in RTS 2 excluding commodity derivatives

Question 26: Please indicate, if applicable, which medium-term targeted improvements you would like to see to the threshold calibrations in RTS 2.

ISDA agrees that an overhaul of SSTI and LIS thresholds should not be pursued as this would front-run revision of MiFIR Level 1. Furthermore, reform of the waiver framework appears premature, considering the relatively recent implementation of MiFID II/MiFIR (with most provisions only applicable as of January 2018 and the SI regime only applicable since September 2020).

ISDA would suggest maintaining the current waiver framework, in particular with respect to different SSTI and LIS waivers. ISDA instead suggests a close collaboration between ESMA, NCAs and industry participants to focus on specific calibrations of thresholds per sub asset classes.

We note that, for trading with systematic internalisers, MiFIR Article 18 (10) limits the quote transparency requirement when dealing in sizes above SSTI, itself referring to MiFIR Article 9 (5) (d), to protect liquidity providers from undue risks.

ISDA members believe it is vital to maintain the SSTI waiver. MiFIR Level 1 embedded the principle that liquidity providers should be protected from undue risk, in order to support their ability to provide that liquidity. ESMA recognises the role of RFQ and voice trading systems and should calibrate the SSTI waiver level with that avoidance of undue risk in mind.

For ETDs, ISDA members agree that there may be some grounds for simplifying the waiver regime and reconsidering the SSTI thresholds. Some members note that for ETD commodity derivatives, the SSTI waiver is not used in practice. For these contracts, the deletion of this threshold could be considered if (at the same time) the LIS threshold is lowered. Members also observe that current LIS calculations lead to counterintuitive results in some cases e.g. very high LIS thresholds being applied to relatively illiquid instruments. Despite these counterintuitive results (which themselves impact liquidity), ISDA generally agrees with the current methodology for the determination of LIS thresholds.

ISDA opposes general deletion of the SSTI-waiver, but recognises that this could be considered for certain sub-asset classes, e.g., exchange traded commodity derivatives.

Amendments to Article 13 [Methodology to perform the transparency calculations]

Question 27: Do you agree with the proposed changes to Article 13? If not, please explain

ISDA members agree with the changes in relation to dates of application.

Other amendments to the main text of RTS 2

Article 4(2)(a) of RTS 2

Question 28: Do you agree with the proposed changes to Article 4? If not, please explain

In general, ISDA agrees that the definition of type and minimum size of orders held in an order management facility are still relevant [members to opine whether ESMA's suggested changes, i.e. moving Q&A into RTS 2]

Article 12 of RTS 2, non-price forming transactions

Question 29: Do you agree with the proposed changes to Article 12? If not, please explain. Please do not reiterate the general comments made in the equity section and try to focus on arguments that are specific to non-equity financial instruments.

ISDA members see merits in ESMA's attempt to streamline cross referencing and remove duplicate references. We would like to stress the following comments on the detailed suggestions proposed in this respect:

- regarding asset management companies, we support ESMA's suggestion that asset management companies are not investment firms and thus are technically not in scope of the rules.
- regarding give ups and give ins, which we understand that ESMA considers them covered under the settlement and clearing limb of RTS 22 Art (2)(5)(b), we consider that this provision is mostly relevant in equity markets but not necessarily in derivatives markets.
- regarding collateral transfers, we understand that ESMA consider them as covered under the settlement and clearing limb of RTS 22 Art (2)(5)(b). We consider that collateral transfers are actually covered under RTS22 Art (2)(5)(o): "*the acquisition or disposal that is solely a result of a transfer of collateral*".

Commodity derivatives, emission allowances and derivatives on emission allowances

Question 30: Please provide your comments on the analysis and proposals related to the liquidity framework applicable to commodity derivatives, EA and DEA detailed in Section 4.2 and summarised in Section 4.2.5. Please list the proposals with their ID (#1 to #9) for ease of reference.

Proposal Commodity Derivatives 1: [Metals] Determine that all metal sub-asset classes do not have a liquid market

ISDA agrees with ESMA's assessment that metal derivatives should be deemed illiquid following Brexit.

Proposal Commodity Derivatives 2: [ADNT] Maintain the criterion "average daily number of trades" (do not switch to "median daily number of trades")

Proposal Commodity Derivatives 3: [ADNT] Increase the parameter of the ADNT to 50 trades per day for all commodity, C10, EA and DEA sub-classes.

Proposal Commodity Derivatives 4: [ADNA] Replace the criterion "average daily notional amount" with the criterion "standard trade size" calculated as the most frequently traded size (mode) and set the parameter of the STS_mode at 5 lots for futures: any class for which the most frequently traded size is lower than or equal to 5 lots would be deemed liquid (provided the other quantitative liquidity criterion is also fulfilled).

Proposal Commodity Derivatives 5: [ADNA] Set the same parameter of the STS_mode for all contract types, including options (5 lots)

Proposal Commodity Derivatives 6: [LIS/SSTI] LIS and SSTI thresholds are equal to a set percentage of the average daily volumes (in lots), rounded to the nearest 5 lots and bounded by a floor and a cap.

Proposal Commodity Derivatives 7: [Units or Lots] Set the liquidity framework in lots (STS_mode parameter set in lots, volumes reported to ESMA in lots, LIS and SSTI thresholds published in lots) accompanied by Level 3 measures to address the risk of downward revisions of the lot sizes

Some members note that for exchange traded commodity derivatives, the SSTI waiver is not used in practice and that for these contracts the deletion of this threshold could be considered if (at the same time) the LIS threshold is lowered. We observe that work is needed to revise the LIS calculation to remove factors leading to counterintuitive results, in particular relatively high LIS thresholds being applied to illiquid instruments.

Proposal Commodity Derivatives 8: [Reporting to FITRS] number of transactions shall be reported to FITRS per trade-size bins which are defined in the new Annex V of RTS 2. Total volumes in lots and total volumes in underlying units shall also be reported to FITRS as specified in the new Annex V of RTS 2.

Proposal Commodity Derivatives 9: [data scope] The transparency calculations continue to be performed with all data (on-venue, SI and OTC)

Reporting fields (Tables 1, 2 and 4 of Annex II, Annex III and Tables 1 and 2 of Annex IV)

Question 31: Do you agree with the changes proposed to Table 2 of Annex II of RTS 2 (List of details for the purpose of post-trade transparency) presented above? If not, please explain and provide any alternative proposal you might have. Are there other issues to be addressed and how?

Further to our response to Question 25, ISDA agrees with ESMA regarding the deficit of guidance to market participants on reporting prices and specific trade events for each asset class, leading to inconsistent reporting through use of 'free text fields'.

ISDA strongly believes that the use of ISINs for derivatives is leading to a pollution of reference data and transparency information due to a) an exponentially increasing number of ISINs for derivatives, adding little value and b) the fact that heterogenous derivative contracts with significant differences may share the same ISIN code, while in other instances, homogenous contracts with similar features concluded on several days would be likely to receive different ISINs.

The problems associated with pre-trade and post-trade transparency implemented through use of ISINs is illustrated by the fact that OTC derivatives with the same ISIN often have very different prices

A further difficulty is caused in respect of the identification of underliers, particularly in respect of indices. As ESMA notes in section 4.3.1.4, data quality has not been good in the reporting of underlying index names, including the use of invalid ISIN codes. It appears to ISDA members that the mandate to use only ISIN as a financial instrument identifier for underliers is problematic (including problems with general lack of valid ISIN coverage). ESMA should work with the industry to explore alternative methods of identifying such underliers in an unambiguous way, to reduce confusion and improve data quality.

Measure of volume (Table 4 of Annex II)

Question 32: Do you agree with the changes proposed to Table 4 of Annex II of RTS 2 (Measure of volume) presented above? Do you think that it now provides more clarity? If not, please explain and provide any alternative proposal you might have

ISDA members agree with the suggested changes.

Reference data to be provided for the purpose of the segmentation criteria necessary for the performance of the transparency calculations (Reporting to FITRS)

Question 33: Do you agree with ESMA's proposals on Table 1 (Symbol) and Table 2 of Annex IV of RTS 2? If not, please explain and provide any alternative proposal you might have

Question 34: Do you agree with ESMA's proposals on the segmentation criteria for bonds (Table 2.2), securitised derivatives (Table 4.1), interest rate derivatives (Table 5.1), equity derivatives (Table 6.1), credit derivatives (Table 9.2 and 9.3) and emission allowances (Table 12.1) of Annex III of RTS 2? If not, please explain and provide any alternative proposal you might have.

Please refer to our response to Question 31, with respect to ISINs.

Question 35: Please provide your comments in relation to the proposals related to the segmentation criteria applicable to commodity derivatives summarised in Table 11. Please list the proposals with their ID for ease of reference. Do you have other proposals related to the segmentation criteria applicable to commodity derivatives and C10 derivatives?

Generally, ISDA members have experienced issues with the 'free text' field, with no standard being followed for the &DCSL field segmentation criteria used in the Cofia class for Energy Commodity derivatives. ISDA recommends that ESMA follow market naming conventions and provide a list of allowed values.

Quantitative data to be provided for the purpose of transparency calculations (Reporting to FITRS)

Question 36: Do you agree with ESMA's proposal on the new Table of Annex V of RTS 2 (Details of the data to be provided for the purpose of determining a liquid market, the LIS and SSTI thresholds for non-equity financial instruments)? If not, please explain and provide any alternative proposal you might have.

Flags (Table 3 of Annex II of RTS 2)

Question 37: Do you agree with ESMA's proposal to delete the ACTX flag? Please explain

ISDA agrees with ESMA's analysis and supports the deletion of the ACTX flag, given the irrelevance for OTC derivatives markets.

Question 38: Do you agree with ESMA's proposal to merge the current non-equity deferral flags into one general flag?

ISDA members do not see the need to merge the flags into one, especially when the deferral flags may change, and do not see the benefits of such change.

ISDA would like to take the opportunity to reiterate its view that post-trade deferrals should be harmonized across the European Union. A harmonised deferral regime must be appropriately calibrated and continue to ensure market participants are not exposed to undue risk. A consultation on deferrals per asset class would be required. The deferral period for volume information should be a period of at least four weeks, as chosen by France and Germany.

Question 39: Do you agree with ESMA's proposal not to change the existing flags regarding non-price forming transactions in non-equity financial instruments? If not, please explain.

ISDA does not object with ESMA's proposal not to change the existing flags regarding non-price forming transactions but notes that they are not relevant for investment firms.

Question 40: Do stakeholders agree with ESMA's proposal to introduce a general waiver flag for non-equity transactions benefitting from a waiver? For LIS, should it be limited to completely filled LIS orders?

ISDA members do not object with ESMA's proposal to introduce a general waiver flag for non-equity transactions benefitting from a waiver but note that such a flag is not relevant for investment firms.

Question 41: Do you agree with ESMA's proposal to introduce a flag for prearranged non-equity transactions?

ISDA members do not see what added value such flag would bring to end-users.

Implementation and timing issues (RTS1 & RTS2)

Question 42: Do you agree with the proposal on the delayed implementation of certain provisions of the amended RTS 1 & 2? Do you have proposals to minimise the delay?

ISDA believes that ESMA's suggested delayed implementation is sensible as it gives regulators and market participants the time needed to fine-tune implementation. Otherwise, inconsistent implementation and low data quality could seriously hamper the quality and meaningfulness of MiFIR transparency.