ISDA® Safe, Efficient Markets

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Review of EU MiFID II/ MiFIR Framework

The pre-trade transparency and Systematic Internalisers regimes for OTC derivatives

The revised Markets in Financial Instruments Directive and Markets in Financial Instruments Regulation (MiFID II/ MiFIR) were critical elements of the effort by the European Union to address weaknesses in the financial system exposed by the financial crisis and to improve market resilience and liquidity. Among other things, the framework aimed to incentivise the trading of standardised over-the-counter (OTC) derivatives on trading venues, to improve both pre- and post-trade transparency for OTC derivatives traded on a trading venue (TOTV) and to ensure a more level playing field between different trade execution techniques.

Within the spectrum of trade execution techniques, this paper looks at the role played by financial firms regulated as Systematic Internalisers in OTC derivatives markets and whether the new regime introduced in 2018 – including its price transparency elements – has delivered in practice for market participants and end-users of derivatives.

Attractiveness of EU derivatives markets and availability of liquidity in euro in derivatives largely depend upon access by end-users to all instruments – and having a well-functioning SI regime in OTC derivatives is fundamental for that attractiveness.

Systematic Internalisers is a regulatory category applied to investment firms providing liquidity in OTC derivatives markets to help end-users hedge their specific business risks. The SI regime applies when "*an investment firm which, on an organised, frequent systematic and substantial basis, deals on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system" (MiFID II Article 4.1(20)).*

The policy objective behind the MiFID II/ MiFIR's systematic internaliser (SI) regime is to apply transparency rules to trading venues and SIs by requiring greater price transparency for OTC transactions on venue-traded instruments. SIs are market participants and are neither trading venues nor market operators by their very nature; SIs are putting their own capital at risk to facilitate a transaction between two actors with different economic needs.

When assessing the functioning of the SI regime, and its effectiveness for end-users of derivatives, it is important to look at the regime specifically per asset class. A key difference between OTC derivatives and equity markets is that SIs in OTC derivatives markets are not

competing with trading venues by enabling access to fungible instruments whose price is the key factor that the investor is looking at to make a decision.

This paper aims at highlighting why liquidity providers acting as SIs in OTC derivatives markets are essential to EU clients seeking hedging tools and how this essential role requires a specific approach to the pre-trade transparency regime applicable to SIs.

In this paper, references to OTC derivatives:

- are to derivatives that are not executed on a regulated market (sometimes referred to as exchanges); and
- cover both derivatives executed on a multilateral trading facility (MTF) or organised trading facility (OTF) and derivatives executed outside trading venues.

Real-life examples of what SIs are in derivatives markets
Example 1: A German retail bank (Bank A) has to hedge against the risk associated with fixed interest rates of its portfolio of hundreds of thousands of retail clients' mortgage credits. To this purpose, Bank A will contract a fixed-to-floating Interest Rate Swap (IRS) with a liquidity provider (Bank B). The contract will be tailored to the needs of Bank A: credit risks associated with mortgage credit portfolio, credit risk generally associated with Bank A, expected evolution of interest rates. The contract is customised, and no equivalent is available on a multilateral trading venue. If Bank B provides this hedging services with customised IRS to multiple clients, it is likely that it will reach certain thresholds (linked to the size of the OTC trading) and will be deemed an SI.
Example 2: A Franco-Italian industrial joint-venture concludes a long-term floating interest rate loan with a large commercial bank (or with a group of banks if it is a syndicated loan) to finance the building of an infrastructure, e.g., a railroad tunnel under the Alps. The lending bank will need to offset the risks associated with the long-term floating rate loan. To this purpose this bank will contract a floating-to-fixed IRS with another bank. Again, this IRS will be tailored to the needs of the lending bank (credit risk generally associated with this bank, tenor of the loan) and has no equivalent in a multilateral trading venue. The bank providing the hedging tool will likely be an SI.
Example 3: An EU asset manager needs to use customised derivatives to hedge unwanted interest rate or foreign exchange risk, protect portfolios against market volatility, quickly rebalance asset allocations or take views on specific markets or sectors, and enhance returns for the end-investors (many of them being EU retail investors). This asset manager will need a bank to take on these risks and contract customised interest rate derivatives or foreign exchange derivatives to do so. The bank providing the hedging tools will likely be an SI.

1. Executive summary

a. In OTC derivatives, SIs are providers of bespoke hedging tools to clients, not competitors to multilateral trading venues

- The liquidity provider/ SI service in OTC derivatives is different from those provided by multilateral trading venues in three respects:
  - The SI provides a bespoke contract/service that the client seeking a hedging tool will not get on a multilateral trading venue.
  - The SI engages its balance sheet to facilitate a transaction and is exposed to risks whereas a multilateral trading venue operator is never exposed to such risk.
  - The pricing of the contract includes specific elements relating to the clients (credit/counterparty risk) or to the contractual relation (central clearing, netting agreement and existence of a collateral agreement for contracts not subject to clearing) that makes the price specific to the transaction. This price will not be the same for another similar contract.
- There are different concepts used to qualify financial institutions that take on the risks of their clients by offering them OTC derivatives: market makers, liquidity providers, risk providers. And many of these financial institutions will be deemed SIs under MiFID II/ MiFIR because they are providing these services to multiple clients and therefore are reaching certain quantitative thresholds. But the key difference with SIs in equity markets is that they are not competing with trading venues by enabling access to fungible instruments whose price is the key factor that the investor is looking at to make a decision.
- In equity markets, investors are seeking capital gain and are making investment decisions in light of two factors: a) comparison of buying and selling orders to identify the best price and b) comparison of the transaction fees applied by trading venue operators or SIs. In OTC derivatives markets, end-users follow a loss-limiting strategy linked to the risk they are facing in the course of their commercial/ industrial business.

b. Pre-Trade Transparency in OTC derivatives markets consists in publicising the risks faced by the end-user and taken on by liquidity providers

- 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.

- Market makers and liquidity providers (whether or not operating as SIs) play a key role in OTC derivatives markets and it is vital that they are not subjected to requirements that would expose them to undue risk and reduce the ability of EU end-users to access hedging tools.

- The concept of SI is sometimes described as if it was a non-transparent 'trading-venue like' pool of liquidity. The lack of sound distinction in MiFID II between the SI regime for OTC derivatives and bonds, which are all captured under the heterogeneous and misleading concept of 'non-equity instruments', partially explains this confusion. In OTC derivatives markets, as highlighted above, SIs are liquidity providers on instruments that are not traded on multilateral trading venues and they respond to legitimate needs of wholesale clients.

- Attractiveness of EU derivatives markets and availability of liquidity in euro in derivatives largely depend upon access by end-users to all instruments. The application of securities-like transparency rules to OTC derivatives markets will not contribute to any additional liquidity in trading venues or level playing field but it will simply reduce the availability of OTC derivatives for European clients as liquidity providers will not be in a position to engage their capital without being exposed to significant undue risks. Undue risks are additional risks, associated with the publication of their exposure by SIs before they can offset this exposure, that can lead other market participants to take advantage of it with predatorial behaviour. In derivatives markets, OTC derivatives are complementary to exchange traded derivatives rather than competing products.

- For end-users of derivatives, particularly commercial and industrial corporations, transparency on large transactions or on transactions referring to a illiquid underlying can distort the price formation process to the detriment of the end-user. If the transaction is split up into smaller buckets (which is a common practice for larger and/or illiquid transactions), hedging transactions done at a later stage will become significantly more expensive. The reason for this is that it is unlikely that various non-financial corporations have the same hedging need at the same time. Pre-trade transparency then makes it easier to attribute the split transactions to the same end-user, and potentially encourage predatory behaviour to the detriment of end-users. As a result, prices increase and risk management turns more expensive for end-users. Undue risks resulting from publication is faced by both the end-users of derivatives and the financial institution acting as SI.

- The current MiFIR pre-trade transparency regime for OTC derivatives traded outside trading venues does not meaningfully assist price formation or best execution but exposes SIs (i.e. mainly EU banks subject to MiFIDII/ MiFIR requirements) to undue risks.

  In addition, in relation to some of the changes being considered, ISDA members do not support ESMA's proposals to extend the obligations of SIs to publish firm quotes in liquid instruments to all derivatives belonging to the same sub-asset class of derivatives for which they are SIs, even where they are not traded on a trading venue (TOTV). This would increase the risks to liquidity providers without bringing any additional meaningful information.It is critical that this regime does not apply to non-TOTV instruments. Any extension to non-TOTV would put EU end-users at risk and disincentivise EU banks to take on the risks of their clients. In other words, firms

should not be subject to obligations as SIs in relation to non-TOTV derivatives. There is no reliable and comprehensive information available to firms on EU-wide trading in instruments that are not TOTV. Therefore, firms cannot accurately carry out the calculations to determine whether their trading exceeds the pre-set thresholds for classification as an SI if those calculations must take into account trading in non-TOTV instruments.

- The obligation to make post-trade transparency reports should be decoupled from SI status. Firms that deal on own account should be able to opt into the obligation to act as the reporting firm for post-trade transparency for a particular financial instrument or class of financial instruments using the current industry solution without being subject to any other obligations linked to being categorised as SI.

- It would enhance legal certainty if the scope of the restriction on use of a benchmark under the Benchmarks Regulation (BMR) were aligned with the transparency obligations under MiFIR. Linking the scope of the BMR to whether the financial instrument is traded by an SI makes it difficult for many supervised entities to determine the scope of their obligations.

This paper does not discuss:

- the circumstances in which an SI might be regarded as operating as a multilateral venue as a result of hedging activity or back-to-back transactions;
- the conditions under which financial instruments are regarded as TOTV and thus within the scope of the current transparency obligations under MiFIR;
- the scope of the post-trade transparency obligations under MiFIR (which apply to all investment firms not just SIs); or
- the scope or application of the derivatives trading obligation (DTO) under MiFIR.

2. OTC derivatives markets are different from equity markets

ISDA has previously noted with concern that concepts originally designed for equity markets might be applied to derivatives without adequate consideration of the characteristics of derivatives markets[1].

In summary, there are three fundamental differences between OTC derivatives and equities market structures:

- ***The nature of the instruments traded*:**
    - Equities (shares), as funding instruments for a corporate, are fungible. Transactions in the same share issued by a single company can be executed on a venue or OTC and the transactions are generally short-dated and settled through a central securities depository. Prices for equities are uniform independent of counterparty type.
    - OTC derivatives, as hedging or exposure instruments, have no issuer and are generally not fungible. Even standardised OTC derivatives traded on a venue or subject to central clearing are highly customisable[2]. Prices for OTC derivatives that are not cleared on a central counterparty (CCP) will depend on the credit quality of the counterparty.
- ***The nature of the liquidity.*** The trading of derivatives through different protocols, on or off-venue, does not mean that there is a fragmentation of liquidity because liquidity does not depend on the availability of a finite pool of securities. Market makers and liquidity providers can offer customised derivatives on the same underlying asset only limited by risk appetite, capital requirements and balance sheet size. Liquidity depends upon the ability of market makers and liquidity providers to offer hedges rather than a flow of buying and selling orders from investors.
- ***The market structures used for trading.*** SIs and trading venues co-exist as eligible execution venues under the share trading obligation. The DTO can only be satisfied by execution on a trading venue – not by execution via an SI.

3. Market makers and liquidity providers are the source of liquidity in OTC derivatives markets

OTC derivatives transactions result in bilateral contracts (including, for cleared products, with a CCP) which can be long dated. In order for OTC derivatives markets to operate, market participants must stand willing to act as market makers or liquidity providers, and in doing so commit their balance sheet. In so doing, they are exposed to market and hedging risk, whether

[1] ISDA, Review of MiFID II/ MIFIR Framework:'Regulatory Equitisation' would be detrimental to the functioning of derivatives markets (15 December 2020), available at https://www.isda.org/2020/12/15/mifid-ii-mifir-review-regulatory-equitisation/.
[2] See the ISDA research paper: https://www.isda.org/a/Ly9TE/IRS-Cleared-and-Customized.pdf

trading on- or off-venue. Trading venues are not exposed to these risks. It is vital that market makers and other liquidity providers (whether or not operating as an SI) are not subjected to requirements that would expose them to undue risk.

4. The MiFIR pre-trade transparency regime for OTC derivatives traded outside trading venues does not meaningfully assist price formation or best execution but exposes liquidity providers to undue risks.

The purpose of pre-trade transparency is to give investors access to information on current orders and executable quotes before the trade is executed, in order to aid with price formation and help investment firms and banks to provide best execution. This is an important concept for equities and other fungible instruments traded on pre-trade transparent venues. The obligations are applied to instruments that are TOTV to ensure a level playing for trading outside a trading venue in instruments that are also traded on a trading venue.

However, the MiFIR pre-trade transparency regime for OTC derivatives traded outside a trading venue (see Box 1) does not meaningfully aid price formation or assist in best execution but still exposes liquidity providers to undue risks.

MiFIR pre-trade transparency regime does not meaningfully aid price formation or assist in best execution

Most OTC derivatives traded outside trading venues are bespoke, trade episodically and the pricing depends on the credit quality of the counterparties or the relationship between the counterparties.[3] This means that information on quotes given by an SI to another client is inherently of little or no value to other clients or to market participants more generally.

For contracts subject to central clearing, pricing can include factors such as a potential agreement to send the derivative contract to a specific CCP.

For non-centrally cleared derivatives, pricing can include factors such as the existence of a netting agreement, the marginal effect of the new contract in the netting set, the existence of a CSA, and the characteristics of the agreement (e.g. the collateral pool), the potential obligation to exchange initial margin

In addition, any value of the pre-trade transparency regime for OTC derivatives traded outside a trading venue needs to be viewed in the broader context of the other regulatory requirements on SIs:

- SIs are only required to publish their quotes in relation to the relatively small range of derivatives that are regarded as liquid. Information in relation to quotes for illiquid instruments is only available to clients on request and only when there is no waiver.

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

- The regime uses ISINs as instrument identifiers. Derivatives with significant differences that affect pricing may share the same ISIN code while otherwise identical instruments will have different ISIN codes because they are traded on different days.[4]

- The information is provided in a fragmented way that is difficult for market participants to access due to the variety of channels that can be used for publication.

As indicated in the feedback to ESMA on access to quotes in liquid instruments, clients have access to other information for price discovery, including consistently updated market data streams and axes and runs published by dealers, as well as using requests for quote (RFQs) directed at individual or multiple dealers, either directly or via a trading venue.[5]

The feedback received by ESMA indicates that even where an SI's clients are given access to the SI's firm quotes:

> … the complex provisions of Article 18 of MiFIR on access to SI quotes in liquid instruments deliver little benefit to market participants. Most stakeholders confirmed that an SI client expects that the quote provided in response to a request reflects the specific characteristics of the transaction contemplated, including in illiquid instruments and complex transactions, and of the requesting client. SI clients would therefore typically not seek to trade on a displayed quote derived from the request of a different SI client.[6]

Furthermore, in relation to illiquid instruments:

> The feedback to the CP confirmed that SI quotes for illiquid instruments are hardly ever provided to clients, either because the SI benefits from a pre-trade transparency waiver or because clients are not interested in the bespoke quotes provided to another client, notably in illiquid quotes.[7]

However, ESMA has proposed extending the pre- and post-trade transparency obligations and the transaction and reference data reporting obligations of SIs to all derivatives belonging to the same sub-asset class of derivatives for which they are SIs, even where not TOTV.[8] This would extend the obligation to publish pre-trade quotes to an even broader range of non-

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

[5] Para 56, ESMA, MiFIR report on systematic internalisers in non-equity instruments (16 July 2020). ESMA states that "*The overall assessment of the non-equity SI pre-trade transparency framework for liquid instruments attracted negative feedback from most stakeholders based on multiple grounds. A large majority of respondents stressed that there is no demand for SI quotes due to the bespoke nature of each request. Therefore, there is no point in having as a regulatory objective that the quotes are accessed by other clients. Respondents noted that buy-side firms (market participants/institutional investors) continue to use consistently updated market data streams for the purposes of price discovery, together with axes and runs published by dealers as a source of information for price discovery rather than SI quotes*".

[6] Para 62, ESMA, MiFIR report on systematic internalisers in non-equity instruments (16 July 2020).

[7] Para 95, ESMA, MiFIR report on systematic internalisers in non-equity instruments (16 July 2020).

[8] See paras 89 to 91, ESMA, Final Report - MiFIR review report on the obligations to report transactions and reference data (23 March 2021).

standardised OTC derivatives, generating even more market noise of little or no value to other clients or market participants more generally. It would also increase the 'cliff-edge' impact of a firm trading outside a trading venue and thereby exceeding the pre-set limits to be classified or opting in to being classified as an SI in any class of derivatives by requiring a significant increase in the volume of the transparency and reporting required of a firm that becomes an SI.

MiFIR pre-trade transparency regime exposes SIs to undue risks

Even though the pre-trade transparency regime for OTC derivatives traded outside trading venues does not meaningfully assist price formation or aid best execution, it still exposes SIs to undue risks, in particular because SIs must disclose their identity when they publish their quotes. This provides signals to other market participants of the SI's trading intentions, facilitating predatory trading activity.

These risks would be increased if the MiFID II review resulted in:

- the imposition of pre-trade transparency requirements on SIs in relation to instruments traded on their systems which are not also TOTV;[9]
- an expansion of the classes of derivatives considered to be liquid;[10] or
- setting a higher threshold for the exemption of larger trades by deleting the exemption from pre-trade transparency requirements for transactions that are above the size specific to the financial instrument (SSTI) even if partially compensated for by a reduction in the threshold for the exemption for trades that are large in scale (LIS).[11]

Any of these changes would significantly increase the scope of the pre-trade transparency obligations of SIs and the risks that they face as a result of the publication of their quotes.

As already noted, liquidity providers are exposed to market and hedging risk, whether trading on- or off-venue. Trading venues are not exposed to these risks. The pre-trade transparency regime for SIs requires SIs to disclose their identity when they publish their quotes, exposing them to risk of the information being used against them. In contrast, where liquidity providers respond to a request-for-quote (RFQ) in relation to OTC derivatives made via an MTF or OTF, the trading venue is not required to publish the identity of the participants submitting a quote.

In addition, liquidity providers that submit quotes in response to an RFQ made via an MTF or OTF are not required to make their quotes available to other clients for execution (in contrast to the obligation that applies to SIs[12]). There is also is an exemption from pre-trade transparency for derivative transactions executed by non-financial counterparties for hedging purposes on

[9] See above.
[10] Compare proposals for bonds and commodity derivatives in paras 88 and 373, ESMA, MiFID II/ MiFIR review report on the transparency regime for non-equity instruments and the trading obligation for derivatives (25 September 2020).
[11] See para 58, ESMA, MiFID II/ MiFIR review report on the transparency regime for non-equity instruments and the trading obligation for derivatives (25 September 2020).
[12] Article 18(6) MiFIR.

an MTF or OTF which is not available when a non-financial counterparty seeks quotes for a corresponding transaction from an SI.[13]

The information published by MTFs or OTFs under the pre-trade transparency regime applicable to OTC derivatives traded via RFQs on trading venues is also unlikely meaningfully to aid price formation or assist in best execution (for similar reasons to those discussed above) but at least it exposes those providing quotes to less risk of predatory trading behaviour.

Therefore, the current regime provides unbalanced incentives to liquidity providers as regards their choice of execution method so that liquidity providers are exposed to undue risks if they act as SIs by executing trades outside a trading venue. We consider that where the DTO does not apply, market participants should be able to choose their method of execution and the related trading protocols based on their own assessment of the convenience and competitiveness of the particular method or protocol for the trade in question.

ESMA's proposal to extend the pre- and post-trade transparency and the transaction and reference data reporting obligations of SIs to all derivatives belonging to the same sub-asset class of derivatives for which they are SIs which are not TOTV would increase the unbalanced incentives for SIs and other liquidity providers to trade via a trading venue. It would increase the 'cliff-edge' impact of a firm trading outside a trading venue and thereby exceeding the pre-set limits to be classified as an SI in any class of derivatives by requiring a significant increase in the volume of the transparency and reporting required of a firm that becomes an SI. Firms trading outside a trading venue risk being classified as an SI and, under the proposal, would be subject to significantly more burdensome transparency and reporting obligations even if the instrument being traded is not itself already TOTV. It also ignores the rationale for imposing pre-trade transparency obligations on SIs in the first place, which was to provide similar levels of pre-trade transparency to that on trading venues when SIs execute trades in instruments that are TOTV.

The MiFIR pre-trade transparency regime for SIs in OTC derivatives should be limited to TOTV instruments

Therefore, we welcome ESMA's recommendation that the pre-trade transparency regime for SIs be simplified by removing the obligation for SIs to make quotes available to clients, both for liquid and illiquid instruments.[14]

However, we do not agree with ESMA's proposals to extend the obligations of SIs to publish firm quotes in liquid instruments to all derivatives belonging to the same sub-asset class of derivatives for which they are SIs, even where not TOTV. This would increase the risks to liquidity providers/ market makers who are offering valuable hedging services to EU end-users (corporates as well as buy-side firms). As a result, certain market makers might not be able to offer hedging services to EU clients.

[13] Article 8(1) MiFIR.

[14] Paras 64 and 97, ESMA, MiFIR report on systematic internalisers in non-equity instruments (16 July 2020).

5. The requirement for SIs to report reference data on uTOTV OTC derivatives is excessively burdensome and does not materially assist transaction reporting

SIs are required to provide their competent authority with reference data on OTC derivatives traded on their system that are not TOTV but where the underlying is a financial instrument that is TOTV or an index or a basket composed of financial instruments that are TOTV (uTOTV). This requires SIs to create ISINs for any OTC derivative traded by them as an SI which is uTOTV.

The aim of this requirement is to facilitate transaction reporting by investment firms. All investment firms are required to report to their competent authority transactions in financial instruments that are TOTV or uTOTV (whether executed on or outside a trading venue).

However, this requirement is very burdensome for SIs as it requires them to report reference data (and obtain ISINs) for large numbers of trades, many of which are bespoke and unlikely ever to be traded by other investment firms.
In addition, the requirement does not materially assist other investment firms to comply with their transaction reporting obligations. Inevitably, the uTOTV trades reported by SIs are only a sub-set of the huge possible range of instruments that are uTOTV and that may be traded by other investment firms. The very large number of ISINs is itself an obstacle to correct transaction reporting.

Therefore, we recommend deleting the requirement for SIs to report reference data on uTOTV instruments. We also recommend revisiting the way in which ISINs are used to identify OTC derivatives for transaction reporting and transparency purposes.

In contrast, ESMA has proposed extending the transaction and reference data reporting obligations of SIs to all derivatives belonging to the same sub-asset class of derivatives for which they are SIs, even where not TOTV or uTOTV.[15] We do not agree with extending SIs' obligations in this way:

- It would still not materially assist other investment firms to comply with their transaction reporting obligations. It would generate even larger volumes of ISINs for one-off transactions that are unlikely to be traded by other investment firms, increasing their search costs.

- It would extend the SI's transaction reporting obligations to instruments that are outside the scope of the market abuse regime. The primary justification for the transaction reporting obligations is to facilitate the ability of competent authorities to detect and investigate market abuse under the Market Abuse Regulation.

- It would increase the unfair incentive for SIs and other liquidity providers to trade via a trading venue. It would increase the 'cliff-edge' impact of a firm trading outside a trading venue and thereby exceeding the pre-set limits to be classified as an SI in any class of derivatives by requiring a significant increase in the volume of the transparency and reporting required of a firm that becomes an SI. Firms trading outside

[15] See paras 89 to 91, ESMA, Final Report - MiFIR review report on the obligations to report transactions and reference data (23 March 2021).

a trading venue risk being classified as an SI and, under the proposal, would be subject to significantly more burdensome transparency and reporting obligations even if the instrument being traded is not itself already TOTV.

In addition, extending SIs' reference data and transaction reporting obligation in this way would not resolve the issues discussed in the next section as to whether firms can accurately calculate whether their trading exceeds the pre-set limits for classification as SI. ESMA would still not be able to publish the data that firms need to calculate whether they exceed the pre-set thresholds for being classified as an SI, taking into account all EU-wide trading in the relevant classes of OTC derivatives, including trading by non-SIs in non-TOTV instruments.

6. Firms should not be subject to obligations as SIs in relation to OTC derivatives that are not TOTV

ESMA has interpreted the legislative definition of an SI (see Box 2) as applying to investment firms whose trading in financial instruments exceeds the specified pre-set limits, whether those instruments are TOTV, uTOTV or not TOTV or uTOTV.[16] This means that firms may become an SI in relation to TOTV derivatives as result of their trading in non-TOTV derivatives and that some of the other obligations currently applicable to SIs (see Box 3) may apply even where the SI is not trading TOTV instruments. In particular, ESMA has proposed that SIs should be subject to transaction and reference data reporting and pre-trade and post-trade transparency in relation to all derivatives belonging to the same sub-asset class of derivatives for which they are SIs, even where not TOTV or uTOTV.

However, ESMA only publishes information on TOTV instruments for determining whether an investment firm exceeds the pre-set limits for determining whether it should be considered as an SI. ESMA has stated that it "appreciates that, with respect to non-TOTV instruments, it might be challenging for investment firms to access reliable and comprehensive sources of EU wide information to enable them to assess whether their trading exceeds the specified pre-set limits". This understates the practical problem faced by firms. There is no reliable and comprehensive information available to firms on EU-wide trading in instruments that are not TOTV. Therefore, it is currently impractical for some firms accurately to calculate whether they have exceeded those limits based on their share of EU-wide trading in a class of derivatives that includes derivatives that are not TOTV.[17]

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[16] See Question 11 of Section 7, ESMA, Questions and Answers on MiFID II and MiFIR transparency topics (8 July 2020).

[17] For example, assume that, during an observation period, a firm executed 30 relevant trades in TOTV instruments and 5 relevant trades in non-TOTV instruments within the same derivatives sub-class and that ESMA's published data indicates that a total of 1,000 trades in TOTV instruments in that sub-class were executed in the EU during that observation period (for these purposes, a firm's relevant trades are trades on own account when executing client orders outside a trading venue). The firm can conclude that its relevant trades may have exceeded the specified pre-set limit of 2.5% of all trades executed in the EU in that sub-class during that period at least if its relevant trades in non-TOTV instruments in that sub-class were the only EU trades in non-TOTV instruments in that observation period (since [30 + 5] ÷ [1000 + 5] = 3.49%).
However, the firm would not know if had actually exceeded the pre-set limit because there might be a significant volume of other trades executed in the EU in non-TOTV instruments in that sub-class during the relevant observation period which are not required to be reported to ESMA and therefore not included in ESMA's published data. For example, if a total of 500 trades in non-TOTV instruments in that sub-class had been executed in the EU during that observation period, the firm would not have exceeded the pre-set limit (since [30 + 5] ÷ [1000 + 500] = 2.33%).
In contrast, some firms with a limited volume of trading may be able to use ESMA's published data to conclude that they have not exceeded the pre-set limits. If the firm in the example had, during the observation

The result is likely to have been that a number of firms that deal on own account elect to be treated as SIs for at least some classes of financial instrument simply to avoid uncertainty because they cannot carry out the requisite calculations. Firms may also be constrained to opt in to treatment as an SI because of the difficulty of carrying out the SI calculations (even for TOTV instruments), given the complex range of parameters that have to be taken into account (including time to maturity in some cases), as well as by the pressure from clients for investment firms to assume post-trade transparency obligations (see below). As a result, the list of notified SIs may include many firms whose business model is not of the kind envisaged by the co-legislators when they created the SI category and which then may be subject to obligations that are not appropriate for their business model.

As a matter of principle, firms should not be required to carry out calculations to determine their SI status where those calculations require data that is not available to the firm. Increasing the scope of the transaction reporting obligations of SIs as ESMA has proposed would still not enable ESMA to produce the data required by firms to make those calculations. Investment firms would still have to take account of EU trading by non-SIs in non-TOTV instruments when carrying out those calculations. This information is not available to firms or ESMA, meaning that some firms cannot accurately calculate whether they exceed the pre-set thresholds if those thresholds must take into account all EU trading in the relevant class of instruments, including all trading in non-TOTV instruments.

In any event, SIs should not be subject to obligations in relation to non-TOTV instruments. The rationale for imposing obligations on SIs in the first place was to ensure a level playing field with trading venues in instruments that are TOTV, by ensuring that firms trading significant volumes of TOTV instruments outside a trading venue are subject to similar pre-trade transparency obligations as the trading venue itself. Therefore, if any pre-trade transparency obligation is to be retained for OTC derivatives traded outside trading venues, a firm should only be classified as an SI for the purposes of that obligation where it exceeds the pre-set thresholds as a result of its trading in TOTV instruments. In addition, no other obligation in relation to non-TOTV OTC derivatives should be imposed on an investment firm that has been classified as an SI because of the level of its trading in TOTV OTC derivatives. Such obligations would not be related to the objective of ensuring a level playing field between on and off-venue trading in TOTV derivatives.

7. The obligation to make post-trade transparency reports should be decoupled from SI status

Under current rules, where two investment firms conclude a transaction in a financial instrument that is TOTV outside the rules of a trading venue, the seller is generally required to make the details of the transaction public. However, where only one of them is an SI in the relevant instrument, the obligation to make the transaction public falls on the SI (whether it is

period, only executed 10 relevant trades in TOTV instruments and 5 relevant trades in non-TOTV instruments within the same derivatives sub-class, it could conclude that it had not exceeded the specified pre-set limit of 2.5% of all trades executed in the EU in that sub-class during that period - whatever the volume of other trading in the EU in non-TOTV instruments (since [10 + 5] ÷ [1000 + 5] = 1.49% and increasing the denominator by additional trades in non-TOTV instruments would only reduce the percentage result of the calculation).

the buyer or the seller). In addition, the post-trade report must indicate if the transaction in that financial instrument is executed on an SI.

However, the ESMA register of SIs does not help a counterparty determine whether the other counterparty is an SI in relation to a particular instrument and, therefore, whether it or its counterparty will be subject to the post-trade transparency obligations in respect of a particular trade (or how to report the trade). The ESMA register does not disclose with sufficient granularity whether an investment firm is an SI for a particular financial instrument or class of financial instruments. Market participants have had to create an industry solution to facilitate this.

It is clear that many market makers and liquidity providers opt to be treated as SIs because many buy-side investment firms are unwilling to execute their trades with an investment firm that is not an SI (as this would require the buy-side firm to create reporting systems in order to comply with post-trade transparency obligations).[18] Again, this also means that the list of notified SIs may include many firms whose business model is not of the kind envisaged by the co-legislators when they created the SI category and which then may be subject to obligations that are not appropriate for their business model.

There is no reason to link the post-trade transparency obligation to SI status in this way (especially, if the scope of pre-trade transparency is limited in the manner proposed above). Firms that deal on own account should be able to opt into the obligation to act as the reporting firm for post-trade transparency for a particular financial instrument or class of financial instruments using the current industry solution without being subject to any other obligations linked to being labelled an SI.

8. The scope of the BMR should be aligned with transparency obligations under MiFIR

Currently, the BMR prohibits EU supervised entities using benchmarks in any financial instrument within the scope of the BMR unless that benchmark is provided by an EU registered benchmark provider or has been qualified for use in the EU under one of the third-country regimes under the BMR.

OTC derivatives fall within the scope of the BMR if they are TOTV or traded via an SI. ESMA has interpreted the latter element as covering:

- all instruments described in reference data reported by an SI under MiFIR (even if traded outside that SI); and

- all other instruments that are actually traded on an SI, regardless of any requirement of the SI to report reference data under MiFIR.[19]

This makes it difficult for supervised entities to establish when the use restriction applies to them. Not all supervised entities have the systems to be able to analyse whether instruments are described in reference data (as the definition of supervised entities includes many entities

[18] Para 25, ESMA, MiFIR report on systematic internalisers in non-equity instruments (16 July 2020).
[19] See Question 5.8, ESMA, Questions and Answers on the BMR (31 March 2021).

that are not investment firms subject to transparency obligations). The second limb above also implies that transactions with an SI will be subject to the use restriction even if the pre- or post-trade transparency obligations would not apply.

ESMA's interpretation may also deter firms from opting into treatment as an SI as this may restrict the firm's ability to use the benchmarks necessary to meet client needs, especially as many non-EU benchmark administrators may be unable to qualify their benchmarks for use in the EU under the existing third-country regimes.

It would enhance legal certainty if the use restriction only applied to an OTC derivatives transaction where the transaction is subject to pre- or post-trade transparency under MiFIR.

Box 1

MiFIR pre-trade transparency regime for OTC derivatives traded outside a trading venue

<table>
<tr><td>Pre-trade transparency (liquid OTC derivatives that are TOTV): SIs must, except when dealing in sizes above the relevant size specific to the financial instrument (SSTI):
when they are prompted for a quote by a client and agree to provide a quote, publish their firm quotes (in a manner which is easily accessible to other market participants on a reasonable commercial basis) except where liquidity has fallen below the threshold of liquidity specified in Article 9(5) MiFIR;
make those quotes available to other clients (but they may limit access in accordance with their commercial policy and in an objective non-discriminatory way);
enter into transactions with those clients on the basis of those quotes where the quoted size is at or below SSTI (but they may apply non-discriminatory and transparent limits on the number of transactions).</td><td>Art 18(1) and (5) to (10) MiFIR</td></tr>
<tr><td>Pre-trade transparency (illiquid OTC derivatives that are TOTV): SIs must, except when dealing in sizes above the relevant SSTI, disclose quotes to their clients on request if they agree to provide a quote. This does not apply where the conditions specified in Article 9(1) MiFIR are met.</td><td>Art 18(2) MiFIR</td></tr>
</table>

Notes:

- SIs' quotes must reflect prevailing market conditions in relation to prices at which transactions are concluded for the same or similar financial instruments on a trading venue and be such as to ensure that the SI complies with its best execution duties, where applicable.

- SIs may execute orders at a better price than quote provided that price falls within a public range close to market conditions.

- SIs may update their quotes at any time and may withdraw their quotes under exceptional market conditions.

- Pre-trade transparency obligations only apply to package orders as a whole and not to any component of the package order separately.

Box 2

Definition of an SI in OTC derivatives

Systematic internaliser means “an investment firm which, on an organised, frequent systematic and substantial basis, deals on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system”. For these purposes:

- The frequent and systematic basis is measured by the number of trades in the same class of derivatives carried out by the investment firm on own account when executing client orders outside a trading venue (relevant trades).

- The substantial basis is measured either by the size of the relevant trades carried out by the investment firm in relation to the total trading of the investment firm in the same class of derivatives or by the size of the relevant trades carried out by the investment firm in relation to the total trading in the EU in the same class of derivatives.

- The definition of an SI only applies where the pre-set limits for a frequent and systematic basis and for a substantial basis (measured over the last six months) are both crossed or where an investment firm chooses to opt-in under the SI regime.

<table>
<tr><th>Pre-set limit for:</th><th>Method of measurement</th><th>Specified limit</th></tr>
<tr><td rowspan="2">Frequent and systematic basis (liquid instruments)</td><td>BOTH: Number of the firm's relevant trades in the class of derivatives divided by the total number of all trades in the EU in that class</td><td>2.5%</td></tr>
<tr><td>AND: Frequency of the firm's relevant trades in that class of derivatives</td><td>Once a week</td></tr>
<tr><td>Frequent and systematic basis (illiquid instruments)</td><td>Frequency of the firm's relevant trades in the class of derivatives</td><td>Once a week</td></tr>
<tr><td rowspan="2">Substantial basis</td><td>EITHER: The size of the firm's relevant trades in the class of derivatives divided by the firm’s total turnover in that class</td><td>25%</td></tr>
<tr><td>OR: The size of the firm's relevant trades in the class of derivatives divided by the total turnover in the EU in that class</td><td>1%</td></tr>
</table>

Notes: Art 4(1)(20) MiFID II and Article 15 Commission Delegated Regulation (EU) 2017/565.

Box 3

Other obligations applicable to SIs in OTC derivatives

Summary of obligation	Source
Notification of status: Firms that meet the definition of an SI must notify their competent authority (which informs ESMA). ESMA publishes a list of SIs notified to it.	Art 18(4) MiFIR
Reference data: SIs must provide their competent authority with reference data on OTC derivatives traded on their system that are not TOTV where the underlying is a financial instrument that is TOTV or an index or a basket composed of financial instruments that are TOTV (uTOTV).	Art 27(1) MiFIR
Post-trade transparency: Where a transaction in a TOTV instrument is concluded between two investment firms and only one is an SI, the obligation to make the transaction public falls on the SI (whether it is the buyer or the seller).	Art 21(1) MiFIR and Art 7(7) RTS 2[20]
Execution quality data: Market makers and other liquidity providers (including SIs) must publish data on their execution quality.	Art 27(3) MiFID II and RTS 27[21]
OTFs: SIs must not operate an organised trading facility (and an OTF must not connect with an SI in a way that enables orders in an OTF or quotes on an SI to interact).	Art 20(4) MiFID II
Suspension of trading: SIs trading may be required to suspend trading in TOTV instruments where trading is suspended on a trading venue.	Art 32(2) MiFID II
Algorithmic trading (proposed): SIs could be required to comply with obligations on governance arrangements for trading systems and trading algorithms, the controlled deployment of algorithms and kill functionality and other risks controls.	Para 60 ESMA consultation on algorithmic trading[22]
Extension of transparency and transaction and reference data reporting (proposed): Pre- and post-trade transparency, transaction reporting and reference data reporting could be extended to instruments traded by SIs in derivatives belonging to the same sub-asset class of derivatives for which they are SIs.	Para 91 ESMA report on transaction reporting[23]

[20] Commission Delegated Regulation (EU) 2017/583.
[21] Commission Delegated Regulation (EU) 2017/575.
[22] ESMA Consultation Paper: MiFID II/MiFIR review report on Algorithmic Trading (18 December 2020).
[23] ESMA, Final Report - MiFIR review report on the obligations to report transactions and reference data (23 March 2021).

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 950 member institutions from 76 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.