ISDA and GFXD response to ESMA's consultation paper on 'Technical Standards specifying the criteria for establishing and assessing the effectiveness of investment firms' order execution policies'

ISDA and GFXD welcome the opportunity to respond to ESMA's consultation paper (CP) on 'Technical Standards specifying the criteria for establishing and assessing the effectiveness of investment firms' order execution policies'.

Execution in OTC derivatives

ISDA focuses on topics of relevance for OTC derivatives whereas GFXD focuses on FX markets. Our comments should be read with this focus in mind.

Sophisticated and diverse market participants

In principle, OTC derivatives markets are comprised of sophisticated market participants (with very little retail client participation), which may be able and willing to trade customised contracts based on the client's risk management needs. The diverse nature of participants in OTC derivatives markets also translates into divergent counterparty risk profiles, investment and hedging strategies, and abilities to hold cash for collateralisation purposes – with implications for pricing.

Pricing of OTC derivatives contracts

Furthermore, pricing in OTC derivatives is also highly dependent on a counterparty's risk profile, i.e. market participants with a less risky profile may legitimately receive a more favourable price than more risky actors. Pricing also depends on an investment banks' own balance sheet constraints, investment strategy, transaction sizes, the general market environment, and other price-forming factors.

Trading protocols

In addition, trading protocols, such as voice and RFQ practices, significantly differ from order book or auction procedures used in equities (or other securities) and several suggested requirements in the draft RTS, in particular the pre-selection of execution venues may not be appropriate for these types of transactions.

The concept of execution venues

Execution venues under MIFID include regulated markets, MTFs, OTFs, Systematic Internalisers or a market maker or other liquidity providers, OTC derivatives transactions are therefore scoped-in via the execution venues limb.[1] Paragraph 9 of the consultation paper stipulates that firms should assess the results achieved for clients based on a comparison of execution venues:'*… where there is more than one competing venue to execute an order for a financial instrument, in order to assess and compare the results for the client that would be achieved by executing the order on each of the execution venues listed in the investment firm's order execution policy that is capable of executing that order […] the costs for executing the order on each of the eligible execution venues shall be taken into account in that assessment.'* Consider the way OTC derivatives are priced, we think that assessing best execution for OTC derivatives transactions may be problematic on the basis of comparing execution venues.

Mandatory consumption of a consolidated tape

The draft RTS appears to imply (in effect) mandatory consumption of consolidated tapes, which is not required under the revised MiFIR/D level 1 texts. The draft RTS indicates a very high burden of proof for firms to be able to use alternative data sources, which, again, has no basis in the MiFIR/D level 1 text. We observe that an OTC derivatives tape will only be established in 2026 (or later) and will – by alignment with the characteristics of OTC derivatives – be differently designed to the tapes for equities and bonds. We recommend removing wording in the draft RTS which implies mandatory consumption.

Q1: Do you agree with the proposed categorisation of classes of financial instruments? And could the methodology based on, inter alia, the classification of financial instruments in the MiFID II RTSs 1 and 2 be used in the context of MiFID II transparency reporting be an alternative? Please state the reasons for your answers

As a general remark, ISDA and GFXD welcome ESMA's focus on equities and the possibility to cluster groups of non-equity financial instruments *'provided that these groups have homogenous characteristics'* (although it is not clear what 'homogenous characteristics' would mean in practice).

ISDA and GFXD members consider that the two suggested ESMA approaches based on ISO standards and RTS 1 and 2 categorisations are overly prescriptive and unnecessarily granular. Currently existing execution order policies are determined by the business structure and trading desk setups (with firms' having different setups per business structure and trading desk). Therefore, an asset class categorisation based on ESMA's approach may disrupt current best execution and trading practices without providing benefits for clients.

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[1] Article 65 of Commission Delegated Regulation (EU) 2017/565 states that 'execution venue' includes a regulated market, an MTF, an OTF, a systematic internaliser, or a market maker or other liquidity provider or an entity that performs a similar function in a third country to the functions performed by any of the foregoing.

Q2: Do you believe that the current wording of the RTS is clear and sufficient with regard to the content of the order execution policy where an investment firm selects only one execution venue to execute all client orders? Or should the RTS provide for specific criteria to be taken into account when assessing if the selected venue achieves the best possible result in the execution of client orders? Please also state the reasons for your answer.

Paragraph 23 of the CP and draft Article 4 of the draft RTS introduce the concept of pre-selected execution venues as a core concept for obtaining best execution: '*As a basis for an effective order execution policy and order execution arrangements, firms should pre-select the venues eligible for client order execution according to criteria allowing for a meaningful assessment to what extent the best possible result for clients can be obtained on these venues.'* As described above, we think that this concept is not pertinent for OTC derivatives. Trading protocols, such as voice and RFQ practices, significantly differ from order book or auction procedures used in equities (or other securities or exchange traded derivatives) and several suggested requirements in the draft RTS (in particular the pre-selection of execution venues) may not be appropriate for these types of transactions.

For example, if a client reaches out to a bank and requests a quote (RFQ), the bank itself may become the execution venue, having been chosen by the client. Furthermore, given the wide universe of participants in OTC derivatives markets, pre-selection of counterparties may not be possible and this information may not be useful for clients. Lastly, factors like speed or likelihood of execution are not always relevant from an OTC derivatives perspective. Therefore, we request a carve-out from Article 4 for OTC derivatives.

Q3: Do you agree with the proposed factor of "order sizes" respectively for retail and professional clients, to be considered in investment firms' selection of eligible execution venues in their order execution policy and internal execution arrangements (see Article 4(1)(d)(i) and ii) of the draft RTS)? If not, what alternative factor would you propose?

Article 4(1)(d)(ii) suggests that investment firms – when transacting with professional clients – should establish *'at least two different order frequencies and values that are representative of the professional clients of the investment firm, including, where applicable, the order size in relation to the average daily volume of the financial instrument'*

We think that determining 'values that are representative of the professional clients' may be difficult to achieve in OTC derivatives markets, given the diverse types of clients active therein. In addition, firms may not know the 'average daily volume of the financial instrument' or the instrument may be customized and not easily comparable to other volumes of financial instruments.

Q4: Do you agree with ESMA's proposals for the specification of the criteria for establishing and assessing the effectiveness of investment firms' order execution policies? Please also state the reasons for your answer.

Article 4(2) of the draft RTS states that *'For the purpose of taking into account the criterion of price in accordance with paragraph 1, point (g), an investment firm shall use the consolidated tape data or alternative datasets, provided the alternative dataset provides at least the same reference data quality as the consolidated tape data.'* As discussed above, we think that 'the criterion for price' referred to in Article 4(1)(g) is a different concept for OTC derivatives in comparison to securities. In addition, we would like to stress that the CT for derivatives is only likely to be established from 2026 onwards and will be subject to a different design than the currently discussed tapes for bonds and equities. Article 4(2) suggests mandatory consumption of the consolidated tapes, which is not a MiFIR/D Level 1 requirement. ISDA and GFXD members believe mandatory consumption of the consolidated tape for OTC derivatives would be disproportionate.

We would suggest that the provisions are amended to refer to use of the consolidated tape or alternative data sets as equal alternatives, rather than the consolidated tape being the preference, as indicated in Recital 11. We also suggest deleting the reference to the alternative data set being of the same reference data quality as the tape, as this sets a very high burden of proof for firms given that firms cannot guarantee the quality of the data they purchase from data vendors.

Q6: Concerning the specific client instruction, should it be possible for an investment firm to pre-select an execution venue in the order screen, where the firm invites its clients to choose an executing venue out of multiple options? And if so, do you agree that only if the client chooses a different venue than the one pre-selected by the firm, the choice of execution venue does constitute a specific instruction? Please also state the reasons for your answer.

As discussed, we think that the execution venue concept is not appropriate from an OTC derivatives perspective.

Q7: Where an investment firm executes client orders by dealing on own account (including back-to-back trading), in light of the specificity of this execution model and since it is bound by the rules governing best execution, do you believe the current text is clear with regard to what kind of obligations investment firm applying such model should comply with? Or do you believe it would be useful to provide in the RTS list and explanations of information that should be included in the order execution policy, such as related to the method and steps to be taken by the firm to establish the price of client transactions in

back-to-back trading, or the methodology for the firm's application of mark-ups or mark-downs in such order executions? Please also state the reasons for your answer.

ISDA and GFXD are of the view that dealing on own account should not be subject to best execution requirements. Article 9(3) refers to OTC products: *'When dealing on own account in OTC products in accordance with Article 64(4) of Commission Delegated Regulation (EU) 2017/565, an investment firm shall set out in its order execution policy how the fairness of the price proposed to the client is ensured.'* The reference to 'OTC products' may scope-in a wide range of financial instruments traded OTC, translating into an unnecessary administrative burden without benefits to investor protection objectives.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 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 LinkedIn and YouTube.

About the GFXD

The Global Foreign Exchange Division (GFXD) of the Global Financial Markets Association (GFMA) was formed in co-operation with the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and the Asia Securities Industry and Financial Markets Association (ASIFMA). Its members comprise 25[2] global foreign exchange (FX) market participants, collectively representing the majority of the FX inter-dealer market[3]. Both the GFXD and its members are committed to ensuring a robust, open and fair marketplace and welcome the opportunity for continued dialogue with global regulators.

[2] Bank of America, Bank of New York Mellon, Barclays, BBVA, BNP Paribas, Citi, Credit Agricole, Deutsche Bank, Goldman Sachs, HSBC, ING, JP Morgan, Lloyds, Mizuho, Morgan Stanley, MUFG, NatWest Markets, Nomura, Northern Trust, RBC, Standard Chartered Bank, State Street, UBS, US Bank and Wells Fargo

[3] According to Euromoney survey