ISDA Safe, Efficient Markets

13 January 2012

Review of the Markets in Financial Instruments Directive
Questionnaire on MiFID/MiFIR 2 by Markus Ferber MEP

<u>Response of the International Swaps and Derivatives Association (ISDA)</u>

By email to <u>econ-secretariat@europarl.europa.eu</u>

ISDA appreciates the opportunity to respond to this questionnaire on the MiFID review. We have limited ourselves to commenting on those issues that are directly relevant to OTC derivative markets.

1. Are the exemptions proposed in Directive Articles 2 and 3 appropriate? Are there ways in which more could be done to exempt corporate end users?

The main issue in this area is not the application of conduct of business rules but the capital requirements.

We believe that it would not be appropriate to apply to commodity derivatives firms the same capital requirement rules that apply to investment firms. There is a clear need to consider the capital treatment of commodities firms in tandem with legislation under review (MiFID, EMIR, REMIT, MAD, CRD IV).

In this context, the CRD exemption for specialised commodity derivatives trading firms should be kept until the CRD review is completed and the key parameters of a prudential regime to cover commodity derivatives firms have been established.

2. Is it appropriate to include emission allowances and structured deposits and have they been included in an appropriate way?

Regarding emission allowances, ISDA is aware that the application of market abuse regulation to carbon markets is important, but remains doubtful about whether or not emission allowances, given their nature, should be treated as financial instruments. We do, however, believe that non-financial firms who are compliance buyers in the carbon markets (this concerns not only energy producers or utilities but also energy users, such as airlines or aluminium and steel industry participants) should be exempt from the MiFID requirements and the article 2 exemption should clarify this point.

Regarding structured deposits, ISDA generally supports the level playing field for regulation applied to retail investment products, regardless of the legal envelope of these products (deposit, financial instrument or insurance contract).

ISDA supports the extension of the scope of MiFID to structured deposits in the case of provision of advice on and the sale of structured deposits, given that these are used to produce investor returns that can be similar to other categories of structured products and they can be used for similar purposes. The approach taken in MiFID to other categories of retail structured products should also be consistent with that taken in the context of the future PRIPs proposal.

Regarding the definition of structured deposits, ISDA suggests the following language, proposed by the Joint Associations Committee on Retail Structured Products in the context of the PRIPs review:

> "*a deposit paid on terms under which any interest or premium will be paid, or is at risk, according to a formula which involves the performance of:*
>
> *(i) an index or combination of indices (other than (i) money market indices or (ii) interest rate indices)*

(ii) *a financial instrument or combination of financial instruments (other than (i) money market instruments, (ii) debt securities issued by a government or central bank or (iii) interest rate derivatives)*

or

(iii) *a commodity (or combination of commodities)*".

4. Is it appropriate to regulate third country access to EU markets and, if so, what principles should be followed and what precedents should inform the approach and why?

We believe that it is appropriate to regulate third country access to EU markets. The approach to regulating EU markets should be underpinned by the following principles:

- Market participants should have ex ante clarity as to the regulation to which they are subject.
- The assessment of whether the regulatory regime of a third country is equivalent should not be based on the extent of reciprocal market access and should respect WTO obligations.
- No two regulatory regimes are identical in all respects. Therefore equivalence should be defined in terms of intent rather than in terms of specific rules.
- There should be an appropriate degree of consistency in respect of third country issues across different pieces of European financial services legislation.

Specifically on MiFID, we would also highlight that:

- The proposal does not address how professional clients will be treated. Article 36 of MiFIR should be extended to include ‘per se’ professional clients so that third countries may also provide services to professional clients within the EU without setting up a branch, providing they meet the registration criteria. Per se professional clients are sophisticated investors and given that third country firms will be subject to 'equivalent' MiFID type requirements under their home country, it should not be necessary for a firm to also establish a branch in the EU for dealing with them[1].
- Provision should be made for grandfathering arrangements for third country firms that have established authorised branches in the EU already.
- Existing national regimes should be permitted to continue until an equivalence decision has been made for any particular country. Given the complexity of making such an assessment and the number of assessments required, the proposed four year transitional period may be insufficient.
- We welcome the fact that Article 36.4 provides an exemption for 'reverse enquiry' whereby provision of services by a third country firm is initiated by the clients; however, this exemption should be extended to professional clients and there should be further detail prescribing under what conditions firms can rely on this exemption (e.g. use of websites) to ensure a common understanding. The reverse enquiry exemption is valuable and useful for sophisticated investors, but firms require greater regulatory certainty than they have today with regard to when they can rely on this.

6. Is the Organised Trading Facility category appropriately defined and differentiated from other trading venues and from systematic internalisers in the proposal? If not, what changes are needed and why?

We believe that the requirements associated with Organised Trading Facilities could be helpfully amended to ensure that they are suited to OTC derivative and other non-equity markets. In particular, given the introduction of a trading obligation in respect of clearing eligible and sufficiently liquid derivatives, it will be vital that there is a suitable range of venues on which to execute OTC derivatives transactions, including

[1] This approach is foreseen in the European Commission’s FAQ on MiFID II under question 24: “*A firm which is authorised in a third country will be able to provide services directly to professional investors on condition that the country where it is based is deemed by the Commission to have equivalent rules and supervision*”.

voice-brokered facilities. OTFs should not have to conform to a central limit order book model – other trading models, including Request-for-Quote systems, should also be accommodated.[2] We comment further on this in the context of pre-trade transparency requirements for non-equity instruments traded on venues.

As for the structure of the OTF regime, we believe that the proposed ban on an OTF operator executing client orders against his own proprietary capital overlooks the vital role that investment firms' risk capital plays in facilitating client business and thus enhancing liquidity, particularly for OTC derivatives, given the infrequency of trading, relatively small number of market participants, and need for customised solutions to meet specific corporate needs.

Such a move would reduce the level of liquidity clients see in an OTF, as the operator of the OTF is unable to make use of its own, facilitating capital, to bridge the gap between client demand. For example, at one particular time, there may be a temporary disconnect between what clients wish to sell and what they wish to buy. At times like this, the firm who operates the OTF may wish to deploy its capital to facilitate the business of the clients of the OTF. If firms' ability to make use of their own capital in such circumstances is removed, clients' ability to trade large sizes quickly, at a low cost, when they want, will be diminished

Also, even where an investment firm hedges the risk it is exposed to following a transaction with a client (through offsetting trades with other clients), it will typically do so over an extended period of time.[3]

The proposed ban will have the impact of restricting the range of available venues for trading in OTC derivatives subject to the trading obligation, notably limiting the role played by single dealer platforms (SDPs). This is further reinforced by language under Art 2.1 referring to OTFs as bringing together "multiple third-party buying and selling interests". This would mean that platforms that currently account for a significant amount of electronic trading in interest rate swaps (c. 40%) would be ineligible for satisfying the trading obligation. The impact of such a change was not adequately addressed in the European Commission's impact assessment and would need to be assessed more thoroughly to ascertain that such a change would not be damaging for European capital markets. This reflects the fact that these platforms have a very high degree of automation and a very high degree of customer contract specification, thereby allowing a much broader suite of products to be traded electronically and offered to a very wide range of participants.

Removing the restriction on an OTF operator executing client orders against his propriety capital would encourage more investment firms to establish OTFs, which would encourage innovation and increase competition for client business. A more vibrant trading platform landscape would also help Europe to deliver on the G20 commitment to move to exchange and electronic trading of standardised derivatives.

As an association representing sell-side, buy-side and end users, it is therefore not clear to us that any category of client would benefit from such a prohibition. That said, we strongly support appropriately robust best execution and client order handling rules for OTF operators, and believe that these should address the Commission's concerns around conflicts of interest that are behind the ban.

As for the boundary between OTFs and the 'systematic internaliser' regime, the proposal envisages that contracts available on OTFs, MTFs or regulated markets might be traded with a systematic internaliser (notably by describing associated transparency requirements). We understand that this might relate to the trading activities of non-financial counterparties who are not subject to the trading obligation, but we would welcome greater clarity regarding this point.

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[2] The Bank of England paper 'Trading models and liquidity provision in OTC derivatives markets' provides a summary of the key features of order book and quote-driven trading systems for derivatives and their relative benefits: http://www.bankofengland.co.uk/publications/quarterlybulletin/qb110404.pdf

[3] http://isda.derivativiews.org/2011/10/07/the-new-york-fed-report-part-ii-hedging-and-market-making/

Continuing on the issue of SIs, we also believe that the definition of systematic internalisation for fixed income and derivatives should be aligned with that of equities - ensuring that the SI classification applies by class or sub-class of financial instrument, not at the level of legal entity – a firm might be an SI for one or more instrument, but that should not mean that it must act as an SI for all instruments that are not traded on a frequent and regular basis.

7. How should OTC trading be defined? Will the proposals, including the new OTF category, lead to the channelling of trades which are currently OTC onto organised venues and, if so, which type of venue?

OTC trading should continue to be defined as trading outside regulated markets, as currently defined in MiFID. Therefore off-exchange trading should still be considered OTC. However, as highlighted in our response to question 6, we believe that a less narrow OTF regime would help encourage the channelling of OTC derivatives onto organised venues. Whether in practice contracts are executed on OTFs or MTFs will depend on the style of execution, e.g. voice-brokered, electronic, or Request-For-Quote systems. While we understand that some have questioned the appropriateness of the new OTF category, we don't see any material difference between OTFs and MTFs in terms of the level of regulation to which they are subject – the distinctions that exist relate to style of execution, not the level of regulation.

As for trading that occurs off organised venues, we would welcome greater clarity in respect of the boundary between SIs and 'pure OTC' business, the latter being limited to transactions that occur on an "occasional, ad hoc and irregular basis". The problem lies in the potential gap between the "organised, frequent and systematic" trading that characterises the SI regime and the "occasional, ad hoc and irregular" trading that will be viewed as pure OTC. We also note that the description in recital 18 (*"ad hoc and irregular and are carried out with wholesale counterparties and are part of a business relationship which is itself characterised by dealings above standard market size, and where the deals are carried out outside the systems usually used by the firm concerned for its business as a systematic internaliser")* provides a very narrow scope for what would be considered OTC.

Given this lack of clarity surrounding what activities fall within the scope of an SI versus what are 'pure' OTC activities, it might be appropriate to give ESMA a role in setting out the detailed criteria necessary to assess whether trading activity is such that it should fall within the SI rules.

11. What is your view of the requirement in Title V of the Regulation for specified derivatives to be traded on organised venues and are there any adjustments needed to make the requirement practical to apply?

Please refer to our response to question 6, which sets out our views on the interaction between the Organised Trading Facility concept and the trading obligation. We believe that the proposed ban on an OTF operator executing client orders against his own capital will have the impact of restricting the range of available venues for trading in OTC derivatives subject to the trading obligation.

To the extent that the trading obligation is intended to increase transparency, we believe that far greater benefit will be derived from appropriate pre- and post-trade requirements, including reporting to trade repositories and to the market, than from the trading obligation.

In determining which contracts are 'sufficiently liquid', ESMA should be mandated to take account of the fact that liquidity can vary over time, meaning that the assessment of liquidity must be dynamic in nature and contracts should be liquid in a range of conceivable market stress scenarios. We also believe that MiFIR should acknowledge the risks associated with applying the trading obligation to inappropriate contracts, to ensure that only suitable contracts are caught.

We support the fact that the trading obligation does not apply to transactions that are not cleared due to an exemption from the clearing obligation under EMIR. This will help ensure that the needs of end users are suitably accommodated. We also note the practical challenge associated with applying the trading obligation in the case of non-financial counterparties – this is dependent on whether a non-financial counterparty has exceeded the clearing threshold, and a firms' activity may fluctuate above and below the threshold over time.

Finally, we also encourage European policymakers to maintain a close dialogue with other jurisdictions on this issue, given the wider G20 efforts to move standardised OTC derivatives contracts to exchanges and electronic venues, where appropriate. While there are some parallels between the OTF concept and the US Swap Execution Facility, the European architecture for derivatives trading – also including SIs, regulated markets and MTFs – will be quite complex, making it more challenging to ensure that there is a level playing field across jurisdictions.

13. Are the provisions on non-discriminatory access to market infrastructure and to benchmarks in Title VI sufficient to provide for effective competition between providers? If not, what else is needed and why? Do the proposals fit appropriately with EMIR?

We welcome efforts to ensure that there is robust competition between trading venues and between providers of post-trade market infrastructure. We therefore support the requirement that CCPs provide non-discriminatory clearing access for financial instruments regardless of execution venue and specifically, the fact that this covers access to the associated margin pool within the CCP. At the same time, it is important that those seeking access to market infrastructure and to benchmarks should make all reasonable efforts to comply with relevant technical and operational requirements. We are of the view that non-discriminatory access must be subject to reasonable commercial negotiation, when and where appropriate.

We also believe that it is vital to ensure that contracts that are subject to EMIR access provisions benefit from equally favorable access provisions as those subject only to MiFIR.

14. What is your view of the powers to impose position limits, alternative arrangements with equivalent effect or manage positions in relation to commodity derivatives or the underlying commodity? Are there any changes which could make the requirements easier to apply or less onerous in practice? Are there alternative approaches to protecting producers and consumers which could be considered as well or instead?

Generally speaking ISDA would like to state that:

- a pragmatic approach consisting of granting regulators powers to put in place position management rules with the capacity, under certain conditions such as market dislocation, to set temporary position limits, is the right one. Position limits should therefore only be, within a position management regime, the last option to tackle market dislocation, and should be carefully calibrated;
- position limits for individual classes of commodity derivatives risk undermining the efficient functioning of the commodity and associated derivative markets if they are not calibrated correctly. While position limits are used both in the EU and other jurisdictions its should be recognized that they are a blunt and inflexible tool which cannot hope to capture the complex and diverse interactions involved in the underlying production, movement and delivery of physical commodities and the genuine interrelationships between activities across different commodity classes and geographies. A poorly calibrated regime which does not recognize the complexities of the markets and different manner in which participants interact, could potentially fundamentally undermine the ability of producers, wholesale and consumers to manage their commercial risks efficiently.
- exchanges and regulators need information on commodity derivatives positions to enable them to monitor the market (position information) and need mechanisms, subject to appropriate

conditions, to allow them to intervene if any abusive behaviour or market distortion occurred or is likely to occur (position management);
- it is fundamentals, not financial investors, which drive commodity prices in the medium and long term, and while in the short term investors might intensify price trends, they cannot create them; we therefore consider that the emphasis placed on the impact of investors' behaviour on price volatility, which is the main reason raised as a justification for introducing position limit regimes, is misplaced.

Position management rules are recognised by most stakeholders as an effective and sensitive tool to ensure that the markets function well and to help prevent market manipulation without negatively affecting liquidity, while the effectiveness of position limits is doubtful. The most appropriate regulatory regime should be based on the following three pillars:

- Firstly, the general regime should be a sufficiently harmonised position management regime within which position limits should be only one tool among others and more specifically the tool that would be used only in the last resort.
- Secondly, to avoid discrepancies between various national regimes, guidelines for a position management regime should be included within the directive.
- Thirdly, the choice, within the 'position management toolbox', of the appropriate tool to address market disturbances, should remain in the hand of the exchanges under the oversight of national regulators and with a reporting obligation to ESMA whose responsibility would be to gather information on existing regulatory regimes across the European Union.

In applying the three pillars, ISDA calls for the addition of the following guidelines relating to an effective position management regime:

- The exchange shall monitor market activity of and the positions being taken by market participants. A member of an exchange will be required to submit daily or weekly reports of positions held for its own account and those held on behalf of its clients, that are not concluded through organised trading venues. For each contract, the exchange will determine if any participant is potentially building a position which raises a threat to the orderly functioning and integrity of financial markets, given the specific circumstances of the underlying market and taking into account such factors as the levels of open interest, liquidity and the supply of the underlying commodity.
- Where the exchange determines that a position has arisen which has the potential to have an undue influence on the price of the contract, the exchange will call for all necessary information about the positions, including related physical positions, held by individual market participants or controlling traders to understand the purpose of the activity. Having called for such information, the exchange should be able to determine at its discretion whether or not it is appropriate for the position to be maintained. Where the exchange determines that the position needs to be reduced or potentially closed to secure fair and orderly market they may instruct the market participant to do so. If the participant does not comply with such instruction, the exchange has the power to close the position unilaterally, under the oversight of the national regulator;
- The entire position management regime is designed by the exchange and its effectiveness monitored by the national regulator who regularly reports to ESMA. Exchanges in conjunction with national regulators and following consultation with market participants may consider implementing other position management measures which consider the specific circumstances and structure of that market concerned. An example is the London Metal Exchange "Market Aberrations Regime".

From this perspective, we would support, instead of the current wording of article 59, wording as close as possible to the G20 outcome[4]: '*market authorities are granted with intervention powers such as formal position management powers, including the authority to set ex-ante position limits, as well as discretionary powers'*. That would highlight the idea that position management is the normal regime and position limits only a tool (under the oversight of the national regulator) within the position management regime which is employed as last resort measure in individual cases, if there is a threat to the orderly functioning and integrity of financial markets. Article 59 should only mandate position management by market operators.

Finally, we encourage the European Parliament and ESMA to put in place appropriate aggregation rules for the purposes of monitoring positions. Any aggregation regime should be based upon control not ownership and should recognize that market participants can have completely separate management structures which operate independently and thus should not be viewed on a group basis for the purposes of aggregating positions. ESMA should put in place a system for entities to demonstrate to it or the relevant market that they are in fact independently controlled and thus qualify for independent limits.

16. How appropriate is the proposal in Directive article 25 on which products are complex and which are non-complex products, and why?

ISDA recognises that structured products now represent a large part of the supply of financial products sold to professional as well as retail investors. In fact, there is a considerable variety of structured investment products available within the EU (some offering similar returns, but through different legal structures). A variety of product offerings is good for Europe and good for investors. It helps to ensure they have a range of product offerings to best suit their specific investment needs and ensures competition between providers keeps costs low and quality higher than it would otherwise be.

However, it is important to ensure that retail investors understand what they are buying and do not buy unsuitable products. Nevertheless, ISDA notes that it does not necessarily follow that an investment product with a relatively complex structure will also have a complex risk/reward profile or vice versa.

ISDA therefore considers that the regulatory regime for financial instruments (and more broadly for packaged retail investment products[5]) should operate principally (although not exclusively) by reference to the risk/reward profile rather than a product's structure.

Furthermore, it should not be assumed that complexity equates to higher risk, or that a product that is complex for one client is necessarily complex for other clients. A product's level of complexity is not necessarily an appropriate proxy for its risk profile. Indeed, it is very important to note that "complexity" does not mean "more risky". Complexity is sometimes the result of steps taken to simplify or moderate the risk profile of a product; one of the most obvious examples of this is arrangements to provide some level of principal protection and another is the use of caps and floors on exposure. Complex funds can be less risky than plain vanilla strategies, e.g. a capital-protected UCITS is more protective and less risky than a UCITS investing directly in emerging market equities, which may be highly volatile and where liquidity may not necessarily be guaranteed.

It is questionable to what extent investors need to understand the detailed mechanics by which a particular risk/reward exposure is provided as long as they understand the exposure they will take sufficiently to make an informed decision. It is certainly possible that a complex structure could affect an investor's ability to understand that risk profile, so that some discussion of the legal structure may be necessary.

Equally, the exclusion of certain securities that "*incorporate a structure which makes it difficult for the client to understand the risk involved*" is a concern given that the criterion *"difficult...to understand"* is subjective

[4] FSB 'Report to the G20 on the Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability', 4 November 2011.
[5] ISDA considers that the PRIPs proposal and the IMD review should be led in parallel with MiFID.

and does not differentiate between client types. We suggest these sections be calibrated by client type as the level of understanding of a professional client and a retail client will generally be very different.

Revisions to the article should therefore focus on how a product's complexity affects its level of risk in terms of its expected return (i.e. return volatility).

An alternative approach would be to increase the levels of transparency and disclosure required for structured funds. We believe transparency and disclosure are the key elements to consider. Such transparency should in our view include: detailed information on the assets held by a fund; its investment policy and techniques used; and the nature and quality of any collateral received (derivatives, stock lending and/or repo activity). There should also be prominent risk warnings required for more risky speculative or complex funds (which may well be unsuitable to be sold on an execution-only basis).

Finally, we would also encourage policymakers to carefully consider the proposal to define all structured UCITS as 'complex' (and therefore exclude them from the MiFID execution-only regime). We believe such an approach would risk weakening the UCITS framework, leading retail investors to invest in less regulated products.

18. Are the protections available to eligible counterparties, professional clients and retail clients appropriately differentiated?

We believe that the current client classification regime has worked well and, subject to our comments below, should be retained without adjustment. While no regulatory regime is perfect, in practice it seems to have allowed for a suitably graduated approach to applying regulatory rules (and hence the associated costs), tailored to the sophistication of the clients concerned, while at the same time allowing for adjustments to classification where appropriate relying on the ability to opt "up" and "down".

Here it is worth highlighting that the Commission has chosen not to follow the recommendations of CESR, which suggested that it was not necessary to modify the current classification regime which, by virtue of the opt-ups and opt-downs, enables all clients to be catered for and given the appropriate level of protection, including for regulated entities.

It is therefore not clear what benefit any change would deliver at this stage and, in view of the experience of the industry at the time MiFID was introduced, it could be an expensive exercise to introduce. The only area that may be worth some consideration is the classification of private individuals that are sophisticated investors with high net worth and who frequently want access to products more commonly available in the professional market place. While the existing regime recognises that it is appropriate to allow for this class of client to be "opted up" from retail to professional status, in practice, the rules governing that process make it virtually impossible as a result of the requirement that the client must have carried out transactions in significant size on the relevant market at an average frequency of 10 per quarter over the previous four quarters; many categories of investment product simply do not get used or dealt with in that way, such that even if the client satisfies the "opt up" criteria in all other respects, the fact that the relevant market for a particular investment does not operate in the manner that the rule contemplates means that the client cannot be re-classified.

21. Are any changes needed to the pre-trade transparency requirements in Regulation Articles 7, 8, 17 for all organised trading venues for bonds, structured products, emission allowances and derivatives to ensure they are appropriate to the different instruments? Which instruments are the highest priority for the introduction of pre-trade transparency requirements and why?

Equity and non-equity markets differ substantially. Where equities are normally traded on a large scale, continuously, and in a range of sizes, non-equity financial instruments tend to trade sporadically and in volumes which can vary significantly.

This issue is illustrated by CDS statistics showing the *in*frequency of trading:

- About 6,700 trades per day globally
- Only 13 single names trade more than 20 times per day
- 99% of single names trade less than 20 times per day

By way of indirect comparison, the number of transactions that occurs on the London Stock Exchange on any one day frequently exceeds 1,000,000.

<u>Organised trading venues</u>

The differences described above are also apparent in the nature of pre-trade transparency that exists in different markets, including for OTC derivatives: pre-trade transparency already exists in many forms across many different markets and has developed on the basis of the demands of market participants. For more liquid OTC derivatives contracts, for example, investors have access to many sources of information displaying the price they will be able to trade: multi-dealer trading venues offering composite pages and dealers' single dealer platforms, offering firm, "click and trade" quotes.

Other systems might display indicative pricing, allowing investors to send RFQs (Request-for-Quote), then receiving a firm bid/offer with no obligation to trade if the investor is not happy with the price.

As competition is fierce in these products, dealers have a strong incentive to be as transparent as possible in order to ensure that they remain on the counterparty list of their clients.

The drafting of MiFIR does not adequately recognise this variety of transparency. In particular, the high-level transparency obligation to "*make public prices and the depth of trading interests*" and to do so *"on a continuous basis"* (article 7.1, MiFIR) is applicable to a <u>specific execution method</u>, 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.

This obligation is <u>not appropriate for all trading environments</u> and could significantly raise costs for end users of the market. Equally, such an obligation has little relevance in the context of more tailored OTC derivatives transactions, where price depends on various negotiable terms.

We would therefore prefer to see a more targeted approach to pre-trade transparency, based on the needs of end users and the objective of ensuring that the best possible price discovery can continue to occur in each market. This requires a flexible model taking into account the characteristics of each traded product.
In particular, we believe that indicative pricing offered by RFQ systems for OTC derivatives adequately delivers on the policy goal of pre-trade transparency, allowing investors the freedom to seek to improve quotes, and creating a strong reputational incentive on the part of market makers to trade at a price close to indicative prices.

If, however, policymakers do decide to focus on enshrining the sort of transparency associated with a limit order book environment, then such measures should be confined to products that are sufficiently liquid, with ESMA and the Commission playing a determinative role in dialogue with users of the market. This would in some senses parallel the operation of the clearing and trading obligations. The process should also be designed to ensure that a determination takes account of and responds to changes in liquidity of instruments (potentially over a very short period of time).

Systematic internalisation

Under the SI regime, firms would be required to:

- provide firm quotes when prompted for a quote by a client;
- 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

Such a model is untenable for OTC derivatives, both from a client and operational perspective. It is important that the SI regime recognise the critical role that dealers play in providing market liquidity by assuming risk to accommodate client needs. We are concerned that various aspects of the regime as drafted have 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 Commission's objective is to ensure that SIs provide all their clients with fair quotes and that no client is discriminated against. This can instead be fulfilled by requiring firms to have in place "non-discriminatory quoting policies", whereby quotes must be made available to clients on the basis of clear criteria. 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 an appropriate solution, given the range of factors – including counterparty risk – that legitimately influence pricing. Recital 17[6] 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.

We therefore support the idea of firms being required to establish non-discriminatory pricing policies based on criteria such as those in Article 16 MiFIR, and others, including:

- Counterparty credit risk
- Investor credit status
- 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)

This 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:

[6] "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."

- What mechanisms would enable firms to communicate to all clients that they are offering firm prices in a specific instrument?
- How long should "live" prices are advertised. This clearly needs to be 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.

The difficulties we see in the SI regime are compounded by the disparity between the SI regime as drafted for equities and that for OTC derivatives. The requirement for Systematic Internalisers to publish firms 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 there is a liquid market'. If policymakers do decide to pursue the idea of a quote publishing obligation, then it should be limited to liquid instruments. At the same time, there should also be explicit waivers for large transactions (noting that OTC derivatives trades are by nature very large – it would be misleading to assume that there is a meaningful distinction between 'retail' and 'wholesale' transactions); indeed, such a waiver is already implicit in language that states that Systematic Internalisers "shall undertake to enter into transactions with any other client to whom the quote is made available under the published conditions when the quoted size is at or below a size specific to the instrument."

22. Are the pre-trade transparency requirements in Regulation Articles 7, 8 and 17 for trading venues for bonds, structured products, emission allowances and derivatives appropriate? How can there be appropriate calibration for each instrument? Will these proposals ensure the correct level of transparency?

Please see our response to question 21.

23. Are the envisaged waivers from pre-trade transparency requirements for trading venues appropriate and why?

Our suggested approach to pre-trade transparency (see our response to question 21) would in practice mean that less reliance would be placed on the system of waivers from pre-trade transparency as envisaged in the text. That said, we do believe that it is appropriate that regulators have the power to issue transparency waivers and support measures in the text to ensure that waivers are applied consistently across member states and in a timely manner. However, the proposal that the Competent Authority must notify ESMA 6 months before the waiver is intended to take effect is too long – we would suggest that the Competent Authority should notify ESMA at least three months ahead of the waiver taking effect, with ESMA opining on the waiver within six weeks of the notification.

25. What changes if any are needed to the post-trade transparency requirements by trading venues and investment firms to ensure that market participants can access timely, reliable information at reasonable cost, and that competent authorities receive the right data?

We support the development of a post-trade transparency regime for OTC derivatives, providing it is sensitive to the nature of the market, with reporting deferrals and volume masking calibrated in line with transaction size and liquidity. It should at all times be borne in mind that increased transparency does not equate to enhanced liquidity per se. Transparency, without an appropriate system of delays in place, has the potential to significantly reduce liquidity. Clients' ability to trade large sizes quickly, at a low cost, when they want, could be significantly diminished.

The framework of reporting deferrals should reflect the operation of the market and allow market participants sufficient time to manage their positions prior to a disclosure being made. Without such deferrals in place, dealers would be unwilling to take significant positions (institutional flow) onto their book, as there is a danger they will be on-risk when forced to disclose. In this scenario, the dealer risks the market moving against him before he has unwound his risk – meaning he would be unwilling to take large positions onto his book. Ultimately, the price clients execute at would suffer. As such, careful consideration of the appropriate reporting delay for different size trades and different assets classes will help ensure that the impact on the cost of hedging is not such as to discourage provision of liquidity to end users.

Furthermore, liquidity is not a constant. Volatility and liquidity can change dramatically over a relatively short period of time. We consider it necessary to have in place some sort of mechanism to recalibrate, or allow for adjustments during periods of market stress.

We believe that CESR's report on post-trade transparency for non-equities and derivatives, published in 2010, which calls for an appropriately calibrated system by asset class or sub-asset class , should be a good basis from which to form a European post-trade transparency regime.

28. What are the key interactions with other EU financial services legislation that need to be considered in developing MiFID/MiFIR 2?

The main pieces of financial services legislations that have interactions with MiFID/MiFIR 2 are the European Market Infrastructure Regulation (EMIR), the Capital Requirements Directive (CRD), the envisaged Packaged Retail Investment Products proposal (PRIPs) and the Market Abuse Regulation (MAR). All these are currently at different stages of legislative process. There are potential overlaps between parts of these legislative initiatives and this situation may lead to uncertainties for market participants/operators that ultimately would result in an excessive increase of cost to be paid by consumers.

In particular, we believe that MiFID should look to EMIR when defining rules for non-financial counterparties, to ensure that the clearing threshold agreed in EMIR is not undermined.

Beyond financial services legislation, MiFID will also interact with sector-specific legislation in the energy market. In particular, the Regulation on Energy Market Integrity and Transparency (REMIT) recently entered into force, introducing a single oversight regime for gas and electricity markets and market participants across the entire EU. REMIT includes rules on the registration of market participants, prohibition of insider dealing and market manipulation, transaction reporting, monitoring, and enforcement of rules by National Regulatory Agencies supported by the Agency for Cooperation of Energy Regulators (ACER).

29. Which, if any, interactions with similar requirements in major jurisdictions outside the EU need to be borne in mind and why?

We underline in particular rules concerning the energy sector included in the Dodd-Frank Act approved in the US. We strongly support a better specification of the MiFID II perimeter to exclude from the definition of financial instruments all products with delivery in the future that are intended to be, or have the ability to be, physically settled. This is the approach used in the US under the Dodd-Frank Act, and as such any departure from this approach in the EU would create regulatory inconsistency.

Physically settled forward products in particular are of primary use for commercial firms. They would considerably increase the scope of MiFID II to pure commercial activities (e.g. gas/power contracts which aim at the physical delivery) which do not display the characteristics of traditional derivatives.

We believe that it should be possible to trade physical energy contracts in an efficient way without having them defined as financial products. If this clarification is not made in Annex 1C, there is a risk that physical trading will move from today's efficient broker platforms to bilateral trading. We believe that this development is more likely than channelling of trades which are currently OTC onto organised venues. We believe that this would lead to inefficient trading as the benefits of broker trading platforms might be undermined in the future.

Contacts: Adam Jacobs (ajacobs@isda.org) and Benoît Gourisse (bgourisse@isda.org)