ISDA® Safe, Efficient Markets

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Review of MiFID II/ MIFIR Framework
'Regulatory Equitisation' would be detrimental to the functioning of derivatives markets

With the review of the MiFID II/ MiFIR framework, ISDA notes that policy makers and supervisors are particularly concerned by the lack of **accessibility and readability of market data** and by a perceived unlevel playing field between on- and off-venue trading execution (i.e. between multilateral trading venue operators and Investment Firms operating as Systematic Internalisers/ SIs). One view often offered is that the means to achieving consistency in the data submitted by Trading Venues and Investment Firms is alignment of the bond and derivatives to the equity pre- and post-trade transparency regimes. This push toward alignment of regimes is also known as "**Equitisation**".

A key objective of MiFID was the organisation of competition between execution venues in equity markets. Because there are multiple sources of liquidity in equity markets, competition between national Exchanges, the historical trading venues where issuers were listed in the first place, other trading venues (MTFs) or off-venue trading (SIs) have legitimately triggered discussions on access to comprehensive and accurate market data, on the feasibility of a consolidated tape, and around the degree of transparency of off-venue trading.

MiFID was designed in 2004 (and applied from November 2007 to January 2018) to address these issues and MiFID II (applicable since January 2018) added more granularity to the existing framework with the introduction of the OTF category for non-equity instruments.

ISDA does not intend to comment on the appropriate levels of transparency and on market data costs in equity markets or fixed income markets. However, **we note with concern that concepts originally designed for equity markets might be applied to derivatives without adequate consideration of the characteristics of derivatives markets.** This regulatory 'Equitisation' of derivatives business raises many questions as some key concepts at the heart of equity markets are not appropriate for derivatives markets. The predominant risk is that the transparency framework that is under review would not take into account the specifics of derivatives instruments and market structure and would adversely affect both liquidity provision and the efficient functioning of these markets.

The regulatory reforms engaged in derivatives markets after the G20 commitments have led to more standardisation, notably post-trade processes enabling netting of contracts and compression of risks, including through central clearing. However, unlike equities, derivatives other than Exchange Traded Derivatives (ETDs) are not mutually interchangeable.

Most importantly, in equity markets, the use of multiple facilities (multilateral or bilateral) for the trading of a finite pool of shares issued by one single corporation is intrinsically generating a split in liquidity. This is not the case in derivatives markets for the simple reason that ETDs are not traded OTC and that in derivatives other than ETDs there is no 'finite pool of liquidity'.

We would therefore like to re-emphasise some of the key differences between equity markets and derivatives markets and to explain how and where 'Equitisation' of regulation of derivatives markets would lead to negative consequences for users of derivatives and for market efficiency more broadly.

1. The derivatives and equities market structures differ by nature

There are three key differences between equity markets and derivatives markets:
- The nature of the instruments traded
- The nature of the liquidity
- The market structures used for trading

1.1. The nature of the instruments traded

Equities (Shares), as funding instruments for corporates, are fungible:
- the same share issued by a single company can be executed either on an exchange, on an MTF, on an SI or purely OTC / off-venue;
- the share represents the value of the issuer and the investor owns a part of the listed company: he is a shareholder.

Transactions in equities are short dated, with settlement typically within 2 days through a Central Securities Depository.

Split of Equity liquidity can occur as a consequence of choice between different venues and justifies the existence of comparable obligations for different execution venues which provide similar services.

The SI regime established by MiFID I in 2007 was introduced to ensure that a level playing field exists between on-and off-venue trading execution of listed shares. The regulatory tool to assure a level playing field is market transparency (pre- and post-trade transparency). **Transparency is important for the functioning of the cash equity markets for three reasons**[1]:
- The constant **flow of buying and selling orders**, which contribute to the **price discovery**;
- The presence of many **different categories of investors** including retail investors who seek capital gain and therefore the best price when buying or selling;
- The co-existence of **multiple trading venues and off-venue trading**, for the execution of shares issued by a single identified issuer listed on an Exchange, which results in diverse sources of liquidity and competition in the trading of the same instrument.

Derivatives, as hedging or exposure instruments, have no issuer and are generally not fungible[2]. The fundamental differences between equities and derivatives are twofold:
- **The concept of 'Issuer' seeking long-term funding through capital does not exist in derivatives**. A derivative is a bilateral contract between parties whose value is based on an agreed-upon price of underlying assets (currencies, interest rates, equities, commodities, credit). The fact that certain CDSs or Equity derivatives can be physically settled (i.e. delivery of the underlying bonds for a CDS, delivery of the underlying shares for equity derivatives) is not the result of any action from the issuer of the underlying securities to seek additional funding.
- Even standardized derivatives subject to central clearing are highly customisable.[3] For instance, using data from DTCC, ISDA identified 55 different reference rates for cleared fixed-to-floating IRS transactions in 2019 and 497 different tenors, with ranged from less than 3 months to over 40 years. The tenor is an important specific feature of derivatives contracts.

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[1] Exceptions to pre-trade transparency have always been available, for instance for block trades.

[2] At trading level, derivatives other than ETDs remain not mutually interchangeable as securities are. Post-trade processes for derivatives are capable of achieving netting of contracts and compression of risk, including through central clearing, which can serve to achieve comparable effects. However, unlike with equities, these effects are not intrinsic to the instrument, and can only be achieved for a limited universe of highly liquid derivatives and/or with the engagement of a 3rd party vendor offering portfolio compression services

[3] See ISDA paper from July 2020 on IRS-Cleared-and-Customized.pdf

1.2. The nature of the liquidity

The nature of "liquidity" in OTC derivatives markets is different from equity markets.

- The fact that similar derivatives contracts are traded through different trading protocols, on- or off-venue, does not mean that there is a fragmentation or split in liquidity for the simple reason that **the liquidity does not depend upon the availability of a finite pool of securities issued by a single company**.
- Credit institutions/ Investment Firms can offer **derivatives on the same underlying asset without any limitation and under different contractual conditions** (settlement, maturity …).
- As bilateral derivatives contracts entailing mutual obligations, often running over long periods, result from transactions, a key factor in sourcing liquidity is the bilateral contractual trading relationships in place between parties (for instance under ISDA documentation) and which apply whether a transaction is entered into on or off venue.

In derivatives, the liquidity depends upon the ability of market makers to offer hedges at any time whereas in equity markets it very much depends on the continuous flow of buying and selling orders from investors.

1.3. The difference in market structures

For equities, the co-existence of SIs and TVs as eligible venues under the Share Trading Obligation has necessitated the application of aligned transparency rules, which are nonetheless tailored to reflect the distinct role of the different execution venues.

For derivatives, the dynamics between TVs and SIs are different.

- Market-makers and liquidity providers are always the source of liquidity in derivatives available to trade on venue, as well as for liquidity off-venue.
- Many bespoke instruments are, by nature, executed exclusively off-venue and, by nature again, are not available on TVs.
- In terms of transparency, for instruments that are traded on a trading venue (TOTV):
    - post-trade transparency obligations apply to all Trading Venues (TV) and all Investment Firms, not just those acting as SI.
    - pre-trade transparency requirements also apply to TVs and SIs, but for derivatives is generally less used by clients, mainly because of the specific trading protocols, RFQ & voice trading, and other characteristics of the market (bespoke nature of instruments, pricing taking into account counterparty profile / risk, RFQ trading protocols including streaming of indicative or firm prices…). In other words, clients have access to pre-trade information even if there is no public pre-trade transparency.
- In derivatives markets, the Derivatives Trading Obligations (DTO) is not linked to SI, and can only be satisfied on a RM, MTF or OTF, and hence there is no necessity to apply related obligations in DTO instruments to SI.

In derivatives markets, concerns about a level playing field or comparison between Trading Venues and Investment Firms / SIs are generally not relevant because the role of SIs as part of the broader market structure differs from cash equities. In derivatives markets, trading venues are market operators whereas SIs are market participants.

It is important to emphasise the key role of liquidity providers such as SIs in derivatives markets. As noted above, derivatives transactions result in bilateral contracts (including, for cleared products, with a CCP) which can be long dated. In order for derivatives markets to operate, market participants must stand willing to act as market makers, and in doing so commit their balance sheet to offer liquidity. In so doing, market makers are exposed to market / hedging risk, whether trading on- or off-venue. Trading venues are not exposed to these risks. Hence it is vital that market makers (whether or not operating as an SI) are not subjected to requirements that would expose them to undue risk.

ISDA recognises the need to bring more transparency to on- and off-venue trading execution but is calling for a specific transparency regime for derivatives, instead of "Equitisation".

2. The different purposes of transparency for equity and in derivatives markets

The table below summarises the concepts discussed in this section.

	Equity	**Exchange traded derivatives**	**OTC derivatives**
Standardisation	Standardised	Standardised	Customised / bespoke
Fungibility	Fungible	Fungible	Not fungible
Liquidity	Liquid	Liquid	Less liquid
Counterparty credit risk	No (on Exchange)	No (on Exchange)	Yes, although the most liquid IRS & Index CDS instruments are centrally cleared[4]
Trading systems / protocols	Order book, RFQ & Voice	Order book & Voice	Mostly RFQ & Voice, limited order book
Pre-Trade Transparency	Price formation via visibility on orders	Price formation via visibility on orders	Limited
Transparency allowing comparison	Yes because multiple trades on same instrument	Yes because multiple trades on same instrument	Limited because infinite number of custom instruments with specific pricing depending on counterparty risk
Other sources of price information	-	-	Indicative or firms streamed prices, RFQs themselves, to multiple liquidity providers

Pre-trade transparency and price formation for liquid and fungible instruments

The purpose of pre-trade transparency is to give investors access to information on current orders and executable quotes before the trade is executed, in order to aid with price formation and help investment firms/ banks to provide best execution. This is an important concept for fungible instruments traded on pre-trade transparent venues.

End-users of OTC derivatives are not asking for public pre-trade transparency because they are getting pre-trade information through other channels

The MiFIR transparency regime for derivatives takes the equity model as a conceptual basis and is not adapted to the variety of derivative contracts and the bespoke intrinsic nature of OTC derivatives:

- Pre-trade transparency on derivatives is different in nature because **a majority of derivatives markets do not operate with direct interaction between buying and selling orders**;
- **Most OTC derivatives instruments are bespoke**. The fact that derivative contracts with significant differences may share the same ISIN code, while contracts with similar ISIN concluded over several days are not linked, is a strong evidence of this problem[5]. The price of a derivative

[4] Central clearing does not remove counterparty credit risk, but transfers the exposure from multiple counterparties to a single relationship with the CCP or Clearing Member, which must still be risk managed for the life of the contract. BIS statistics show that, at the end of 2019, 77% of IRS and 56% of CDS are centrally cleared.

[5] Some attributes that are price forming are not included in ISINs for certain OTC derivatives instruments, leading to the same ISIN being used for different instruments. For example, 'Effective Date' is not a required attribute for an Interest Rate Swap. Therefore a 5 year swap traded today will have the same ISIN as a 1 year forward starting 4 year swap also traded today with the same attributes; these are different instruments and therefore priced differently despite having the same ISIN.

contract is determined by the components of the derivative on a more granular basis than the ISIN-basis and by the credit quality of the counterparty. The instrument identification system is in itself preventing appropriate transparency. Therefore, pre-trade transparency on OTC derivatives does not always bring relevant information to the market as even for OTC derivatives with the same ISIN, prices are non-comparable.

MiFIR Pre-Trade Transparency

MIFIR has introduced a harmonised pre-trade transparency regime for certain financial instruments traded on a trading venue, including derivatives. According to MIFIR article 8, trading venues should publish information about current bid and offer prices and the depth of trading interest at those prices advertised through their systems.

Article 9 of MIFIR allows certain exemptions from the publication of pre-trade transparency data to preserve an orderly price discovery process and to allow nascent and niche markets to develop.

These exemptions are implemented through pre-trade transparency waivers for:
1. orders above a certain volume threshold (the large-in–scale (LIS) waiver);
2. indications of interest in request-for-quote (RFQ) and voice trading systems above a size specific to the instrument (SSTI);
3. derivatives not subject to the trading obligation and instruments classified as illiquid, regardless of their volumes (illiquid instrument (IL) waiver).

The MiFID 2 / MiFIR framework has led to a significant amount of data being made available to the market and to trading counterparties. However, **for OTC derivatives, the data does not always provide meaningful transparency or add benefits to end-users that justify the complexity and associated costs.**
- Pre-trade and post-trade information is fragmented and reported by APAs and venues in a non-standardised format.
- It is extremely difficult for market participants to access the information reported; the standards and their deployment are sometimes unclear, e.g. reference data taxonomy, ISIN, etc.

The appropriate response is not the alignment between equity and derivatives markets transparency but, on the contrary, the recognition of the specifics of derivatives markets and therefore the need for **a specific transparency regime. Importantly, clients are using other sources of price information than MiFIR pre-trade transparency for OTC derivatives: for instance indicative or firm streamed prices, or simply by raising RFQs to multiple liquidity providers.**

3. The "Equitisation" of the transparency framework for derivatives, via the suppression of the protections for liquidity providers is a hazardous exercise for market liquidity

The table below summarises the concepts discussed in this section.

	Equity	OTC Derivatives
Trading systems / protocols	Order books & voice	RFQ & voice, limited order book
Market liquidity sources	Predominantly meeting of opposite buy and sell interests, with liquidity	Liquidity providers, taking positions and committing their balance sheet

	providers also taking positions and committing their balance sheet	
Protection from real-time transparency	Not needed	Yes, protecting liquidity providers from undue risk, to give their time to hedge positions

Simplification via reduction of deferral length and suppression of thresholds can be hazardous.
Supervisors have expressed strong views about the need to simplify the transparency regime (for instance through the reduction or suppression of post-trade transparency deferrals, or removal of certain pre-trade transparency waivers).

Clear distinction must be made between central order books and RFQ/ voice trading
A clear distinction should be made between the trading protocols used on equity venues (predominantly central order books) and derivatives markets (for OTC derivatives, predominantly RFQ and voice trading systems), irrespective of whether the trading is on-or off-venue.

It is critical to protect liquidity providers from undue risk to guarantee access to liquidity for clients
The SSTI waiver was created under MiFIR to protect liquidity providers from undue risk and to guarantee the provision of and access to liquidity. This is primarily to give time to liquidity providers to hedge their risk/ positions resulting from trading with investors and clients. Moreover, the credit risk profile or the counterparty risk profile associated with a client can expose a derivative dealer to risk. This risk would occur if the data were made public and all market participants, including clients/ end-users, recognise the importance of the SSTI waiver and do not ask for its removal.

MiFIR recognises the role of RFQ and voice trading systems in derivatives markets and defines the SSTI waiver to protect liquidity providers from undue risks. Similarly, for trading with SIs, 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.

“Equitisation” of derivatives would negatively affect market liquidity
“Equitisation” would adversely affect provision of liquidity and the prices offered by liquidity providers (increased price of risk) in derivatives markets, which may force end-users to not use derivatives to hedge their risks and to internalise risk management, which is not sound from a stability perspective.