18 March 2020

ISDA response to ESMA's Consultation Paper

MiFIR report on Systematic Internaliser in non-equity instruments

Question 1: Do you consider that there is a need to clarify what a "firm quote" is? If so, in your view, what are the characteristics to be met by such a quote?

At this stage, ISDA note that market participants have a common and clear understanding of what constitutes a firm quote and that this is no need to open a debate about the meaning of a 'firm quote'..

Question 2: (For SI clients) As a SI client, do you have easy access to the quotes published, i.e. can you potentially trade against those quotes when you are not the requestor? Do you happen to trade against SIs quotes when you are not the initial requestor? How often? If it varies across asset classes, please explain.

ISDA is not responding to this question, which is directly addressed to individual firms.

Question 3: What is your overall assessment of the pre-trade transparency provided by SIs in liquid non-equity instruments? Do you have any suggestion to amend the existing pre-trade transparency obligations? If so, please explain which ones and why.

As a general remark, ISDA broadly agrees with ESMA's legal analysis and its related conclusion that the pre-trade transparency regime for SIs in non-equity instruments is rather complex and burdensome for SIs. While SIs are complying with their pre-trade transparency obligations by publishing their quotes for non-equity instruments to the public, buy-side clients do not show particular interest in quotes.

ISDA would like to raise concerns in relation the treatment of derivatives under MiFIR's pre-trade transparency regime.

- **The treatment of non-Traded on a Trading Venue (non-ToTV) instruments is bringing complexity and inaccuracies**

  ISDA note that the objective of the SI regime is to ensure a level playing field between systematic internalisers and multilateral trading venues by requiring greater transparency in relation to OTC trading of venue-traded instruments, i.e. ToTV.

  Consequently, RTS 1 and RTS2 define transparency requirements. However, Systematic internalisers also have to provide reference data – in accordance with RTS 23 – to the FIRDS system for uToTV instruments[1].

  This approach is problematic for the following reasons:
  - Transparency in relation to non-standardised OTC derivative instruments will be meaningless and arguably misleading as these instruments share reference data with standardised instruments that are traded on trading venues, amid additional price forming terms that alter the product.
  - The requirements to report reference data to the FIRDS system requires the creation of ISINs. If bespoke, non- standardised and not widely traded products are subject to the creation of ISINs, the amount of ISINs will be significant, causing inaccuracies in transaction reporting, while also not constituting transparency advantages for clients since these products are not widely distributed and available on trading venues.
  - Therefore, the requirement of RTS 23, which requires SIs to submit uToTV data to FIRDS, contributes to less accurate and more misleading data in FIRDS. It should be noted that FIRDS only contains the uToTV data of instruments traded via SIs.
  - In light of the above, legislators should consider whether the reference data in relation to uToTV instruments that NCAs are receiving ultimately supports the original policy objectives of the reference data reporting regime.
  - Beyond transparency objectives, the absence of clarification that the scope of the SI regime and the ToTV concept are aligned leads to confusion for investment firms to determine their SI status with respect to certain asset classes. The mandatory SI determination –among other criteria – requires determining the 'total trading in the European Union in a specific instrument', which is impossible for non-ToTV instruments. ESMA acknowledged this shortcoming in its Q&A on Transparency, Question 11.

- **Liquidity assessment of derivatives needs re-calibration**

  As ESMA points out in Paragraph 26 of the consultation paper, derivatives are subject to a static determination with respect to liquid or illiquid markets. With respect to most equity derivatives, which are deemed liquid, ISDA believes that this approach is problematic for the following reasons:
  - The static determination in RTS2 is not aligned with the MiFIR Level 1 text, which defines a liquid market as being "where there are ready and willing buyer and sellers on a continuous basis".

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[1] UToTV means:
- Financial instruments where the underlying is a financial instrument admitted to trading on a trading venue or
- financial instrument where the underlying is an index or a basket composed of financial instruments admitted to trading or traded on a trading venue.

- It undermines the objective of requiring less pre-trade transparency for less liquid markets. It is therefore likely that requiring pre- trade transparency for de-facto illiquid markets may have negative impacts on liquidity and higher hedging costs for end-users.

In addition, ISDA believes that the pre-trade transparency regime for certain categories of derivatives instruments (such as interest rate options and commodity derivatives) requires re-calibration.

This need for re-calibration is further amplified by the implications of Brexit.

Question 4: (For SI clients) do you have access to quotes in illiquid instruments? If so, how often do you request access to those quotes? What is your assessment of the pre-trade transparency provided by SIs in illiquid instruments?

ISDA is not responding to this question, which is directly addressed to individual firms.

Question 5: (For SIs) Do you disclose quotes in illiquid instruments to clients upon request or do you operate under a pre-trade transparency waiver? In the former case, how often are you requested to disclose quotes (rarely, often, very often)? Does it vary across instruments / asset classes?

ISDA members, acting as SIs in non-equity instruments, are very rarely experiencing that clients are requesting the disclosure of quotes in illiquid instruments.

Question 6: Do you consider that there is an unlevel playing field between SIs and multilateral trading venues active in non-equity instruments, in particular with respect to pre-trade transparency? If so, please explain why and suggest potential remedies.

ISDA acknowledges the arguments ESMA raises in Paragraphs 42 with respect to a possible unlevel playing field between SIs and multilateral trading venues.

In particular, in the context of pre-trade transparency, co-legislators and regulators are facing the challenge to maintain a level playing field while taking into account the very different roles of SIs and multilateral trading venues in financial markets, i.e. pre-trade transparency rules should not be the same for trading venues and SIs as they function differently.

- As SIs are 'trading on own account' bilaterally with clients, a SI is acting as a counterparty and an investment service provider taking on proprietary risk. Therefore, as ESMA points out in Paragraph 42, SIs have to disclose their identity and put their own capital at risk, resulting in SIs being subject to capital requirements. ISDA would like to add that SIs are also subject to strict conflict of interest requirements as a result to the dual role SIs, i.e. counterparty and investment provider, play in financial markets.
- In this context, ISDA considers that the regulatory obligations for SIs in Article 18 exceed those for trading venues, and as such constitute an unlevel playing field. Those additional obligations require SIs to make the firm quotes 'available to their other clients' (Article 18(5)) and 'enter into transactions under the published conditions with any other client to whom the quotes is made available (Article 18(6)). Therefore, ISDA believes that this obligation of 'actionality' by other clients should be removed. Please see ISDA's suggested reforms, outlined in answer 8. SIs' crucial role to provide liquidity also means that SIs require a degree of anonymity with respect to pre-trade transparency obligations as it is the case when dealers trade on

multilateral venues. SI should therefore be allowed to anonymise their reports should they wish to.

Additionally, the pre-trade transparency obligations not only require a reporting obligation for SI but also requires SIs to 'make the quotes available to other clients' and 'undertake to enter into transactions'. ISDA considers these additional obligations complex and not aligned with the obligations when quotes are sent to a multilateral trading venue.

Most importantly, as already mentioned in the answer to question 3, ESMA's Level 3 guidance suggests that the SI regime may also apply to non-ToTV products. Therefore, SIs are faced with an additional administrative burden compared to trading venues, which by nature only deal with ToTV products. Another negative aspect of applying the SI regime not only to ToTV instruments is an incentive to trade those products on a 'pure OTC' basis and not via a SI.

Question 7: (for SIs who are also providing liquidity on trading venues): What are the key factors that determine whether quote requesters (your clients) want to receive the quote through the facilities of a trading venue or through your own bilateral trading facilities?

Clients would request quotes either through a trading venue or bilaterally depending on the type and size of the transactions or the market conditions.

Question 8: What is your view on the proposal to simplify the requirements in relation to SI quotes in liquid non-equity instruments under Article 18(6) and 18(7)?

ISDA strongly endorses ESMA's proposal to simplify the pre-trade transparency regime for SIs by deleting MiFIR Article 18(6) and 18(7). ESMA's argument in paragraph 45, i.e. dealers on trading venues do not have to execute multiple trades on a displayed quote, and the role of SIs being risk-takers, does not justify to introduce more stringent requirements and de-facto force multiple transactions on a given quote.

However, in light of ESMA's conclusion outlined in Paragraph 46, stating that SI would only be required to trade on the published quote with the requesting clients while enjoying discretion with respect to other clients, it may be argued that MiFIR Article 18(5) could also be further simplified or even deleted. Since it is only the requesting client who is expected to trade on the published quote, Article 18(5) requirements (and its caveats) do not add any meaningful benefit to pre-trade transparency.

Question 9: Do you consider that the requirements in relation to SI quotes in illiquid non-equity instruments (Article 18(2)) are appropriate? What is your preference between the options presented in paragraph 52 (please justify)?

ISDA supports ESMA's proposal and shares the views as expressed from Paragraph 47 to 52.

- The pre-trade transparency regime for non-equity instruments in illiquid markets, including derivatives, is overly complex and proved to be difficult to apply in practice.
- Applying Article 18(1) to illiquid instruments while constructing another complicated waiver regime seems indeed to be suboptimal, as the complexities for SIs would possibly increase without serving clients with additional transparency.
- As a result, ISDA would tend to prefer Option 3, which suggest deleting Article 18(2). However, we are unsure of what ESMA's has in mind when it mentions 'developing an ad-hoc

supervisory convergence tools for SIs'. Clarification on this point would be helpful. ISDA would welcome that a work stream in this regard includes the views of stakeholders via public consultations, to reflect applied market practices and increase the efficiency of supervisory convergence with respect to illiquid instruments. ISDA would endorse a deletion of Article 18(2) and recommends to use any supervisory convergence tool if its design is fit for purpose.

Question 10: What is your view on the recommendation to specify the arrangements for publishing quotes?

ISDA members estimate that there is no evidence to support that the current regime should be modified unless it is to clarify things that firms are already complying with in the derivatves space (under the Q&As for example).

Question 12: Do you have any comment on the analysis of derivatives data and the relation with the SSTI threshold as presented above?

ISDA agrees with ESMA's analysis, as expressed in paragraph 79 in the consultation paper, that 'there is no evidence of significant quoting and trading activity just beyond SSTI thresholds. I follows that the data does not suggest any intention to circumvent pre-trade transparency obligation via the SSTI thresholds.

Question 13: What is your view on the influence of the SSTI thresholds on the pre-trade transparency framework for SI active in non-equity instruments? Are there any changes to the legal framework that you would consider necessary in this respect?

ISDA agrees with ESMA that no change to the legal framework appears necessary. However, there may be a need to recalibrate thresholds more broadly in the context of Brexit, possibly including SSTI thresholds.
As an example, in the context of OTC Interest Rate(IR) options, the transitional transparency calculations for the SSTI and LIS thresholds for these products are extremely high, in the billions of Euros. The calculations have probably only used data from listed options as opposed to OTC IR options, OTC IR options being very different products that trade at much smaller sizes. If the sub-asset class is interpreted to mean IR options and OTC IR options that are ToTV, the transparency calculations need to be re-run using a more representative sample, to avoid significantly impairing liquidity in those markets as a result of the thresholds as they stand.

Question 14: What is your view on the best way for ESMA to fulfil the mandate related to whether quoted and traded prices reflect prevailing market conditions and in particular:
(1) the source of data for the SI quotes/trades (RTS 27, APA);
(2) the source of market data prices; and
(3) the methodology to compare the two and formulate an assessment?

ISDA members have constantly reported that there is no aggregated source of standardised data and that the existence of many APAs with no mandate to aggregate their data is aggravating the issue SIs consider obtaining the relevant data points in accordance with RTS 27 as burdensome without providing any added value for other market participants in terms of transparency. Therefore, ISDA would consider to standardize the submission of data for APAs.