ISDA Safe, Efficient Markets

ISDA commentary on MiFID2/MiFIR
Prepared in advance of the meeting of attachés planned for 6 September 2012

Summary

This paper has been produced by the International Swaps and Derivatives Association (ISDA) in order to help inform on-going European Council discussions on MiFID2/MiFIR. In the paper we make the following points:

Pre-trade transparency for non-equities trading venues (MiFIR Articles 7 and 8)

- The scope of transparency requirements under Article 7 should be explicitly linked to OTC derivatives contracts that are subject to the derivatives trading obligation.
- There should be a clearer recognition of the importance of Request-For-Quote or voice trading for OTC derivatives markets, in support of the move to exchange and electronic trading.

Systematic internalisation in non-equities instruments (MiFIR Article 17)

- Uncleared OTC derivatives transactions should not be subject to the provisions of Article 17, particularly sharing of quotes with multiple clients, given that uncleared OTC derivatives transactions are priced according to the credit risk of an individual client.

Derivatives trading obligation (MiFIR Articles 24 and 26)

- Transactions that are large in scale should not be subject to the trading obligation.
- The assessment of whether a contract is sufficiently liquid to trade only on trading venues should be further defined in the Level 1 text.

Organised Trading Facility (MiFIR Recital 8; MiFID Article 20)

- The ban on use by the OTF operator of its proprietary capital should be removed or, alternatively, allowance should be made for client facilitation.

We have used the published Presidency compromise text of 20 June 2012 as the basis for our drafting suggestions, although we appreciate that further working texts are being used by working group members. Suggested changes are marked in blue and underlined.

Pre-trade transparency for non-equities trading venues (MiFIR Articles 7 and 8)

The first published Presidency compromise text on MiFIR provided a re-worked waiver framework for non-equity instruments under Article 8, including waivers for:

(i) orders that are large in scale compared with normal market size and orders held in an order management facility of the trading venue pending disclosure;
(ii) indications of interest in request-for-quote and voice trading systems that are above a size specific to the instrument;
(iii) markets with trading restricted to professional participants;
(iv) financial instruments for which there is not a liquid market;

The re-worked Article 7 also stipulates that indicative pre-trade prices must be published where a waiver is granted in accordance with point (ii) or (iii).

We understand that Council working group members have discussed this drafting further and provided feedback to the Cypriot Presidency.

Central to the challenge faced by working group members is finding an approach that balances the policy objective of greater transparency with the need to ensure continued market functioning, whilst also doing so in a way that does not create potential loop holes. In this spirit, ISDA suggests the following with respect to OTC derivatives trading venues:

The scope of transparency requirements under Article 7 should be explicitly linked to contracts that are subject to the derivatives trading obligation. Given that such contracts must meet the test of being 'clearing eligible and sufficiently liquid', they are more likely to be suited to some degree of transparency (unless, for example, part of a large in scale transaction ['block trade']). However, we also anticipate that some OTC derivatives contracts will be traded on trading venues on a purely voluntarily basis, including those that are not cleared and which are illiquid. This is particularly likely to be the case for Request-For-Quote trading systems, where a price is made following the client's expression of interest. Extending pre-trade transparency requirements to such transactions would, paradoxically, create a strong disincentive to venue trading for such instruments, which would not be in keeping with the spirit of the MiFID revision.

We propose the following solutions.

Redraft Article 7(1) as follows:

> **Market operators** and investment firms operating **a trading venue** shall make public prices and the depth of trading interests at those prices for orders or quotes advertised through their systems for bonds**,** structured finance products**,** emission allowances and derivatives which are ~~traded on **a trading venue**~~ subject to the trading obligation under Article 24. This requirement shall also apply to actionable indications of interests. **Market operators** and investment firms operating **a trading venue** shall make this information available to the public on a continuous basis during normal trading hours.

Alternatively, introduce an explicit waiver under Article 8(1) for contracts that are not subject to the trading obligation:

> Competent authorities shall be able to waive the obligation for **market operators** and investment firms operating **a trading venue** to make public the information referred to in Article 7(1) for:
>
> […]
>
> (iv) OTC derivatives contracts that are not subject to the trading obligation under Article 24.

We would also caution against any approach to pre-trade transparency that would require indicative pre-trade price transparency for activity that takes place under a waiver. Where indicative price transparency is possible, and demanded by users of a trading system, it is likely to be provided, although not necessarily on an instrument by instrument basis given the potentially limitless number of non-equities instruments. For this reason, seeking to *mandate* such provision of pre-trade price data on a broadly defined basis would not be in keeping with market functioning or with encouraging the move to organised trading.

In addition to this, we also believe that there is a need for a clearer **recognition of the importance of Request-For-Quote or voice trading for OTC derivatives markets**. In the case of cleared, liquid OTC derivatives, some policymakers have a tendency to envisage the possibility of equities-like exchange trading on platforms based on an order book. While such trading systems do exist for a limited range of contracts, they are only part of the solution. This reflects the fact that even liquid OTC derivatives contracts trade infrequently; for example, the most actively traded contract, the 10-year USD Interest Rate Swap contract, trades only 200 times per day on average. For this reason, RFQ trading will continue to play an important role in OTC derivatives markets, even after the move of cleared, liquid contracts to trading venues.

One solution would be to refine the Article 8 waiver provision for RFQ and voice trading as follows:

> (ii) indications of interest in request-for-quote and voice trading systems ~~that are above a size specific to the instrument;~~

This is not to suggest that all RFQ or voice activity should be subject to a waiver; it would, however, strengthen the ability of competent authorities to calibrate pre-trade transparency according to the nature of a given trading system.

Systematic internalisation in non-equities instruments (MiFIR Article 17)

We are broadly supportive of the direction of travel in the context of the Article 17 rules on systematic internalisation (which define when an investment firm must provide a firm quote to its client for an internalised trade and which also require that this quote be provided to the firms' client base more broadly). Specifically, we support the new language that makes clear that the rules apply in the case of instruments for which firms "…are systematic internalisers and for which there is a liquid market…". We also support the addition of 'commercial policy' provisions allowing firms greater control over how they share quotes with clients.

There is, however, an additional point that we believe should be addressed in the drafting. Specifically, it is important to clarify that uncleared OTC derivatives transactions should not be subject to the provisions of Article 17, notably the requirement that a firm provide one client's quote to other clients (subject to a size threshold), allowing them to transact on it.

When a client enters into an uncleared OTC derivatives contract with its bank, this establishes a credit relationship between the client and bank that lasts over the life of the contract, potentially many years. This risk is managed in many ways, including through the exchange of collateral, and through pricing the contract relative to the credit risk associated with the client. Thus a bank will provide different quotes to different clients based on the specific characteristics of an uncleared OTC derivatives transaction, including a price adjustment to reflect an individual client's credit standing. It follows that it would be extremely undesirable from a risk management perspective if a bank were required to provide the same price to all clients for uncleared OTC derivatives transactions.

This point could easily be addressed by a small change to the scope of Article 17 as follows:

> **Investment firms** shall **publish a** firm quote in **those** bonds**,** structured finance products**,** emission allowances and derivatives which are clearing eligible and traded on **a trading venue and for which they are systematic internalisers and for which there is a liquid market** when the following conditions are fulfilled: […]

Derivatives trading obligation (MIFIR Articles 24 and 26)

We are generally supportive of the drafting of Articles 24 and 26, which cover the obligation to trade particular OTC derivatives on an organised trading venue (OTF, MTF or regulated market). Specifically, we believe it is appropriate to limit this to contracts that are subject to the EMIR clearing obligation and which are also sufficiently liquid, as the text does.

We do, however, see a need for a more explicit exemption from the obligation for transactions which are large in scale, and which therefore would not be suited to the sort of transparency associated with trading venues. This could be addressed by amending Article 24 as follows:

> Financial counterparties as defined in Article 2(6) and non financial counterparties that meet the conditions referred to in Article [5(1b)] of Regulation [ ] (EMIR) shall conclude transactions which are not intragroup transactions as defined in Article [2a] of Regulation [ ] (EMIR) with other financial counterparties as defined in Article 2(6) or non financial counterparties that meet the conditions referred to in Article [5(1b)} of Regulation [ ] (EMIR) in derivatives pertaining to a class of derivatives that has been declared subject to the trading obligation in accordance with the procedure set out in Article 26 and listed in the register referred to in Article 27 only on:
>
> […]
>
> This obligation shall not apply to transactions that are large in scale.

Alternatively, Article 26(1) could be amended as follows:

> ESMA shall develop draft implementing technical standards to determine the following:
>
> (a) which of the class of derivatives declared subject to the clearing obligation in accordance with Article 4 paragraphs 2 and 4 of Regulation [ ] (EMIR) or a relevant subset thereof shall be traded on the venues referred to in Article 24(1);
>
> (aa) the size of transaction for a class of derivatives or subset thereof above which the trading obligation under Article 24 does not apply;
>
> […]

We also believe that the test of whether a contract is 'sufficiently liquid' should be developed further in the Level 1 text to ensure that ESMA is able to consider all relevant factors and data in making such a determination. As such, article 26(3) could helpfully be expanded as follows:

> In developing the draft implementing technical standards, ESMA shall consider the class of derivatives or a relevant subset thereof as sufficiently liquid pursuant to the following criteria, when assessed on a forward-looking basis in light of different market scenarios:
>
> (a) the average frequency of trades;
> (b) the average size of trades;
> (c) the number of active market participants;
> **(d) the average size of the spreads**
> (e) the number of trading venues available

Organised Trading Facility (MiFIR Recital 8; MiFID Article 20)

We have previously expressed our support for the creation of the Organised Trading Facility, noting however that the ban on use of proprietary capital by the OTF operator is likely to limit its usefulness. We therefore believe that the move by the Council to permit 'matched principal' activity under the OTF rules is helpful, particularly for trading in equities. We do, however, remain of the view that the operator capital ban should be removed completely in the interests of allowing a diverse range of platforms to operate under the OTF category, supporting client choice and the implementation of the trading obligation.

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

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

In the absence of a complete removal of the ban on use of operator capital, we would at least suggest that the exemption for matched principal trading is re-drafted to cover client facilitation activities more generally (with the consent of clients). Recital 8 of MiFIR should explicitly recognise that matched principal transactions are only a small subset of a much wider range of customer-facilitation activity that plays an important role in generating liquidity in line with the needs of clients.

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