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ISDA Commentary on Presidency Compromise Texts on MiFID2/MiFIR

Introduction

ISDA welcomes publication by the Danish Presidency of a first complete Compromise Text on MiFID2/MiFIR, dated 20 June 2012. It remains our view that legislative reform should support liquidity in the interests of systemic resilience; should protect the funding requirements of corporates and sovereigns; and should advance the principle of strong risk management.

We therefore welcome the following developments in the Compromise text:

- The effort to strike an appropriate balance between liquidity and transparency in the context of non-equities markets
- The streamlining of the pre-trade transparency waiver process
- The move to align the SI regime with the approach to trading venues, as well as the strengthening of commercial policy provisions in line with the approach to the equities regime

We do, however, believe there is some way to go before the text fully balances regulatory objectives with the need to preserve the functioning of OTC derivatives markets:

- Further changes are needed in respect of the derivatives trading obligation; there is a need for an explicit block trade exemption above which the trading obligation would not apply
- Given the sheer breadth of non-equity instruments that are available, it is not feasible – or indeed helpful to investors – to require a venue to make indicative prices in *every single* available contract
- The proposed changes to the OTF category do not yet address the problem posed by the ban on use of proprietary capital by the operator of the OTF

We comment in detail on these points below.

Trading obligation

We welcome the change to Article 26 of MiFIR specifying that the trading obligation procedure should entail consideration of spreads in determining which contracts are sufficiently liquid to be made subject to the trading obligation.

We also call for further refinements of the trading obligation to ensure that only appropriate transactions are caught.

Most importantly, we believe that there is a need for an explicit block trade exemption and that ESMA should determine specific and carefully calibrated size thresholds above which the trading obligation under Article 24(1) of MiFIR would not apply for that class of contracts (as being discussed in US rulemakings). This would parallel the approach to pre-trade transparency for non-

equity instruments, where a large-in-scale waiver is available. We therefore believe that Article 26(2)a, which establishes the possibility that only a 'subset' of a class of contracts is treated as sufficiently liquid, should explicitly refer to such a size threshold.

We would also stress the need to consider the potential for changes in the frequency of trading, average size of trades, the number of active market participants, and width of spreads – all of which can vary markedly over time, meaning that a contract that is liquid today is not guaranteed to remain so. Similarly, market infrastructure capacity, such as the available range of venues trading the contract, is also an important point and would support systemic resilience.

This should be further supported by a more effective mechanism to suspend the trading obligation. While Article 26(5) enables the Commission to suspend and revoke implementing technical standards, it is silent on the conditions under which it may be important to do so. We believe Article 26(5) should refer to periods of liquidity strain during which the trading obligation could have an adverse impact on liquidity and might therefore be suspended.

Finally, in order to make for consistency with EMIR, the trading obligation should be subject to phasing in provisions, operating by class of derivatives, or subsets thereof, or for particular client types. We would suggest a small addition to Article 26(1)b making this clear.

Transparency for trading venues

We note that the Council compromise text includes changes to Article 7(1) aimed at simplifying the text. While these changes are helpful, we would reiterate our concern that significant reliance will be placed on the waiver process under Article 8 in order to calibrate transparency requirements.

We also note the inclusion of a new MiFIR Article 7(3) requiring the provision of indicative prices by trading venues that are subject to a waiver of pre-trade transparency requirements by virtue of MiFIR Article 8(1)(ii-iii). While we understand the motivation for this change – namely that calibration of pre-trade transparency should not be such as to undermine the principle of transparency itself – we are concerned that the drafting of the new provision could limit the ability of trading venues to offer clients a broad choice of products: given the sheer breadth of non-equity instruments that are available, it is not feasible – or indeed helpful to investors – to require a venue to make indicative prices in *every single* available contract. We believe that MiFIR Article 7(3) should establish a requirement to make available “an appropriate level of indicative pre-trade price information”, potentially supported with Level 2 measures. This is particularly important for derivatives contracts, where the number of contract specifications is large.

We welcome explicit reference in the context of Article 8 waivers to purely professional markets, where transparency has evolved in line with the needs of the users of those markets without regulatory intervention. Likewise, we are very supportive of the inclusion of the “large in scale” waiver, which will be vital for derivatives markets, where ‘block’ trades play an important role in risk transfer.

We also believe that greater accommodation of voice and Request-For-Quoting trading systems is needed. In particular, we would suggest rewording MiFIR Article 8(1)(ii) to allow for a waiver for voice and RFQ trading systems without referring to order size.

Experience with EMIR has shown that it is easy to have logical inconsistencies in sequencing, specifically where exemptions are theoretically available but with no explicit provision to suspend the related obligations while such exemptions are processed. We would urge attention to the detail here within MiFIR, such that any justified waivers can be put in place before the related transparency measures come into effect.

We note that MiFIR Article 8(5) has been deleted in the compromise text, given that it cross-refers to MiFID1 provisions enabling pre-trade transparency waivers for shares. This appears technically correct, but we would urge the Council to ensure that this is indeed in line with how national Competent Authorities have applied the MiFID1 framework, particularly those who already supervise non-equity MTFs.

SI and pre-trade transparency rules for investment firms

We have previously expressed our view that the application of the SI regime is not clear in the case of OTC derivatives, given the fact that the trading obligation is defined so that derivatives subject to the obligation can only be traded on regulated markets, MTFs and OTFs (and not under the SI rules). In order for the pre-transparency obligation to be workable, we have suggested a focus on liquid instruments that are available on a trading venue. We therefore support the proposed changes to MiFIR Article 17(1), and the fact that this is supported through Level 2 measures under Article 18(2) – although ESMA technical standards might be more appropriate in this instance. We would reiterate the importance of ensuring that firms are not put in a position where they are required to provide firm quotes to clients (on which other clients may also be able to trade), in cases where there is no liquid market for the instrument. Separately, we note that the obligation in Article 17(1) should be to ‘provide’ quotes to clients on request, rather than to ‘publish’ these. Reverting to the previous ‘provide’ wording here would ensure that there is no confusion between this obligation and the obligation to make quotes public under Article 17(5). We would also suggest that the conditions in Article 17(1)(a) and (b) should refer specifically to the requirement to provide a ‘firm quote’ and that an ‘and’ is inserted between (a) and (b) to make clear that this does not prevent investment firms from providing indicative quotes if that is what the client requests or the firm agrees to provide.

We have also previously expressed our concerns that provisions under the SI regime enabling multiple clients to transact on one client’s quote are at odds with appropriate risk management and could lead to defensive quoting and poorer pricing. It is helpful to see that the ‘commercial policy’ provisions as apply to equities SIs are now included under MiFIR Article 17(2) in clear support of sound risk management. This paragraph could be further clarified by adding that the quotes will be provided ‘on request’ by the client and making it clear that the investment firm may refuse to provide a quote or provide an amended quote where it determines that it would not be appropriate to make the quote available.

To ensure a consistent approach on this issue, we would accordingly amend *recital* 17 too, to read: ‘Systematic Internalisers may decide on the basis of their commercial policy and in an objective non-discriminatory way the clients to whom they give access to their quotes, ~~distinguishing between categories of clients.~~’

To make it clearer that the size threshold of Article 17(3) covers the entirety of Article 17, including the quoting obligation in Article 17(1), we would also suggest it should be moved to a separate paragraph. There should also be a cross-reference to MiFIR Article 8 to clarify that the provisions do not apply to instruments which are subject to a pre-trade transparency waiver. This

would ensure proper harmonisation of provisions covering trading venues and OTC activity under the SI regime.

We note that there is currently no ability for SIs to amend or remove quotes and we suggest this is added as necessary to reflect changes in market conditions or to correct technical errors.

OTF regime

We do not believe that the new MiFIR recital 8 which states: “if an order is retracted it may only be rerouted to a regulated market or an MTF, or an SI platform not owned by the OTF operator in question, even when this is partly prejudicial to the obligation of best execution” is in the best interests of market functioning or investors. We believe that conflicts of interest rules could adequately deal with the interaction between an SI and OTF, without prejudicing best execution.

We believe that the move to facilitate ‘matched principal’ activity under the OTF rules is helpful, particularly for trading in equities, but would reiterate our view that the operator capital ban should be removed completely in the interests of allowing a diverse range of platforms to operate under the OTF category, supporting client choice and the implementation of the trading obligation.

In derivatives markets, client transactions necessarily involve firms employing their own capital and managing the risk associated with client-facing transactions over time. As the ‘matched principal’ activity is unlikely to capture this form of client facilitation (since buying and selling interests rarely perfectly coincide), the proposals would interfere with the way the markets have naturally developed over time (to assist that need for liquidity by the mechanism of firms using their own capital to take the risk on a short term basis, or ‘warehouse’ it). This could mean a significant withdrawal of liquidity in such markets. That would in turn entail a risk that commercial counterparties would find it more difficult to hedge their risks at the right time or at the right price. Reduced liquidity would also make it more expensive to hedge risks. Allowing firms to use their own capital for client facilitation purposes renders trading more efficient and less costly for the client and any related end beneficiaries of trades. Clients are protected in such a structure by comprehensive conduct-of-business rules, which ensure that client trades are treated appropriately. In particular, neutrality and fair and orderly trading conditions can be ensured by requiring OTF operators to have in place proper conflicts-of-interest management processes.

Being able to use operator capital to facilitate client trades is particularly important if the OTF cannot find a matching interest on the other side of the trade and the client wants to get the trade done at a certain time and at a certain price.

In the absence of a complete removal of the ban on use of operator capital, we would at least suggest that the exemption for matched principal trading is re-drafted to cover client facilitation activities more generally (with the consent of clients), noting that ‘matched principal trading’ will otherwise be narrowly defined in terms of the correspondence of the timing, pricing and quantities of the client orders in question [MiFID Article 20(8)]. Recital 8 of MiFIR should explicitly recognise that matched principal transactions are only a small subset of a much wider range of customer-facilitation activity that plays an important role in generating liquidity in line with the needs of clients.

The provisions as currently drafted also mean that firms will not be able to operate single-dealer platforms as OTFs. The simplest route for bringing existing trading practices within the new

MiFID/MiFIR framework, and to comply with the G20 trading commitment, would therefore not have been pursued. We note that many standardised OTC derivatives are currently traded on these platforms. These may continue to operate under the systematic internalisation rules, but with a much reduced scope as firms would not be able to trade in standardised derivatives subject to the MiFIR trading obligation (as that is currently drafted in a way that only allows such trading to occur on regulated markets, MTFs and OTFs). The trading obligation under MiFIR combined with the OTF operator capital ban therefore means that these platforms will not be able to be used for a large proportion of what they currently facilitate, without meeting any particular policy objective.

We do not support the new MiFID Article 20(3) that states that “Member States shall not allow the operation of an OTF and systematic internalisation to take place within the same legal entity.” Requiring subsidiarisation is unnecessary, when conflicts of interest rules already address the potential conflicts that arise from having both activities in the same entity. The additional costs to clients of requiring such restructuring would not provide any additional benefits.

Post-trade disclosure

It appears that MiFIR Article 20 contains a drafting error. MiFIR Article 20(2) includes a cross-reference to MiFIR Article 10, stipulating that where a venue-traded contract is subject to deferred publication under Article 10, then deferred publication also applies when it is traded on an over-the-counter basis. However, Article 10 only deals with contracts traded on trading venues, so the cross-reference in Article 20 does not provide for deferred publication for contracts that are only traded OTC, where the need for post-trade deferral and volume masking is in fact particularly great, due to the generally lower level of liquidity and higher degree of customisation typical of purely OTC contracts.

There are a number of potential solutions here:

- Re-draft Article 10 so that it allows for deferred publication and volume masking for all instruments, including ones that are not traded on a trading venue.
- Introduce new wording to Article 20 to enable the adoption of delegated acts specifying when deferred publication applies to contracts that are not traded on a trading venue.
- Change the scope of derivatives contracts covered under Article 20, such that only contracts that are traded on a trading venue are caught. The cross-reference to Article 10 would then no longer be problematic.

We believe the latter option would be the most practical to implement and would avoid unnecessary duplication of EMIR provisions on reporting to trade repositories.

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