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Demystifying Derivatives Trading in the EU

This paper examines the dynamics of derivatives trading in the EU. It analyzes transactions executed on and off trading venues (TVs), such as multilateral trading facilities (MTFs) and organized trading facilities (OTFs). The analysis considers why some transactions outside the scope of the derivatives trading obligation (DTO) are executed on TVs.

The paper also explores the composition of transactions executed by systematic internalizers (SIs) and describes the role SIs play in the market, both as liquidity providers to clients and on TVs, where they are commonly referred to as market makers or dealers.

The analysis is based on European data collected by ISDA from 30 European approved publication arrangements (APAs) and TVs in the fourth quarter of 2021. EU interest rate derivatives (IRD) trading activity is measured by IRD traded notional reported by APAs and TVs located in the EU. Of the 30 APAs and TVs included in the ISDA database, 13 are located in the EU.

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EXECUTIVE SUMMARY

About 64.0% ($6.3 trillion) of total IRD traded notional reported in the EU in the fourth quarter of 2021 was executed on TVs. Of this amount, 44.0% ($2.8 trillion) was required to trade on venues under the DTO.

Total IRD traded notional executed on TVs in the EU was therefore more than double the IRD traded notional subject to the trading obligation. The percentage of IRD traded notional executed on TVs in the EU also exceeds the proportion of transactions executed on swap execution facilities (SEFs) in the US[1]: 57.4% of total IRD traded notional was executed on SEFs in the US in the fourth quarter of 2021 compared to 64.0% of IRD traded notional executed on TVs in the EU[2].

There are several possible reasons why non-DTO transactions trade on TVs. For example, counterparties may find it more effective to bilaterally negotiate certain contracts off venue and then electronically execute them via TVs. TVs do not play a role in price discovery and negotiation in these transactions but facilitate more efficient trade processing.

This appears to be particularly relevant for overnight index swaps (OIS), but also applies to other transactions, such as forward rate agreements (FRAs). FRA matching algorithms are used to execute FRAs to reduce short-term floating rate fixing risk exposures in interest rate portfolios. In the fourth quarter of 2021, 65.7% of OIS traded notional and 36.7% of FRA traded notional in the EU was executed on TVs.

Some IRD transactions, including fixed-for-floating interest rate swaps (IRS), OIS and FRAs, have more customized product features that allow them to meet the risk management needs of counterparties. These transactions are generally executed bilaterally by SIs, which are often the same firms that provide liquidity on TVs[3]. Transactions executed by SIs totaled $2.7 trillion and comprised 27.9% of total IRD traded notional in the fourth quarter of 2021.

Fixed-for-floating IRS accounted for about 50.0% of total IRD traded notional executed by SIs. Of this amount, about half ($0.7 trillion) comprised fixed-for-floating IRS that have non-standard features, ranging from settlement currency, trade start type, tenor, fixed leg payment frequency, fixed leg day count convention, floating leg reference index, floating leg reset frequency and floating leg day count convention[4]. Some of the fixed-for-floating IRS transactions executed by SIs were in classes that are subject to the DTO but were executed with counterparties that are exempt from the trading obligation[5].

Over two-thirds of US dollar-denominated fixed-for-floating IRS traded notional was executed by SIs. Of this amount, 62.7% was 'broken dated' (ie, had a non-standard tenor). Average transaction size for US dollar-denominated fixed-for-floating IRS executed by SIs was more than four times larger than transactions executed on TVs.

[1] US trading activity is based on data from the Depository Trust & Clearing Corporation (DTCC) swap data repository (SDR), which only includes trades that are required to be disclosed under US Commodity Futures Trading Commission (CFTC) regulations

[2] In the EU, transparency reporting requirements apply to instruments that are admitted to trading on regulated markets (RMs), as well as those that are traded on other trading venues (TVs), including multilateral trading facilities (MTFs) and organized trading facilities (OTFs). The transparency requirements also apply to investment firms not trading on TVs if the underlying financial instrument is 'traded on a trading venue' (TOTV) or is an index or basket composed of financial instruments that are traded on a TV. Financial instruments that are solely traded outside of TVs are not subject to the requirements and, therefore, are not included in this analysis

[3] Interest rate derivatives (IRD) trades on TVs are typically executed via a request-for-quote (RFQ) protocol, where a firm seeking liquidity requests a price from market makers or dealers

[4] Given EU data limitations, ISDA could not identify the transactions that have all the above-mentioned non-standard terms. However, several attributes of fixed-for-floating interest rate swap transactions that were executed by SIs were analyzed, including currency, tenor, floating reference rate and transaction size

[5] Given EU data limitations, ISDA could not identify counterparty type

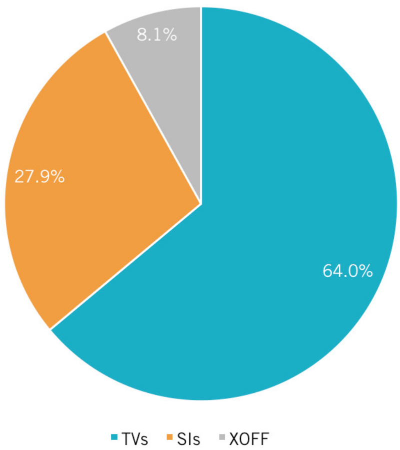
The average transaction size of all trades executed by SIs is significantly larger than those executed on TVs. This underscores the importance of the size-specific-to-an-instrument (SSTI) threshold for pre- and post-trade transparency for SIs, and of post-trade deferrals based on the size and liquidity of derivatives contacts.

As SIs are required to make firm quotes below the pre-trade SSTI threshold public on a name-disclosed basis, this threshold protects SIs from 'undue risk' – the risk they are unable to hedge the exposures they assume in facilitating client hedges because the market has clear sight of their positions.

IRD EXECUTED ON TRADING VENUES

IRD traded notional reported by APAs and TVs in the EU in the fourth quarter of 2021 totaled $9.8 trillion. About 64.0% of EU IRD traded notional ($6.3 trillion) was executed on TVs (see Chart 1). This included products covered by the DTO, but most of this volume was not subject to the trading obligation and was voluntarily executed on TVs.

Chart 1: IRD Traded Notional Reported by APAs and TVs in the EU[6]



Source: EU APAs and TVs

The Derivatives Trading Obligation

The derivatives trading obligation (DTO) under the EU Markets in Financial Instruments Regulation (MIFIR) requires certain derivatives contracts to trade on regulated markets, multilateral trading facilities, organized trading facilities or equivalent third-country trading venues (TVs).

The DTO is closely linked to the clearing obligation (CO) under the European Market Infrastructure Regulation (EMIR). Once a class of derivatives is required to be cleared under EMIR, the European Securities and Markets Authority must determine whether these derivatives (or a subset of them) should be subject to the DTO. The DTO applies only to classes of derivatives that are sufficiently liquid and available for trading on at least one TV.

As of year-end 2021, fixed-for-floating interest rate swaps denominated in euros, US dollars and sterling, as well as the iTraxx Europe Main and iTraxx Europe Crossover credit derivatives indices, were subject to the DTO[7,8].

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[6] The XOFF market identifier code is used for financial instruments admitted to trading or traded on a trading venue or for which a request for admission was made, where the transaction on that financial instrument is not executed on a trading venue, systematic internalizer (SI) or organized trading platform outside of the EU, or where an investment firm does not know it is trading with another investment firm acting as an SI

[7] European Securities and Markets Authority (ESMA) Public Register for the Trading Obligation for Derivatives under the Markets for Financial Instruments Regulation (MIFIR) www.esma.europa.eu/sites/default/files/library/public_register_for_the_trading_obligation.pdf

[8] On May 18, 2022, Delegated Regulation 2022/749 amending the regulatory technical standards (RTS) in Delegated Regulation (EU) 2017/2417 for the transition to new benchmarks referenced in certain over-the-counter (OTC) derivatives was published. The RTS relate to a mandate under Article 32(1) of MIFIR (600/2014) and specify the classes of OTC derivatives subject to the derivatives trading obligation (DTO) under MIFIR. The RTS amended (and reduced) the scope of instruments covered by the DTO following the switch to new risk-free rates (RFRs) and away from interbank offered rates. The scope of products covered by the DTO will increase over time as trading in contracts linked to RFRs become more liquid. The RTS entered into force the day after publication

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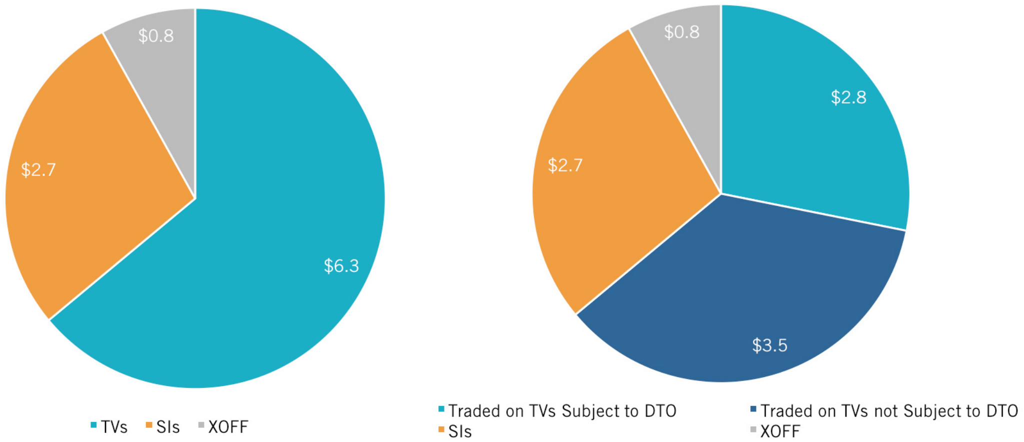
The DTO applies when a transaction is executed between two financial counterparties as defined under EMIR (broadly, investment firms and credit institutions). Although small financial counterparties (SFCs) as defined under the EMIR Refit are exempt from the CO, there is no explicit exemption from the DTO for these counterparties.

As TVs typically support cleared derivatives, being exempt from the CO but subject to the DTO would force firms to clear. Regulatory forbearance is currently applied in relation to the DTO for trades involving SFCs, pending alignment of the scope of the DTO and CO in the current MIFIR review.

Additionally, the trading obligation applies to non-financial counterparties that are subject to the CO.

Of the $6.3 trillion IRD traded notional executed on TVs in the fourth quarter of 2021, $2.8 trillion was covered by the DTO. This means IRD traded notional executed on TVs in the EU far exceeded (by 56.0%, or $3.5 trillion) the IRD traded notional subject to the trading obligation (see Chart 2).

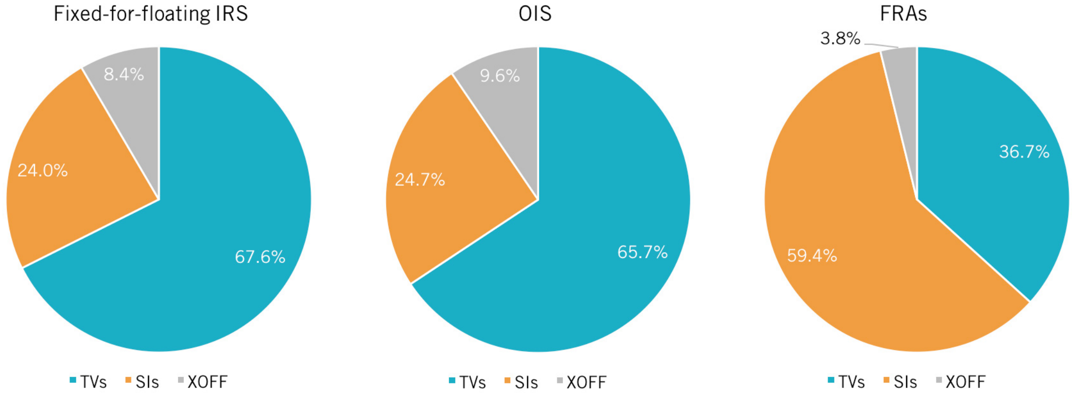
Chart 2: IRD Traded Notional by Execution Venue



Source: EU APAs and TVs

While fixed-for-floating IRS denominated in euros, US dollars and sterling were subject to the DTO during this period, a substantial share of OIS and FRAs was also executed on TVs. In the fourth quarter of 2021, 67.6% of fixed-for-floating IRS traded notional, 65.7% of OIS traded notional and 36.7% of FRA traded notional was executed on TVs (see Chart 3).

Chart 3: IRD Traded Notional by Product Type and Execution Venue



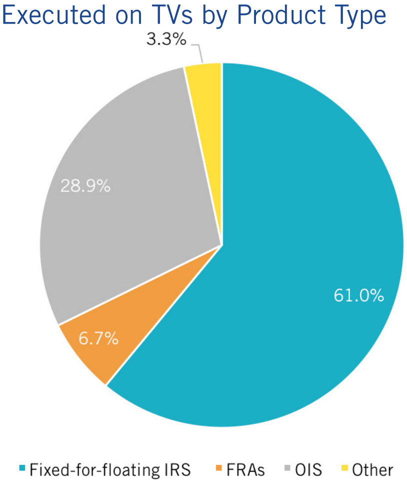
Source: EU APAs and TVs

There are several possible reasons why non-DTO transactions trade on TVs. For example, counterparties may find it more effective to bilaterally negotiate certain contracts off venue and then electronically execute them via TVs. TVs do not play a role in price discovery and negotiation in these transactions but facilitate more efficient trade processing.

Another possible reason is that firms want to put dealers in competition for smaller orders (where information leakage is less of a concern) to achieve better execution. It is more efficient from a workflow perspective to do this via a request for quote (RFQ) on an electronic venue than to call various dealers.

In the fourth quarter of 2021, fixed-for-floating IRS traded notional accounted for 61.0% of total IRD traded notional executed on TVs. OIS and FRA transactions represented 28.9% and 6.7%, respectively (see Chart 4)[9].

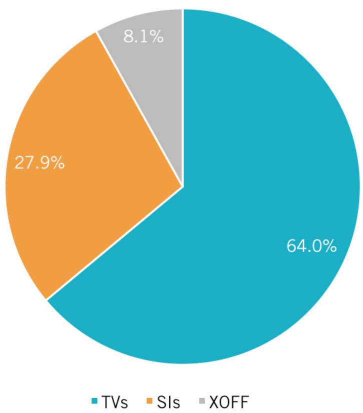
Chart 4: IRD Traded Notional Executed on TVs by Product Type

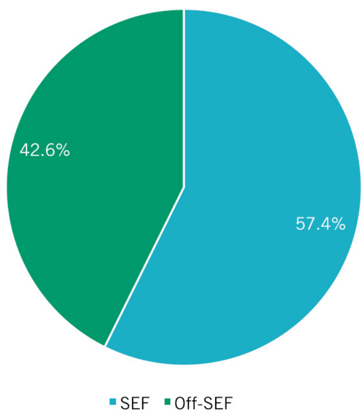


Source: EU APAs and TVs

The percentage of IRD traded notional executed on TVs in the EU exceeded the proportion of transactions executed on SEFs in the US[10]. In the fourth quarter of 2021, 57.4% of total IRD traded notional was executed on SEFs compared to 64.0% of IRD traded notional executed on TVs in the EU[11] (see Chart 5).

Chart 5: IRD Traded Notional by Execution Venues Reported in the EU and US





Source: EU APAs and TVs and US DTCC SDR

9 The fourth quarter of 2021 was a key period for LIBOR transition. As market participants moved to risk-free rates, it affected the product composition

10 US trading activity is based on data from the DTCC SDR, which only includes trades that are required to be disclosed under CFTC regulations

11 In the EU, transparency reporting requirements apply to instruments that are admitted to trading on RMs, as well as those that are traded on other TVs, including MTFs and OTFs. The transparency requirements also apply to investment firms not trading on TVs if the underlying financial instrument is TOTV or is an index or basket composed of financial instruments that are traded on a TV. Financial instruments that are solely traded outside of TVs are not subject to the requirements and, therefore, are not included in this analysis

Overall, 74.4% of fixed-for-floating IRS, 83.7% of FRA, 40.4% of OIS and 37.4% of other IRD traded notional was executed on SEFs in the fourth quarter of 2021. The percentage of IRD traded notional that is 'made available to trade' (see box) accounted for 3.4% of total IRD traded notional and 5.9% of SEF-traded IRD notional in the fourth quarter of 2021[12].

Made Available to Trade

In the US, swaps subject to the trade execution mandate – known as 'made available to trade' (MAT) – must be traded on a swap execution facility (SEF) or a designated contract market (DCM). SEFs are multilateral trading platforms that operate a multi-dealer request-for-quote (RFQ) functionality and a central limit order book. Regulations require an RFQ to be sent to at least three market participants.

DCMs and SEFs determine whether a swap is MAT for the purpose of the trade execution requirements[13]. Once a swap is determined to be MAT, all DCMs and SEFs must comply with the trade execution requirements in listing or offering that swap for trading.

The current list of MAT products includes spot- and forward-starting fixed-for-floating US dollar swaps with three- or six-month LIBOR floating rate references, as well as spot-starting fixed-for-floating euro and sterling swaps referencing three- and six-month EURIBOR and sterling LIBOR, respectively. Various tenors of one to 30 years are included for all three currencies[14].

Pre- and Post-trade Transparency Requirements for TVs

The revised Markets in Financial Instruments Directive/Markets in Financial Instruments Regulation transparency regime includes pre- and post-trade transparency requirements for non-equities. Pre-trade transparency requirements are designed to provide market participants with near real-time data on firm quotes. Post-trade transparency rules oblige firms to publicly disclose data on executed trades.

Market operators and investment firms operating trading venues (TVs) must make current bid and offer prices and the depth of trading interest at those prices public on a continuous basis during normal trading hours. That also applies to actionable indications of interest (IOIs). Transparency requirements are calibrated for different types of trading systems, including order book, quote driven, hybrid, periodic auction trading and voice trading systems[15].

Pre-transparency requirements can be waived for orders that are:

- Large in scale (LIS) compared with normal market size;
- Orders held in an order management facility;
- Actionable IOIs in request-for-quote and voice trading systems that are above a size specific to the instrument (SSTI);

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[12] Most of the trading volume that occurs on swap execution facilities (SEFs) is a result of the inclusion of Footnote 88 within the CFTC final SEF rules. Footnote 88 requires multiple-to-multiple trading venues used by US persons (such as those offered by interdealer brokers) to register as SEFs, even if the products they offer aren't subject to the execution mandate. As a result, instruments traded by the interdealer community drive the level of SEF trading for the various IRD and credit derivatives products

[13] CFTC 17 CFR Part 37 and 38 Process for a Designated Contract Market or Swap Execution Facility To Make a Swap Available to Trade, Swap Transaction Compliance and Implementation Schedule, and Trade Execution Requirement Under the Commodity Exchange Act; Final Rule www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2013-12250a.pdf

[14] www.cftc.gov/sites/default/files/idc/groups/public/@otherif/documents/file/swapsmadeavailablechart.pdf Made-available-to-trade swaps also comprise untranched credit default swap indices including CDX Investment Grade and High Yield, iTraxx Europe and iTraxx Europe Crossover with a five-year tenor, including on-the-run and off-the-run series

[15] MIFIR Article 8 Pre-trade Transparency Requirements for Trading Venues in Respect of Bonds, Structured Finance Products, Emission Allowances and Derivatives www.esma.europa.eu/databases-library/interactive-single-rulebook/clone-mifir/article-8-0

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- Derivatives that are not subject to the derivatives trading obligation and other financial instruments for which there is no liquid market;
- Orders for the purpose of executing an exchange for physical; and
- Certain package orders[16].

Post-trade transparency rules require market operators and investment firms operating TVs to make the price, volume and time of the transaction public. Transaction details must be disclosed as close to real time as technically possible[17].

Trade information must be publicly disseminated either by TVs through which a transaction was executed or through approved publication arrangements. The reporting obligation always falls on one party in a trade. If the trade is transacted on a regulated market, multilateral trading facility or organized trading facility, the venue has the reporting obligation. When a trade is executed by a systematic internalizer (SI), the SI has the reporting obligation. When a trade is not executed on a venue, the selling counterparty is required to report.

Publication of transaction details can be deferred based on the size and type of the trade. Deferrals are vital to the ability of liquidity providers to offer quotes and trade at the quoted price when transactions are above a certain size or in an illiquid class of derivatives. Deferrals (of price and/or volume information) provide liquidity providers with the time necessary to hedge the risk they assume from clients when facilitating their hedging activity in these sizeable and/or illiquid trades. If information on these exposures is published close to real time, other market participants would use this information to take positions in markets at the expense of liquidity providers, which would have to pay a premium to hedge these exposures. Deferrals are allowed for transactions that are LIS compared to normal market size, those that don't have a liquid market, and transactions above the SSTI threshold[18].

An LIS deferral is given if the trade is larger than the average size of trades within that asset class. An SSTI deferral is granted to transactions that are larger than a minimum size threshold but smaller than the LIS threshold.

The European Securities and Markets Authority publishes annual transparency calculations for non-equity instruments, including information on the liquidity assessment and LIS and SSTI thresholds above which pre-trade transparency requirements can be waived and the publication of post-trade transparency information can be deferred[19].

[16] MIFIR Article 9 Waivers for Non-equity Instruments www.esma.europa.eu/databases-library/interactive-single-rulebook/clone-mifir/article-9-0

[17] MIFIR Article 10 Post-trade Pre-trade Transparency Requirements for Trading Venues in Respect of Bonds, Structured Finance Products, Emission Allowances and Derivatives www.esma.europa.eu/databases-library/interactive-single-rulebook/clone-mifir/article-10-0

[18] MIFIR Article 11 Authorization of Deferred Publication www.esma.europa.eu/databases-library/interactive-single-rulebook/clone-mifir/article-11-0

[19] ESMA Annual Transparency Calculations for Non-equity Instruments www.esma.europa.eu/annual-transparency-calculations-non-equity-instruments

IRD EXECUTED BY SYSTEMATIC INTERNALIZERS

27.9% of IRD traded notional reported in the EU in the fourth quarter of 2021 was executed by SIs. These transactions are generally more customized and less liquid than transactions subject to the DTO. Additionally, SIs can execute transactions in classes of derivatives that are subject to the DTO with counterparties that are exempt from the trading obligations[20] (eg, those categorized as non-financial counterparty 'minus').

Systematic Internalizers

A systematic internalizer (SI) is "an investment firm which, on an organized, frequent systematic and substantial basis deals on own account when executing client orders outside a [regulated market], [multilateral trading facility], or [organized trading facility] without operating a multilateral system"[21].

The concept of SIs was introduced under the Markets in Financial Instruments Directive (MIFID I) but were only authorized for equities. Under MIFID II, SIs were authorized to handle equity-like instruments, such as depositary receipts, certificates and exchange-traded funds, as well as non-equity instruments like bonds, emission allowances, structured finance products and derivatives.

The SI regime requires investment firms to assess whether they are SIs in a specific instrument or for a sub-class of instruments on a quarterly basis based on data from the previous six months. An investment firm is required to compare the trading it undertakes on its own account to the total volume and number of transactions executed in the EU.

A significant number of investment firms have decided to voluntarily opt in under the SI regime to provide Markets in Financial Instruments Regulation/MIFID reporting services to their clients.

SIs are market participants and are neither trading venues nor market operators. SIs use their own capital to facilitate transactions between end users with different economic needs.

As SIs use their balance sheets to facilitate transactions, they are exposed to risks. In comparison, TVs don't have a similar risk exposure. Most SIs are run by banks and high-frequency trading firms. Many investment firms that provide liquidity to clients as SIs also provide liquidity as members of TVs.

SIs in derivatives provide bespoke hedging tools to clients and don't compete with TVs. For example, SIs can help pension funds hedge the interest rate and inflation risk inherent in long-dated pension liabilities. Asset managers might use customized derivatives to hedge unwanted interest rate or foreign exchange risk, protect portfolios against market volatility, enhance returns, quickly rebalance asset allocations or take views on specific markets or sectors.

Customized IRD transactions executed by SIs can help banks and mortgage lenders manage the mismatch between predominantly short duration floating-rate borrowings (deposits and wholesale financing, for instance) and longer-term fixed-rate mortgages. Corporates use IRD to hedge the interest rate risk associated with debt issuance. Insurance companies can use customized derivatives to manage their assets and liabilities, hedge variable annuity guarantees and enhance investment income[22].

Derivatives products in these examples usually need to be customized for a client's specific needs and do not have equivalents readily available on TVs. Most of these transactions trade episodically and pricing depends on the credit quality of the counterparties and/or relationship factors[23].

[20] ISDA does not have data to determine whether transactions were executed by counterparties exempt from the DTO

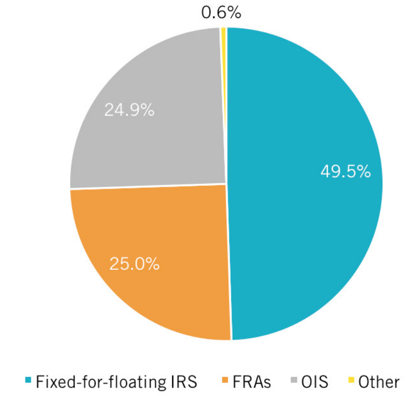
[21] MIFID II Article 4.1(20) www.esma.europa.eu/databases-library/interactive-single-rulebook/clone-mifid-ii/article-4-0

[22] Dispelling Myths: End-User Activity in OTC Derivatives, August 2014 www.isda.org/a/gSiDE/isda-dispelling-myths-final.pdf

[23] The pricing of the contract includes specific elements relating to the client (credit/counterparty risk) and/or to the contractual relationship (ie, whether the trade is cleared, whether a netting agreement is in place and whether a collateral agreement exists for contracts not subject to clearing) that makes it specific to the transaction. This price will not be the same for another similar contract

In the fourth quarter of 2021, fixed-for-floating IRS traded notional accounted for 49.5% of total IRD traded notional executed by SIs. OIS and FRA transactions represented 24.9% and 25.0%, respectively (see Chart 6).

Chart 6: IRD Traded Notional Executed by SIs by Product Type



Source: EU APAs and TVs

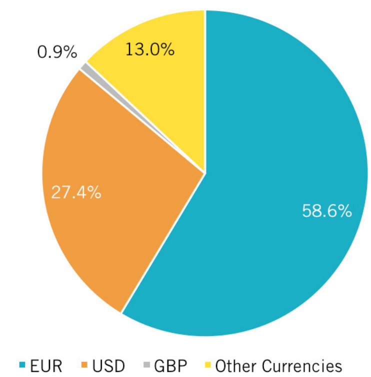
Overall, 24.0% of fixed-for-floating IRS traded notional reported in the EU in the fourth quarter of 2021 was executed by SIs. 24.7% of OIS and 59.4% of FRA traded notional was executed by SIs (see Chart 3).

Some fixed-for-floating IRS transactions executed by SIs have non-standard terms, such as settlement currency, trade start type, tenor, fixed leg payment frequency, fixed leg day count convention, floating leg reference index, floating leg reset frequency and floating leg day count convention, which are not covered by the DTO[24].

Given EU data limitations, ISDA couldn't identify the transactions that have these non-standard features[25]. However, several attributes of fixed-for-floating IRS transactions that were executed by SIs were analyzed, including currency, tenor, floating reference rate and transaction size.

About 13.0% of total fixed-for-floating IRS traded notional executed by SIs was denominated in currencies that were not subject to the DTO. Euro transactions accounted for 58.6% of total fixed-for-floating IRS traded notional executed by SIs in the fourth quarter of 2021, while US dollar- and sterling-denominated IRS traded notional comprised 27.4% and 0.9%, respectively (see Chart 7).

Chart 7: Fixed-for-floating IRS Traded Notional Executed by SIs by Currency



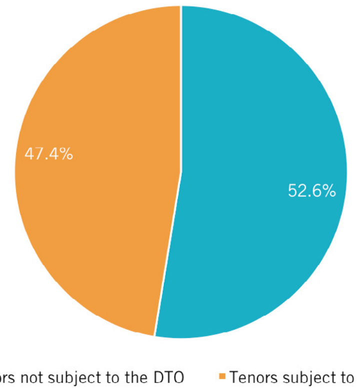
Source: EU APAs and TVs

24 Some of these transactions can be executed on TVs, but it is more typical that transactions with non-standard terms are executed by SIs

25 APAs and TVs provide limited trade details, including international securities identification number (ISIN), trade date, publication date, publication ID, venue of execution, notional amount, notional currency, cleared status and supplementary flags. For this data analysis, ISDA matched historical IRD ISINs with daily transaction files reported by APAs and TVs. Using ISIN data, ISDA identified IRD instrument type (swap, option, forward, etc), IRD product taxonomy (fixed-for-floating IRS, FRAs, OIS, etc), underlying reference rate and tenor

About 52.6% of total fixed-for-floating IRS traded notional executed by SIs had tenors that fall outside those covered by the DTO for euro-, US dollar- and sterling-denominated fixed-for-floating IRS. Additionally, some transactions were broken dated, meaning they had non-standard tenors with a fraction of a year[26] (see Chart 8).

Chart 8: Fixed-for-floating IRS Traded Notional Executed by SIs by Tenor



Source: EU APAs and TVs

Average transaction size of trades executed by SIs was significantly larger than trades executed on TVs. For example, average transaction size of fixed-for-floating IRS executed by SIs totaled $97.4 million compared to $73 million for fixed-for-floating IRS executed on TVs in the fourth quarter of 2021.

Over two-thirds of US dollar-denominated fixed-for-floating IRS traded notional ($370.8 billion) was executed by SIs. Of this amount, $232.4 billion (62.7%) was broken dated or had tenors that fell outside those covered by the DTO for US dollar-denominated fixed-for-floating IRS (see Table 1)[27].

This might reflect the fact that EU counterparties requiring US dollar-denominated IRS for hedging purposes find greater liquidity when executing with SIs, particularly when the trades are more customized. Market participants often execute US-dollar denominated swaps to match the maturity of on-the-run US Treasuries.

87.2 % ($323.3 billion) of US dollar-denominated fixed-for-floating IRS executed by SIs in the fourth quarter of 2021 referenced three-month LIBOR. Other reference rates included one- and six-month LIBOR.

Table 1: US Dollar-denominated Fixed-for-floating IRS Executed by SIs

	Traded Notional (US$ billions)	% of Total Traded Notional
USD LIBOR 3M	**323.3**	**87.2%**
2 to 7, 10, 12, 15, 20 and 30Y	91.7	24.7%
Other tenors and broken-dated transactions	231.6	62.4%
USD LIBOR 6M	**1.0**	**0.3%**
2 to 7, 10, 12, 15, 20 and 30Y	0.2	0.1%
Other tenors and broken-dated transactions	0.8	0.2%
USD LIBOR 1M	**46.6**	**12.6%**
Total Traded Notional	**370.8**	**100.0%**

Source: EU APAs and TVs

[26] Some fixed-for-floating IRS transactions that are subject to the DTO can be executed by SIs with counterparties that are exempt from the trading obligation. Given data limitations, ISDA cannot identify counterparty type in this data set

[27] As some market participants were unwinding US dollar LIBOR risk in the fourth quarter of 2021, that activity might have contributed to a relatively high percentage of broken-dated transactions

Average transaction size for US dollar-denominated fixed-for-floating IRS executed by SIs was more than four times larger than transactions executed on TVs. Average transaction size of US dollar-denominated fixed-for-floating IRS executed by SIs was $137.4 million versus $31.8 million for fixed-for-floating IRS executed on TVs in the fourth quarter of 2021.

Pre-trade and Post-trade Transparency Requirements for SIs

Under Markets in Financial Instruments Regulation Article 18, systematic internalizers (SIs) are required to make firm quotes for derivatives traded on a trading venue public when there is a liquid market, they are prompted for a quote by a client, and they agree to provide a quote. When there isn't a liquid market and SIs agree to provide a quote, they must disclose that quote to the client on request, but they don't have to make it public[28].

The pre-trade transparency regime requires SIs to disclose their identity when they publish their quotes. In contrast, when liquidity providers respond to a request for quote for over-the-counter derivatives on multilateral trading facilities or organized trading facilities, the trading venue is not required to publish the identity of the participants submitting a quote.

For pre-trade transparency for quotes provided on SIs, the size-specific-to-an-instrument (SSTI) threshold defines the scope of the transparency requirements. Quotes for transactions below the SSTI level must be disclosed.

As part of the post-trade transparency regime, investment firms are required to make the volume and price of transactions public, as well as the time at which they were concluded. Each transaction must be made public once through a single approved publication arrangement. This applies to transactions executed by an SI's own account and on behalf of clients. Data should be published as close to real-time as technically possible[29].

There are several post-trade transparency deferrals, including for financial instruments that aren't liquid, trades that are large in scale compared to normal market size, and transactions above the SSTI threshold that would expose liquidity providers to undue risk.

Deferrals (of price and/or volume information) provide liquidity providers with the time necessary to hedge the risk they assume from clients when facilitating their hedging activity in these sizeable and/or illiquid trades. If deferrals are too short or unavailable, other market participants would use this information to take positions in markets at the expense of liquidity providers, which would have to pay a premium to hedge these exposures.

The SSTI threshold and deferrals are crucial to SIs, as they mean pre-trade transparency requirements (which oblige quotes by SIs for potential derivatives client trades to be shared on an attributed basis with the entire market) do not apply for quotes for large trades that entail 'undue risk' to SIs. Post-trade publication of information on the volume of trades conducted above the SSTI level can also be deferred[30].

Undue risk occurs when liquidity providers are unable to hedge the risks they assume in facilitating client hedges because the market has clear sight of their exposures. If liquidity providers fear they are exposed to undue risk, they will either price in this extra risk or not trade with the client that wants to hedge.

[28] MIFIR Article 18 Obligations for Systematic Internalizers to Make Public Firm Quotes in Respect of Bonds, Structured Finance Products, Emission Allowances and Derivatives

[29] MIFIR Article 21 Post-trade Disclosure by Investment Firms, including Systematic Internalizers, in Respect of Bonds, Structured Finance Products, Emission Allowances and Derivatives

[30] ISDA Commentary on EC MIFIR Proposal: Removal of the SSTI Threshold www.isda.org/a/t0PgE/ISDA-Commentary-on-EC-MIFIR-proposals-SSTI-Threshold.pdf

Table 2: SSTI Use in Reporting Obligations under MIFIR

		Trading Venues	SIs
Pre-trade Transparency	SSTI	SSTI waiver	SSTI level (not a waiver) defining the scope of SI Pre-Trade Transparency
	Key characteristics	Pre-Trade Transparency is anonymous	SI Pre-Trade Transparency is attributable
	Objectives	Protect liquidity providers (not trading venues) from undue risk	Protect liquidity providers from undue risk
Post-trade Transparency	SSTI	SSTI deferral available if authorised by competent authority	
	Key characteristics	Post-Trade Transparency is anonymous	
	Objectives	Protect liquidity providers (not trading venues) from undue risk	

CONCLUSION

About 64.0% of IRD traded notional reported in the EU was executed on TVs in the fourth quarter of 2021. This includes trades covered by the DTO, but also a substantial volume of other types of transactions. The analysis shows IRD traded notional executed on TVs in the EU was more than double the traded notional subject to the DTO.

The percentage of traded notional executed on TVs in the EU also exceeded the proportion of transactions executed on SEFs in the US. In the fourth quarter of 2021, 57.4% of total IRD traded notional was executed on SEFs compared to 64.0% of IRD executed on TVs in the EU.

IRD transactions executed by SIs comprised 27.9% of total IRD traded notional in the fourth quarter of 2021. SIs play an important role in the EU market by enabling clients to access bespoke hedging tools. Transactions executed by SIs are generally more customized and less liquid than transactions subject to the DTO.

Average transaction size executed by SIs is significantly larger than trades executed on TVs. This underscores the importance of the SSTI threshold for pre- and post-trade transparency for SIs. As SIs are required to make firm quotes below the pre-trade SSTI level public on a name-disclosed basis, this threshold has protected SIs from undue risk. Undue risk occurs when SIs are unable to hedge the risks they assume in facilitating client hedges because the market has clear sight of their exposures.

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