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ISDA Commentary on draft European Parliament MiFID2/MiFIR Compromise Texts

The International Swaps and Derivatives Association welcomes the swift progress made by the European Parliament on the MiFID2/MiFIR dossier and would like to take this opportunity to comment on the proposed compromise on market structure and transparency recently circulated to MEPs by Rapporteur Markus Ferber. Our comments are underpinned by the view that the outcome of the MiFID review should be to support liquidity in the interests of systemic resilience; to protect and advance the ability of corporates and sovereigns to raise finance; to advance the principle of strong risk management; and to further the goals of competition and investor protection.

Pre-trade transparency for non-equity trading venues – MiFIR Articles 7 and 8

We believe the changes made to Article 7 and 8 are largely helpful, recognising as they do the fact that trading activity in non-equity instruments is often episodic, with transactions taking place in large sizes, and with generally lower levels of liquidity compared to equity markets; this is particularly true of OTC derivatives. Linking Article 7 to contracts subject to the trading obligation is helpful, as is the allowance made for the hedging activities of non-financial entities. We also support the new Article 8.3b allowing for suspension of transparency requirements in the case of a loss of liquidity, something that will help promote resilience of non-equities trading activity. We do not, however, support the changes to the waiver provisions of Article 8.4, which entail deletion of references to market model and the specific characteristics of trading. These references are important in the context of derivatives markets, where voice intermediation and 'Request-for-Quote' trading functionality are vital to maintaining liquidity; it should be possible to calibrate transparency provisions for such venues, thus we do not support the proposed deletion.

Post-trade transparency for non-equity instruments – MiFIR Article 10

We are particularly concerned by the proposal to delete from MiFIR Article 10 the reference to the potential for volume omission in post-trade reporting. The ability to omit volume from post-trade reports – in appropriate circumstances as determined by regulators – is vital to ensure that liquidity is not compromised by revealing market participants' trading interests, particularly in OTC derivatives markets where the number of trades on any given day is very small: even the most commonly traded interest rate swap, the 10 year US Dollar swap, trades only 200 times a day.

Obligation to trade OTC through systematic internalisers – MiFIR Article 13a [new]

We do not support the proposed new article 13a in MiFIR that would require all OTC transactions to take place under the Systematic Internalisation rules. In the case of OTC derivatives, the trading obligation already defines a set of contracts – those that are clearing eligible and sufficiently liquid – that must be traded on an organised trading venue (regulated market, MTF or OTF). Residual OTC activity in derivatives will therefore be limited to transactions in non-standardized and/or illiquid instruments, which by definition are less likely to lend themselves to the transparency requirements associated with the Systematic Internalisation rules (note, however, that all such transactions will be reported to trade repositories under EMIR, meaning full transparency to regulators). Forcing such instruments to trade under the SI rules could mean that they are no longer traded, making it more difficult for end users to enter into risk management or 'hedging' transactions whose terms are specifically tailored to the risks being managed. For this reason, we believe that the proposed Article 13a should be deleted.

Systematic Internalisation rules for non-equity instruments – Article 17

We believe that the changes to Article 17 represent a clear improvement on the text as originally proposed, appropriately linking Article 17 provisions to instruments for which the firm is a systematic internalizer and for which there is a liquid market, although we would also suggest a further scope change such that the article covers derivatives that are "clearing eligible ~~or~~ ***and*** are admitted to trading…". We support the inclusion of additional 'commercial policy' criteria in the context of quote-sharing, paralleling the approach to equities markets. We would, however, reiterate our view that there should be a clear size threshold above which Article 17 provisions would not apply.

Trading obligation – MiFIR Articles 24 and 26

We note that the Rapporteur is not proposing significant changes to the derivatives trading obligation (MiFIR Articles 24 and 26). We believe this overlooks the importance of these articles, which deliver on the 2009 G-20 commitment that standardised OTC derivatives should be traded on exchanges and electronic platforms, where appropriate. Specifically, we would suggest a number of targeted changes to ensure only appropriate contracts are covered by this obligation, in the interests of ensuring that OTC derivatives markets can continue to serve their ultimate purpose of risk management.

Most importantly, we believe that there is a need for an explicit block trade exemption and that ESMA should determine specific and carefully calibrated size thresholds above which the trading obligation under Article 24(1) of MiFIR would not apply for that class of contracts (as being discussed in US rulemakings). This would parallel the approach to pre-trade transparency for non-equity instruments, where a large-in-scale waiver is available. We therefore believe that Article 26(2)a, which establishes the possibility that only a 'subset' of a class of contracts is treated as sufficiently liquid, should explicitly refer to such a size threshold.

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

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

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

Open Access – MiFIR Article 28

We do not support the proposal to limit access provisions to cash markets; broader open access provisions will ensure that users of OTC derivatives markets benefit from competition in post-trade services, rather than protecting the 'vertical silo' model of execution/clearing.

Organised Trading Facilities

We support the introduction of the Organised Trading Facility concept and believe it will be important in the context of OTC derivatives markets, given that the MiFIR derivatives trading obligation will require activity in clearing eligible and sufficiently liquid contracts to take place on a regulated market, MTF or OTF; the new OTF category will increase the range of venues available to satisfy this obligation, aiding successful implementation of the derivatives trading obligation. We therefore welcome the retention of the OTF category for non-equity markets.

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