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Review of the MIFID II/ MIFIR Framework

The revised Markets in Financial Instruments Directive and Markets in Financial Instruments Regulation (MIFID II/MIFIR) were critical elements of the European Union's (EU) effort to address shortcomings exposed by the financial crisis. Among other things, the framework was aimed at incentivizing the trading of standardized over-the-counter (OTC) derivatives on exchanges and electronic trading platforms where appropriate, in order to improve transparency and ensure a level playing field between existing trading execution techniques.

These objectives have not entirely been met, and adjustments are required to make rules on data and reporting, transparency and systematic internalisers (SIs) more effective. In addition, the lack of equivalence decisions for non-EU trading venues, particularly in a post-Brexit environment, could result in market fragmentation.

EU policy-makers are now reviewing MIFID II/MIFIR in light of market developments to determine which legislative adjustments are appropriate. ISDA believes the European Commission (EC) should adopt a 'Refit' approach, rather than a complete re-write of the legislation. This paper explores five key areas where a recalibration of the rules would be appropriate and would further enable safe, efficient derivatives markets.

INTRODUCTION

The MIFID framework is the cornerstone of EU financial legislation, and covers a number of key issues. In particular, it defines:

- The conditions under which investment firms are licensed to provide investment services and the conduct of business rules they have to comply with;
- Trading venues and the conditions under which trading venue operators can provide services;
- Financial instruments covering all asset classes accessible to wholesale and retail investors.

As MIFID defines financial instruments, it is cross-referenced in all major pieces of EU financial legislation including the Market Abuse Regulation (MAR), the Short Selling Regulation, the European Market Infrastructure Regulation (EMIR), the EU Benchmarks Regulation (BMR) and the Securities Financing Transactions Regulation.

MIFID I was originally drafted to create the conditions for broader competition between banks and investment firms and between traditional exchanges and alternative trading venues. The aim was to provide more choice for investors and lower intermediation prices.

In drafting MIFID II, the EC stated that it would:

- Ensure organized trading takes place on regulated platforms;
- Improve the transparency and oversight of financial markets – including derivatives markets – and address some shortcomings in commodity derivatives markets; and
- Improve conditions for competition in the trading and clearing of financial instruments.

In addition, MIFIR sets out requirements on the disclosure of trading activity data to the public and disclosure of transaction data to regulators and supervisors. It also covers the mandatory trading of derivatives on organized venues.

The MIFID II/MIFIR framework became applicable on January 3, 2018, overhauling existing regimes and addressing all asset classes. This makes it one of the most ambitious implementation exercises carried out by the financial industry.

The constant dialogue between the industry and national competent authorities (NCAs) and the European Securities and Markets Authority (ESMA) has helped both market participants and regulators to apply the legislative and regulatory framework. In this respect, the various ESMA Q&As, opinions and consultations have been of significant importance.

However, the EC is now reviewing MIFID II/MIFIR and will propose legislative adjustments.

ISDA strongly supports a 'Refit' approach to MIFID II/MIFIR rather than a complete re-write of the existing legislation.

In this paper, ISDA sets out five areas where a recalibration of the rules would be appropriate:

- Reporting and post-trade transparency:
- Re-calibration of the pre-trade transparency regime for certain asset classes;
- Limitation of the mandatory systematic internaliser regime to 'traded on a trading-venue' (ToTV) instruments only;
- Re-focus of the commodity derivatives position limits regime to meet the stated policy objective;
- The derivatives trading obligation (DTO).

In addition, the industry and regulators face new related uncertainties and implementation challenges associated with Brexit. As an example, where the MIFID II/MIFIR framework is based on EU metrics (eg, the SI regime or calibration of the transparency regime), ESMA should consider the impact of Brexit and the recalibration of rules once UK data is no longer included in the calculation of EU metrics.

POLICY RECOMMENDATIONS	
Reporting and post-trade transparency	Improve the accuracy, consistency and quality of reference data in order to achieve the Markets in Financial Instruments Directive's (MIFID) objectives of investor protection through best execution, broader and fair competition between trading venues and enhanced market supervision. Consult the industry on calibration and use of International Securities Identification Numbers (ISINs) for derivatives, and then amend Table 3 of the Annex to regulatory technical standard (RTS) 23 to improve the generation of ISINs to make the Financial Instruments Reference Data System (FIRDS) an accurate source of data for products reported. Ensure the reference data system collects accurate information on products and trades and protects the anonymity of counterparties.
Pre-/post trade transparency	Support market liquidity by ensuring an appropriate assessment and calibration of pre-/post-trade transparency waivers. Consult the industry on a review of Annex III to the European Securities and Markets Authority (ESMA) RTS 2 to appropriately calibrate the waivers to match the economic characteristics of certain asset classes.
Scope of the mandatory systematic internaliser (SI) regime	In line with MIFID II/Markets in Financial Instruments Regulation (MIFIR) policy objectives for a level playing field between SIs and trading venues, realign the scope of the transparency requirements for SIs to cover only products that are traded on trading venues. Amendments to article 4.1(20) of MIFID II and article 27 of MIFIR to clarify that the mandatory as well as the optional SI regimes apply to 'trading on a trading venue' (ToTV) instruments only.
Commodity derivatives position limits regime	Re-focus the scope of the position limits regime on the most critical contracts, and particularly food commodity contracts, and clarify that limits do not apply to securitized contracts and to contracts with no physical underlying commodity. Expand the hedging exemption to make it available to financial institutions.
Derivatives trading obligation (DTO)	Provide relief for small financial counterparties from the conflicting requirements of the DTO under MIFIR and the clearing obligation under the European Market Infrastructure Regulation (EMIR) (amendment to article 28 of MIFIR) by clarifying that the former should be a subset of the latter. Enable a DTO suspension power under a pre-defined mechanism and pre-defined criteria. Clarify that the introduction of benchmark fallback clauses (under article 28(2) of the EU Benchmarks Regulation (BMR)) in legacy contracts does not trigger application of the DTO.
Trading venue equivalence	Mitigate potential market fragmentation and disruption by publishing the equivalence assessments due to be carried out by mid-2020 between the EU and UK under MIFIR article 28(4) in order to enable mutual equivalence decisions by jurisdictions in the early part of the second half of 2020. Absent such equivalence decisions, the European Commission (EC) would have to find another legal path to address the conflict of rules or to re-scope the EU DTO so it does not prevent provision of services to clients across jurisdictions.

REPORTING AND POST-TRADE TRANSPARENCY

Policy Recommendations

Improve the accuracy, consistency and quality of reference data in order to achieve MIFID's objectives of investor protection through best execution, broader and fair competition between trading venues and enhanced market supervision.

Consult the industry on calibration and use of ISINs for derivatives, and then amend Table 3 of the Annex to RTS 23 to improve the generation of ISINs to make FIRDS an accurate source of data for products reported.

Ensure the reference data system collects accurate information on products and trades and protects the anonymity of counterparties.

Regulatory reporting and post-trade transparency serve two different purposes:

- Regulatory reporting aims to enable NCAs to supervise the trading behavior of market participants – in particular, involving any build-up of risk – and improve the detection of possible market abuse or breach of conduct of business rules.

- Post-trade transparency aims to give investors information on trades after execution.

As a result, their scope is different. For derivatives instruments, regulatory reporting applies to ToTV and uToTV[1] instruments, whereas post-trade transparency applies only to ToTV instruments.

However, the way in which the MIFID II/MIFIR was implemented created some ambiguity over the scope of transparency and weaknesses in the reference data system.

It is critical to ensure the accuracy of the Financial Instruments Reference Data System (FIRDS) and the identification of derivatives

- **FIRDS is best placed to be the reference data 'master' source …**

A number of key objectives of MIFID – broader and fair competition between trading venue operators to lower intermediation prices, protection of investors through best execution and market supervision by regulators – depend on data. More precisely, they depend on data quality, accuracy of data and access to data.

In order for reporting to be consistent and accurate across all submitting parties, the reference data must be consistent and equally available to all market participants. There is currently a lack of a single 'master' source of reference data, which increases the risk of inconsistent reporting. Recognition of a single source would enable market participants to work from the same data and be confident that all reporting parties are applying it consistently.

[1] uToTV means: a) financial instruments where the underlying is a financial instrument admitted to trading or traded on a trading venue; or b) financial instruments where the underlying is an index or a basket composed of financial instruments admitted to trading or traded on a trading venue

FIRDS should be that 'master' source and it is best placed to be treated as such. However, it would be illogical to require the reporting of all product information to FIRDS if the industry cannot rely on the system. Reliability of FIRDS would avoid the need to develop a second 'master' source at great cost for little (if any) value. Currently, there are some ambiguities in the data specifications for submission to FIRDS, which can lead to inaccurate reference data being held.

Market participants have observed instances where firms have independently verified reference data for in-scope instruments, only to see their submissions using this reference data being rejected from NCA systems. This results in re-reporting of information when the data in FIRDS is updated (eg, International Securities Identification Numbers (ISINs) on newly issued bonds, and reference data attributes associated with ISINs issued by bodies such as the Association of National Numbering Agencies).

- **But the origination of ISINs requires improvements**

The origination of ISINs for derivatives has proved challenging in many instances and requires improvements. ISINs are used for the identification of derivatives in the EU and are the basis for transparency, which itself is based on ToTV instruments.

However, there have been issues with the origination of ISINs for derivatives that require appropriate adjustments. These issues make transparency for OTC derivatives difficult to implement and potentially misleading for end users.

On the one hand, there are large numbers of ISINs and often multiple ISINs for economically comparable products. Several trade-level attributes are included in ISINs for certain OTC derivatives instruments – for example, 'expiry date' (maturity date) is a required attribute for interest rate swaps. Each day, interest rate swaps are traded with a different maturity dates and therefore map to different ISINs.

The consequence of including these trade level attributes is the creation of multiple ISINs for comparable OTC derivatives instruments/products, making it very difficult for end users to benefit from transparency. If interest rate swaps referenced the tenor of a swap instead of the maturity date, the number of ISINs required for what would essentially be the same swap product would be greatly reduced[2]. While tenor was introduced in ESMA's Q&A on September 26, 2018, it was added alongside maturity date, resulting in more ISINs, not less. This example supports the view that ESMA should reassess the criteria for generating ISINs.

On the other hand, some price forming attributes 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 five-year swap traded today will have the same ISIN as a one-year forward-starting four-year swap with the same attributes. These are different instruments and are therefore priced differently despite having the same ISIN.

[2] There may be instances where there is duplication with the tenor model – eg, if a five- year swap is closed out in a year's time with a four-year swap, meaning those two trades (that would compress to zero) would have different ISINs. However, tenor remains much more sensible than maturity

In addition, there is no way to distinguish between standard and non-standard versions of OTC derivatives instruments that may include additional price-forming terms and features (such as embedded options and bespoke fallbacks). Not including all these price-forming attributes means transparency on such ISINs is not meaningful for end users[3].

European policy-makers also need to clarify how the ISIN will be used after the international standard for the identification of derivatives – the unique product identifier (UPI) – goes live. ISINs are now so ingrained in MIFID that it is important to make UPIs converge with ISINs to avoid creating duplication and forcing firms to obtain two different identifiers for the same contract. A wide consultation with all stakeholders is necessary to agree how to improve the ISIN system (notably, the calibration and usefulness of ISINs for some derivatives).

The reporting of trades and financial instruments should not lead to a systematic disclosure of counterparties

The reference data reporting regime under MIFID II is designed to collect instrument reference data. The publication of SI market identifier codes (MIC) and legal entity identifiers (LEIs) in publicly available reference data is a concern because SIs trade on a bilateral counterparty basis, unlike multilateral trading venues. They therefore need some anonymity to be able to provide an important source of liquidity to the market.

However, data collected on instruments traded on SIs currently includes information that identifies the counterparty, and this data is made available to all users that consume FIRDS data. Even with no price or volume data, this substantially increases the risk of an SI not being able to trade at market terms and may affect their ability to provide vital liquidity, which ultimately affects end users.

In contrast, the transparency framework in MIFID II/MIFIR does not require the identity of trading counterparties to be disclosed in the transparency data, which recognizes the important role that SIs play in providing alternative sources of liquidity. We would urge legislators to consider changing the reference data reporting requirements so the identity of the SI is not disclosed publicly in the FIRDS file.

In addition, it is important to work towards a solution for the reporting of personal data for natural persons. Currently, sensitive information including surnames, dates of birth and national identifiers (ie, raw personal data) must be disclosed in MIFID II/MIFIR transaction reports and kept in the records of firms and trading venues. This information is shared among multiple entities – for example, approved reporting mechanisms (ARMs) and trading venues.

The large volume of raw personal data that is being transferred between market participants exposes them and their data transmission arrangements to increased risk of cybersecurity threats. It also increases the risk of identity theft for natural persons whose personal information is being reported or kept for the purposes of the MIFID II/MIFIR order record-keeping requirements. Any trading venue, ARM or other financial market infrastructure that holds personal data should be required to demonstrate to its regulator that it meets a minimum standard of cybersecurity – for example, ensuring this information is held in encrypted form.

[3] Given the price basis between: a) the same swap at different central counterparties (CCPs); and b) bilateral swaps and cleared swaps in general, there is insufficient information contained within the ISIN for the end user to understand whether this price is relevant to them (ie, at a CCP at which they clear) or whether it is irrelevant and perhaps misleading

Rather than personal identifiers specified in the MIFID II/MIFIR technical standards, it would be beneficial if a unique universal identifier was developed as a long-term solution. This would help mitigate concerns about sharing raw personal data, as well as assist regulators by creating a reliable and persistent form of identification that would not change over time (eg, if passport numbers change).

An International Organization for Standardization (ISO) study group has been established to consider the creation of an ISO standard for the identification of natural persons (similar to an LEI for natural persons). European policy-makers should monitor ISO's work and consider potentially endorsing such an ISO standard in the future.

The reporting of trades should reflect the economic features of the product

Transaction reports under MIFID II are very granular. However, some aspects of the information that needs to be reported do not improve the understanding of a product's economic features. This is particularly the case for certain categories of equity derivatives, where the price field can lead to an inaccurate understanding of the economics of the product. Dialogue between the industry and ESMA to find appropriate solutions is critical here.

RE-CALIBRATION OF TRANSPARENCY FOR CERTAIN ASSET CLASSES

Policy Recommendations

Support market liquidity by ensuring an appropriate assessment and calibration of pre-trade transparency waivers.

Consult the industry on a review of Annex III to ESMA RTS 2 to appropriately calibrate the waivers to match the economic characteristics of certain asset classes.

The purpose of pre-trade transparency is to give investors current orders and executable quotes before the trade is executed, in order to facilitate price formation and help investment firms/ banks provide best execution. This is a central concept for liquid and fungible instruments traded under different techniques – for example, equities.

Pre-trade transparency on derivatives is often different in nature because a majority of derivatives markets do not operate with direct interaction between buying and selling orders. In addition, many derivatives instruments are not liquid.

MIFIR has introduced a harmonized 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.

However, article 9 of MIFIR recognizes that certain exemptions from the general requirement to publish pre-trade transparency data are necessary 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:

- Orders above a certain volume threshold (the large-in–scale (LIS) waiver);
- Indications of interest in request-for-quote and voice trading systems above a size specific to the instrument (SSTI);
- Derivatives not subject to the trading obligation and instruments classified as illiquid, regardless of their volumes (illiquid instrument (IL) waiver).

ESMA regulatory technical standard (RTS) 2 sets out the methodology for calculating LIS thresholds and determining illiquid instruments. The LIS calculation is based on a threshold floor expressed in notional trade value in a given sub-asset class and the trade size below which lies the percentage of transactions corresponding to the trade percentile specified by the RTS for that sub-asset class. The IL thresholds are determined on the basis of the average daily trade notional amount and the average daily number of trades as specified by RTS 2 for a given sub-asset class (except for certain equity derivatives, as explained further in this section).

Industry participants have consistently stated that the transparency regime is not calibrated correctly to match the economic characteristics of certain products that are actually traded, and this could significantly impair liquidity in those markets. Fundamentally, a 'crude' taxonomy applies to a heterogeneous asset class characterized by low liquidity, so this asset class is treated as homogeneous and deemed liquid.

The calibration of transparency is therefore not appropriate for some asset classes or sub-asset classes.

Interest rate derivatives

There have been conflicting messages regarding the scope of the interest rate options sub-asset class in RTS 2, resulting in a scope of application covering listed interest rate options and OTC options that are ToTV (there is a separate sub-asset class for swaptions).

In the context of OTC interest rate options, the transitional transparency calculations (TTC) for the SSTI and LIS thresholds for interest rate options are extremely high because the calculations have only incorporated data from listed rather than OTC interest rate options (which are traded at much smaller volume).

Credit derivatives

For index credit default swaps (CDS), the specified 'time to maturity bucket' in the TTC is inconsistent with the RTS 2 additional qualitative liquidity criterion for this sub-asset.

The five-year 'on-the-run' index CDS includes any maturity from 5.25 to 4.75 years. The market moves to a new 'on-the-run' contract every six months (on March 20 and September 20). For example, the 'on-the-run' five-year index CDS contract on April 1, 2020 was the June 20, 2025 maturity. On September 20, 2020, the market will move to trading the December 20, 2025 maturity. This concept of 'on-the-run' status is consistent with how 'five-year tenor' is defined for the purpose of the clearing obligation.

The RTS 2 additional qualitative liquidity criterion for index CDS (Table 9.1 of RTS 2) states that the underlying index is considered to have a liquid market: (1) during the whole period of its 'on-the-run status'; and (2) for the first 30 working days of its '1x off-the-run-status'.

ESMA has clarified that instructions on how to calculate the four- to five-year time-to-maturity buckets in the templates for data collection on non-equity instruments took into account the additional 0.25 year period of the five-year 'on-the-run' contract. However, while the full period of the 'on-the-run' series is captured, the entire period of the '1x off-the-run-status' is also captured. This is not consistent with part (2) of the additional qualitative liquidity criterion. This inconsistency can potentially lead to inappropriate SSTI/LIS threshold levels.

It is essential that the SSTI/LIS post-trade thresholds are calibrated correctly to ensure end users can continue to transact in large trade volumes. If set too high, very large trades will be subject to real-time transparency, and market makers may be unable hedge and unwind their positions. This will ultimately result in a reduction of liquidity and wider spreads at the expense of end users. This is likely to impede non-financial investment decisions or investment decisions in other financial asset classes.

Equity derivatives

RTS 2 (Annex 1, Table 6.1) considers all instruments within the equity derivatives options and futures/forwards sub-asset classes to have a liquid market, despite data showing low levels of trading in many of the instruments within these sub-asset classes. Although the impact of inappropriate pre-trade transparency requirements applying to illiquid contract types is different across trading venues and OTC markets, this approach is not aligned with the primary MIFIR legislation.

The Level 1 legislation defines a liquid market as being "where there are ready and willing buyers and sellers on a continuous basis", and requires assessment based on average frequency and size of the transactions criteria. ISDA recommends that ESMA adopts a granular approach to determine the liquidity of sub-classes within these equity derivatives sub-asset classes, similar to the approach taken for interest rate and credit derivatives sub-asset classes.

LIMITATION OF THE SI REGIME TO TOTV INSTRUMENTS ONLY

Policy Recommendations

In line with MIFID/MIFIR policy objectives for a level playing field between SIs and trading venues, realign the scope of the transparency requirements for SIs to cover only products that are traded on trading venues.

Amendments to article 4.1(20) of MIFID II and article 27 of MIFIR to clarify that the mandatory and the optional SI regimes apply to ToTV instruments only.

The policy objective behind MIFID II/ MIFIR's SI regime is to apply a level playing field between trading venues and SIs by requiring greater price transparency for OTC trading of venue-traded instruments, with the ultimate aim of encouraging trading of these types of instruments on trading venues. SIs are therefore subject to the post-trade transparency regime, which applies only to ToTV instruments.

The MIFID II SI regime consists of:

- The mandatory regime where an investment firm becomes an SI on a product when each of the pre-set limits for a frequent and systematic basis and for a substantial basis are crossed; and

- The optional regime where an investment firm can choose to opt in for any financial instrument.

Under article 4(1)(20) of MIFID II, an SI is an investment firm that, on an organized, frequent, systematic and substantial basis, deals on its own account when executing client orders outside a regulated market, a multilateral trading facility (MTF) or an organized trading facility (OTF). The frequent and systematic part is measured by the number of OTC trades in the financial instrument carried out by the investment firm on its own account when executing client orders.

The substantial criteria is measured by:

- The size of OTC trading carried out by the investment firm in relation to the total trading of the investment firm in a specific financial instrument; or

- The size of OTC trading carried out by the investment firm in relation to the total trading in the EU in a specific financial instrument.

Becoming an SI for derivatives triggers various requirements that come in addition to the reporting of transactions under RTS 22 that is applicable to all investment firms:

- Pre-trade transparency requirements under RTS 2 for SIs trading ToTV products;

- Supply of FIRDS under RTS 23 if instruments are uToTV only (and not ToTV).

In order for an investment firm to determine whether it is a mandatory SI in a financial instrument, it must undertake two steps:

- Calculations based on the pre-set limits;

- Final determination of SI status at a class-of-instrument level once the obligation is triggered as a result of the calculations.

Mandatory SI assessment (calculations)

Mandatory SI assessments seek to identify investment firms' trading activity meeting the SI criteria in instruments that are traded on trading venues. As transparency applies only to ToTV instruments[4], the scope of the mandatory SI assessment should also only apply to ToTV instruments. Only this interpretation supports the original policy objective of the mandatory SI regime. The legislative framework should therefore be amended to achieve this aim.

In addition, ESMA noted in its Q&A on transparency[5] that it would only publish data on ToTV instruments for the purposes of the SI assessment. ESMA also confirmed that types of transactions that were not subject to transparency should be excluded from the SI assessment[6].

[4] Under article 22 of MIFIR, only trading venues, approved publications arrangements and consolidated tape providers are required to submit data on which ESMA bases its transparency calculations. The scope is necessarily limited to instruments subject to the transparency obligation (ie, ToTV instruments)

[5] ESMA's Q&A transparency, Section 7 – the SI regime – Question 11 pages 60-61: *ESMA is only publishing information on ToTV instruments for determining whether an investment firm meets the thresholds to be considered as a systematic internaliser*

[6] ESMA's Q&A transparency, Section 7 – the SI regime – Question 3 pages 53: *Article 13 of RTS 1 and Article 12 of RTS 2 exempt investment firms from reporting certain types of transactions for the purposes of post-trade transparency. ESMA is of the view that those types of transactions should not be part of the calculations for the purposes of the definition of the systematic internaliser regime, both for the numerator and the denominator of the quantitative thresholds*

Applying the mandatory SI assessment to instruments that are not ToTV ultimately does not provide comparable information because these instruments are, by their nature, not traded on any trading venue. If any of these instruments were traded on any trading venue later, it would be appropriate to apply the mandatory SI assessment to those instruments at that time.

Unfortunately, there are different interpretations on the scope of application of the mandatory SI calculations across the industry and between NCAs. Some NCAs believe calculations should only include ToTV instruments, while others think uToTV should also be part of the calculations. This creates uncertainty and confusion.

Given the main purpose of the SI regime was to ensure a level playing field between trading venues and investment firms operating as SIs for the trading of ToTV instruments, there is no reason why an investment firm operating an SI should be subject to the obligations applicable to trading venues when they transact in instruments that are not ToTV.

Obligations triggered by the mandatory SI regime – supply of reference data

Limiting the scope of application of the SI regime to ToTV instruments only will affect reporting of uToTV reference data to FIRDS under RTS 23. That's because only investment firms that have opted into being SIs for uToTV instruments will have the obligation to report reference data under RTS 23[7].

Under RTS 23, trading venues have responsibility for reporting reference data in relation to instruments traded on a trading venue, and SIs have responsibility for reporting reference data in relation to uToTV instruments. However, legislators should carefully consider whether reference data relating to uToTV instruments that NCAs receive ultimately supports the original policy objectives of the reference data reporting regime.

FIRDS aims to help NCAs in their effective monitoring of the markets by standardizing instrument reference data, notably using ISINs for the identification of derivatives products.

With or without uToTV instruments, FIRDS will never mirror the entire scope of instruments that NCAs have to monitor. That's because uToTV instruments that are not traded by SIs will not be part of it. In contrast, all trading venues must submit reference data on instruments traded on their platforms, so the data in FIRDs will reflect the full scope of instruments that are traded on a trading venue.

The transaction reporting regime under RTS 22 already provides NCAs with good information to support their market monitoring objectives, for three reasons. First, the reporting of transactions includes the same data fields as under RTS 23. Second, uToTV instruments are covered in transaction reports. Third, transaction reporting under RTS 22 relieves some of the concerns that market participants have regarding the use of the ISINs for derivatives[8].

The application of the reference data reporting obligation to uToTV is posing insoluble practical issues without giving the full picture to NCAs and ESMA. As the policy objective of collecting reference data under RTS 23 is to support NCA's market monitoring responsibilities, incomplete data that is not comparable does not ultimately support that aim.

[7] In contrast, it is clear that RTS 2 (transparency) applies to ToTV instruments only and that RTS 22 (transaction reporting) applies to ToTV and u-ToTV instruments irrespective of their SI classification

[8] Reporting through FIRDS involves the generation of ISINs, whereas transaction reporting does not. This means an SI uToTV would require the generation of an ISIN, whereas the identical non-SI uToTV would not

Ability to opt-in for all instruments is questionable as it creates confusion and inaccuracies in FIRDS

Recital 33 of MIFIR refers to the obligation of trading venues to supply reference data to support the market monitoring objectives of NCAs. It is therefore logical to assume the original scope of the RTS 23 reporting regime was intended for ToTV instruments only.

The ability to use the SI regime on a voluntary basis for non-ToTV instruments does not pose any operational problem with the trading of these instruments. However, because it triggers the supply of reference data into FIRDS, the opt-in regime for non-ToTV instruments creates confusion because FIRDS will mirror only a small fraction of the non-ToTV market, because those non-TOTV instruments not traded on an SI are not supplied to FIRDS.

Limiting the SI optional regime to ToTV instruments would therefore solve problems associated with the supply of non-ToTV instruments data into FIRDS, such as the quality of data in FIRDS, the anonymity of SIs in FIRDS, and ISIN generation for derivatives.

It would also solve one of the issues raised in the context of the EU BMR. As stated earlier, ESMA's updated market transparency Q&A 11 acknowledges that "it might be challenging for investment firms to access reliable and comprehensive sources of EU wide information preventing de facto the systematic internaliser test to be carried out".

It may be practically impossible for firms to know whether they have become an SI in particular non-TOTV instruments. The unfortunate result is that these firms cannot know which OTC derivatives are 'financial instruments' in scope of the BMR, and therefore cannot be sure they are complying with their obligations on the use of benchmarks, except by assuming that all OTC derivatives are in scope.

The Annex includes a template of the existing scope of the rules and the targeted scope after reform.

RE-FOCUS OF THE COMMODITY DERIVATIVES POSITION LIMITS REGIME

Policy Recommendations

Re-focus the scope of the position limits regime to the most critical contracts, and particularly food commodity contracts, and clarify that limits do not apply to securitized contracts and to contracts with no physical underlying commodity. This requires amendments to article 57.1 of MIFID II and a mandate to ESMA in article 57.3 to define criteria for 'critical contracts'.

Expand the hedging exemption to cover financial institutions. This requires an amendment to article 57.1 of MIFID II.

The MIFID II commodity derivatives position limits regime set out in article 57 of MIFID II is an unprecedented regime in the EU and has no equivalent in other jurisdictions.

The legitimate objective behind this regime is to prevent market abuse through excessive speculation on certain commodities, particularly food, and to support orderly pricing and settlement conditions – notably, by ensuring convergence between prices of derivatives in the delivery month and spot prices for the underlying commodity.

Industry participants have highlighted two fundamental issues in the way the regime is defined.

- First, the ambiguity of the scope of application of the regime. This derives from the definition of commodity derivatives under article 2.1(30) of MIFIR, which covers transferable securities or derivatives with no physical underlying. This therefore creates uncertainties and complexity;

- Second, the lack of flexibility of the regime as applied to new and illiquid contracts. The rules under ESMA RTS 21 prevent the development of markets for new and illiquid contracts.

The objectives of the regime are still relevant and it would not be appropriate to modify the general equilibrium of it. However, fine-tuning is required to make the framework more precise, fit for purpose and effective.

For industry participants, amendments to the current regime would improve its effectiveness in preventing excessive speculation on underlying commodities while allowing market growth. It would also allow the EU to remain competitive in a global commodities market.

Re-focus the scope of the position limits regime to apply to the most critical contracts, and particularly to food commodity contracts

This would help solve problems with the application of limits to new and illiquid contracts, where exchanges, dealers and end users have raised concerns that the existing limits are a hurdle to the development of markets for new contracts, even with the flexibility granted under ESMA RTS 21. ESMA recently proposed in this respect to limit the regime to a “set of important, critical derivatives contracts”.

The criteria used to shape the scope of ‘critical contracts’ is undefined and should be considered in light of the following elements:

- Given the regime is focused on convergence between the pricing of derivatives and the underlying commodity, it would be sensible to remove limits from any contracts where there is no associated deliverable supply. Such an approach would also be consistent with the proposal to remove securitized derivatives, which also have no deliverable supply, from the regime;

- The nature of the underlying commodity;

- The size of the markets;

- The importance for the supply of the underlying commodity across the EU;

- The existence of non-EU markets for the same commodity, with EU competitiveness in mind.

Explicitly exclude those financial instruments covered by article 2.1(30) of MIFID that are not derivatives or are derivatives but have no physical underlying

Expand the scope of the hedging exemption

While the position limits regime includes exemptions for market participants pursuing hedging activity, the MIFID II definition of 'hedging' as set out in RTS 21 is clear that only non-financial entities can engage in such activity. As a result, the exemption is unavailable for investment banks and commodity trading houses that are MIFID II authorized. Both of these groups play a vital role in providing smaller commercial entities with access to commodity derivatives markets.

No change to the carve-out for physically settled power and gas contracts

Physically settled power and gas contracts traded on OTFs are already regulated under the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT) and supervised by the Agency for the Cooperation of Energy Regulators. The interlinkage of wholesale gas and power markets in the EU remains unique in commodity markets. Even though the Market Abuse Directive was reformed after REMIT's adoption, and MAR now addresses insider trading and market manipulation of commodity derivatives and spot commodity contracts, the basis for a specific regulation addressing European gas and power markets remains. It would not be appropriate to duplicate regulation and to apply the MIFID framework to these markets.

DERIVATIVES TRADING OBLIGATION

Policy Recommendations

Provide relief for smaller financial counterparties from the conflicting requirements of the DTO under MIFIR and the clearing obligation under EMIR (amendment to article 28 of MIFIR) by clarifying that the former should be a subset of the latter.

Create a power to suspend the DTO under a pre-defined mechanism and pre-defined criteria.

Clarify that the introduction of benchmarks fallback clauses (under article 28(2) of the EU BMR) in legacy contracts does not trigger application of the DTO.

The DTO under article 28 of MIFIR needs to be amended in order to:

- Address the misalignment with the EMIR clearing obligation;
- Address potential unintended consequences from the introduction of benchmark fallback clauses under the EU BMR.

Misalignment between the MIFIR DTO and the EMIR clearing obligation

Aligning MIFIR with changes introduced by the EMIR Refit – ie, the misalignment of the DTO under MIFIR and the clearing obligation under EMIR – is a critical concern for market participants.

Following the entry into force of the EMIR Refit, all financial counterparties remain subject to the DTO, despite the introduction of the small financial counterparty (SFC) regime[9]. SFCs are exempt from the CO but still need to apply the DTO, meaning they face two inter-related problems.

- Small counterparties are effectively forced back into clearing. Trading venues in the EU do not widely offer trading of non-cleared derivatives. If SFCs continue to comply with the DTO, they will be subject to the clearing obligation as a result. This would undermine the objective of the SFC regime, which is intended to make compliance with EMIR more proportionate and less onerous for SFCs.

- Required trading venue connectivity for small counterparties translates into a disproportionate administrative burden. Many SFCs only execute a handful of trades per year. It is therefore inappropriate to require these entities to execute these transactions on trading venues. In order to comply with the DTO, counterparties may have to establish connectivity to multiple trading venues. Despite this, these transactions would not contribute to the objective of the DTO – ie, enhancing liquidity and transparency in EU financial markets.

- In light of this, industry participants believe the scope of transactions subject to the DTO under MIFIR should be a subset of transactions covered by the clearing obligation under EMIR. In order for a derivatives transaction to be subject to the DTO, it should, as a precondition, be covered by the clearing obligation. Alignment should not be expressed solely in terms of counterparties covered.

This would ensure that future amendments to EMIR (and supplementary regulations) would not lead to misalignment. Cross references in MIFIR to specific EMIR articles could be replaced by a broader clarification. ISDA believes the cross-reference on non-financial corporates between MIFIR article 28(1) and EMIR illustrates the added value of an alignment, as the current situation does not lead to any logical conclusion.

Unintended consequences of the introduction of benchmark fallback clauses under the EU BMR

Article 28(2) of the EU BMR requires EU supervised entities to have written plans in place setting out robust fallbacks that would take effect following the discontinuance or material modification of a benchmark, including the nomination of a substitute index where feasible and appropriate.

ISDA has published supplements to the relevant ISDA definitional booklets to address this requirement. Entities located outside the EU may in the future receive requests to incorporate these supplements into derivatives trading documentation with supervised entities in the EU.

On December 5, 2019, the European Supervisory Authorities (ESAs) published a statement on the introduction of fallbacks in OTC derivatives contracts and the impact on margining requirements for non-cleared trades. The ESAs clarify that: *"Fall-backs introduced in OTC derivative contracts, reflect written plans which set out the actions that counterparties would take in the event that the benchmark used in these contracts materially changes or ceases to be provided. The ESAs are of the view that amendments made to outstanding uncleared OTC derivative contracts (legacy contracts) for the sole purpose of introducing such fall-backs should not create new obligations on these legacy contracts. In particular, margining requirements should not apply to these legacy contracts where they were not subject to those requirements before the introduction of the fall-backs."*

[9] ESMA supports realignment of the clearing obligation under EMIR and the DTO under MIFIR, as expressed in its final report on *Alignment of MIFIR with the changes introduced by EMIR Refit*, published on February 7, 2020. Furthermore, on July 12, 2019, ESMA published a public statement, expecting *"authorities not to prioritise their supervisory actions in relation to the MIFIR DTO towards counterparties who are not subject to the EMIR CO, and to generally apply their risk-based supervisory powers in their day-to-day enforcement of applicable legislation in this area in a proportionate manner"*

The ESAs also called for greater legal clarity in EU legislation on this point, and it is possible another EU legislative instrument may provide this clarity.

Furthermore, the introduction of fallback clauses in legacy contracts should not trigger the DTO where these contracts are in classes subject to this requirement.

In a February 2020 report on alignment between the clearing obligation under EMIR and the DTO[10] under MIFIR, ESMA to some extent acknowledged the de facto application of the clearing obligation to contracts entered into by SFCs that are subject to the trading obligation. Similarly, if it is deemed to be proportionate that a legacy contract should remain exempt from clearing if/when it is amended to insert a fallback provision, it should also be made explicit that the trading obligation does not apply to such an amended contract (given that the clearing obligation would then be likely to apply to it).

TRADING VENUE EQUIVALENCE

Policy Recommendations

Mitigate potential market fragmentation and disruption by publishing the equivalence assessments due to be carried out by mid-2020 between the EU and UK under MIFIR article 28(4) in order to enable mutual equivalence decisions by both jurisdictions in the early part of the second half of 2020. Absent such equivalence decisions, the EC would have to find another legal path to address the conflict of rules or to re-scope the EU DTO so it does not prevent the provision of services to clients across jurisdictions.

MIFID is the European vehicle to deliver the Group-of-20 commitment made in Pittsburgh in September 2009 to trade standardized OTC derivatives on exchanges or electronic trading platforms, where appropriate.

Several jurisdictions have implemented rules to apply this commitment. Derivatives markets are global by nature, meaning it is critical that equivalence decisions are taken between jurisdictions to avoid market disruption and fragmentation.

For the purpose of the trading obligation, third-country trading venues may be treated as regulated markets for shares and derivatives under MIFIR (articles 23 and 28(4)) if the EC considers the third country equivalent for this purpose.

So far, the EC has adopted two equivalence decisions for the DTO involving the US and Singapore[11]. The decision means certain trading venues authorized by the US Commodity Futures Trading Commission and the Monetary Authority of Singapore are recognized as eligible for compliance with the DTO.

[10] https://www.esma.europa.eu/emir_final_report_on_alignment_clearing_and_trading_obligations.pdf

[11] See: 1April2019_EC_equivalence_decision_Singapore_exchanges; and 5December2017_EC_equivalence_decision_US-SEFs

There are four conditions that currently need to be fulfilled before a third country's legal and supervisory framework can be considered equivalent:

- Third-country trading venues are subject to authorization and effective supervision and enforcement on an ongoing basis;
- Trading venues have clear and transparent rules on the admission of financial instruments, so those instruments are capable of being traded in a fair, orderly and efficient manner and are freely negotiable;
- Issuers of financial instruments are subject to periodic and ongoing information requirements ensuring a high level of investor protection; and
- The third country's framework ensures market transparency and integrity via rules addressing market abuse in the form of insider trading and market manipulation.

The political declaration[12] setting out the framework for the future relationship between the EU and the UK (paragraph 36) notes that both jurisdictions will have equivalence frameworks in place that allow them to declare a third country's regulatory and supervisory regimes equivalent for the relevant purposes, and that both should endeavor to conclude these assessments by mid-2020.

Liquidity fragmentation and operational complexity will be significantly exacerbated if no such decision is taken.

The extraterritorial application of the DTO under MIFIR is already creating conflicts of rules for firms operating on a cross-border basis (ie, between the EU and other jurisdictions applying a DTO).

To avoid such conflicts of rules, it is critical the EC produces equivalence decisions under MIFIR article 28(4) in favor of third-country trading venues with equivalent legal and supervisory frameworks regarding the trading obligation. Equivalence decisions would mitigate the conflict of rules that could otherwise prevent clients from accessing the services of investment firms on a cross-border basis (eg, non-EU clients using the services of an EU-based firm).

If equivalence decisions are not published, the EC will have to find another legal path to address the conflict of rules, or re-scope the EU DTO so it avoids preventing the provision of services to clients across jurisdictions.

[12] https://ec.europa.eu/commission/sites/beta-political/files/revised_political_declaration.pdf

ANNEX

MIFID II Scope Based on ToTV and uToTV

Terminology:

- *Trading Venue (TV): European economic area (EEA) trading venue as defined by ESMA – ie, exchanges, MTFs and OTFs, and based on MICs that are in the ESMA register*
- *ToTV: Financial instruments that are admitted to trading on an EEA trading venue (regulated markets, MTFs, OTFs)*
- *uToTV: Financial instruments not ToTV and with an underlying that is a financial instrument admitted to trading on an EEA trading venue – ie, ToTV (regulated markets, MTFs, OTFs)*
- *Others: Not ToTV and not uToTV*

PRESENT STATE	Pre-trade Transparency	Post-trade Transparency	Trading Venues Transparency Reporting	APAs Transparency Reporting	Mandatory SI Regime Calculations (Based on ESMA Data)	Mandatory SI Regime Application Determination	Reference Data Reporting To FIRDS	Transaction Reporting	Opt-in SI Regime
SCOPE	ToTV	ToTV	ToTV	ToTV	ToTV	ToTV	ToTV (only from TVs) uToTV (only from SIs)	ToTV (from TVs, SIs and non-SIs) uToTV (All from SIs and non-SIs)	ToTV uToTV Others

POTENTIAL TARGETED STATE	Pre-trade Transparency	Post-trade Transparency	Trading Venues Transparency Reporting	APAs Transparency Reporting	Mandatory SI Regime Calculations (Based on ESMA Data)	Mandatory SI Regime Application Determination	Reference Data Reporting To FIRDS	Transaction Reporting	Opt-in SI Regime
SCOPE	ToTV	ToTV	ToTV	ToTV	ToTV	ToTV	ToTV (only from TVs)	ToTV (from TVs, SIs and non-SIs) uToTV (All from SIs and non-SIs)	ToTV

ABOUT ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 900 member institutions from 74 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.