ISDA
Safe, Efficient Markets

Cross-Border Debate
Issues to Watch in 2017 and Beyond
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Electronic Trading Requirements: EU v. US Regulations

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Agenda

Market structure

Derivatives trading obligation

Pre- and post-trade transparency

MiFIR framework for trading of OTC derivatives

New market structure

Implementing G20 trading mandate

New pre- and post-trade transparency regime

Market structure

New market structure

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Key changes:

- New trading venue – OTFs
- SIs wider in scope
- Trading pushed on venue or SI
- Align RM and MTFs

MiFID1

Multilateral*
- Regulated Markets (RMs)
- Multilateral Trading Facilities (MTFs)

Bilateral
- Systematic internalisers (SIs)
- OTC

MiFID2

Multilateral*
- Regulated Markets (RMs)
- Multilateral Trading Facilities (MTFs)
- Organised Trading Facilities (OTFs)

Bilateral
- Systematic internalisers (SIs)
- OTC

* "trading venues"

Key definitions

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Multilateral

RMs and MTFs

- a multilateral system... which brings together … multiple third-party buying and selling interests in financial instruments – in the system <u>and in accordance with non-discretionary rules</u> – in a way that results in a contract

OTFs (new)

- A multilateral system or facility, which is not a regulated market or MTF, ... in which multiple third-party buying and selling interests in financial instruments are able to interact in the system in a way that results in a contract

Multilateral system

- any system or facility in which multiple third parties buying and selling trading interests in financial instruments are able to interact

Bilateral

SIs

- an investment firm which, on an organised, frequent, systematic and substantial basis, deals on own account by executing client orders outside a regulated market or an MTF or an OTF, without operating a multilateral system.

  (Level 2 to specify criteria)

OTC transactions

- Not defined in MiFID2 or MiFIR

<u>Relevant Articles</u>
MiFIR Article 4

Market structure under MiFID2

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	RMs	MTFs	OTFs[1]	SIs	OTC
Operator	Exchange	Exchange or Firm	Exchange or Firm	Firm	Firm
Non-discretionary execution	Yes	Yes	No	Where quotes binding	No
Conduct of business rules	No	No	Yes	Yes	Yes
Operator can use own capital	No	No	No	Yes	Yes
Access to facilities	Transparent, non-discriminatory rules, objective criteria	Transparent, non-discriminatory rules, objective criteria	Transparent, non-discriminatory rules, objective criteria	Commercial policy (in objective, non-discriminatory way)	Commercial policy
Admission to trading	Clear, transparent rules (+ other criteria)	Transparent rules (+ adequate PAI[2])	Transparent rules (+ adequate PAI[2])	N/A	N/A
Resilience, circuit breakers, tick size	Yes	Yes	Yes	No	No
Surveillance required (MAR)	Yes	Yes	Yes	No	No

1. Non-equities only; 2. Publicly available information

Market structure under MiFID2 (continued)

	RMs	MTFs	OTFs[1]	SIs	OTC
Pre-trade transparency	Yes (incl. non-equities)	Yes (incl. non-equities)	Yes	Yes (incl. non-equities)	No
Pre-trade waiver available	Yes (incl. non-equities)	Yes (incl. non-equities)	Yes	No	N/a
Post trade transparency	Yes (incl. non-equities)	Yes (incl. non-equities)	Yes	Yes (incl. non-equities)	Yes (incl. non-equities)
Publish execution quality data	Yes	Yes	Yes	Yes	Yes (if liquidity provider)
Eligible OTC derivs platform	Yes	Yes	Yes	No	No
Authorities can suspend trading	Yes	Yes	Yes	Yes	Yes
Record orders	Yes	Yes	Yes	Yes	Yes

1. Non-equities only

Derivatives trading obligation

Overview: The trading obligation for derivatives

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OTC derivative subject to the clearing obligation under EMIR	
Not an intragroup transaction under Article 3 EMIR	Not subject to transitional provisions under Article 89 EMIR

Relevant class/sub-class declared subject to mandatory venue trading obligation

Must be traded only on:			
RM	MTF	OTF	Equivalent third country market

"Bottom up" process

1. Class of OTC derivatives is declared subject to mandatory clearing under EMIR
2. ESMA consults on whether to impose mandatory trading on that class or a subset of that class
3. ESMA proposes draft regulatory technical standards (RTS) to Commission within six months after adoption of RTS on clearing under EMIR
4. Mandatory trading may be phased-in for some counterparty types

"Top down" process

1. Where a class of OTC derivatives has not been declared subject to mandatory trading
2. ESMA shall regularly monitor activity in those derivatives to identify cases where this may pose systemic risk and to prevent regulatory arbitrage
3. ESMA shall, on its own initiative, identify and notify to the Commission derivatives that should be subject to the trading obligation but which no CCP is authorised to clear under EMIR or which are not admitted to trading.

Trading obligation: The venue and liquidity tests

Derivatives

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Venue Test	Liquidity Test

Venue Test

Is the relevant class/sub-class of instruments admitted to trading on a RM/MTF/OTF or equivalent third country market?

- In contrast to the US regime, the test is not 'venue led'
- If the class/sub-class fails the venue test no need to consider liquidity. However, ESMA may consider using 'top-down' process

Liquidity Test

Is there sufficient third-party buying and selling interest in the class/ sub-class so that such class/sub-class is considered sufficiently liquid to trade only on venue?

- ESMA will first assess which specific liquidity factors are relevant in a particular case
- ESMA will then apply the four liquidity criteria based on different weightings as appropriate for the case
- Ultimately requires an overall assessment of whether a class or sub-class sufficiently liquid to support the introduction of a trading obligation
- ESMA must also:
  - Consider **anticipated impact** on liquidity of relevant derivatives and commercial activities of end users
  - Consider whether the derivatives are only sufficiently liquid in **transactions below a certain size**
  - **periodically review** the liquidity of the relevant instrument/class and the liquidity thresholds

What venues qualify?

OTC derivative subject to the clearing obligation under EMIR

Not an intragroup transaction under Article 3 EMIR	Not subject to transitional provisions under Article 89 EMIR

Relevant class/sub-class declared subject to mandatory venue trading obligation

Must be traded only on:

RM	MTF	OTF	Equivalent third country market

- Commission decision that there are equivalent legally binding requirements:
  - Authorisation and supervision;
  - Venue has clear and transparent rules on admission to trading;
  - Issuers are subject to periodic information requirements;
  - Market abuse rules
- Effective equivalent recognition for EU trading venues for derivatives
- Commission decision only for purposes of determining eligibility as a trading venue for these purposes, and may be limited to a category or categories of trading venues
- Also need to address licensing issues for third country firms

Who is subject to mandatory trading?

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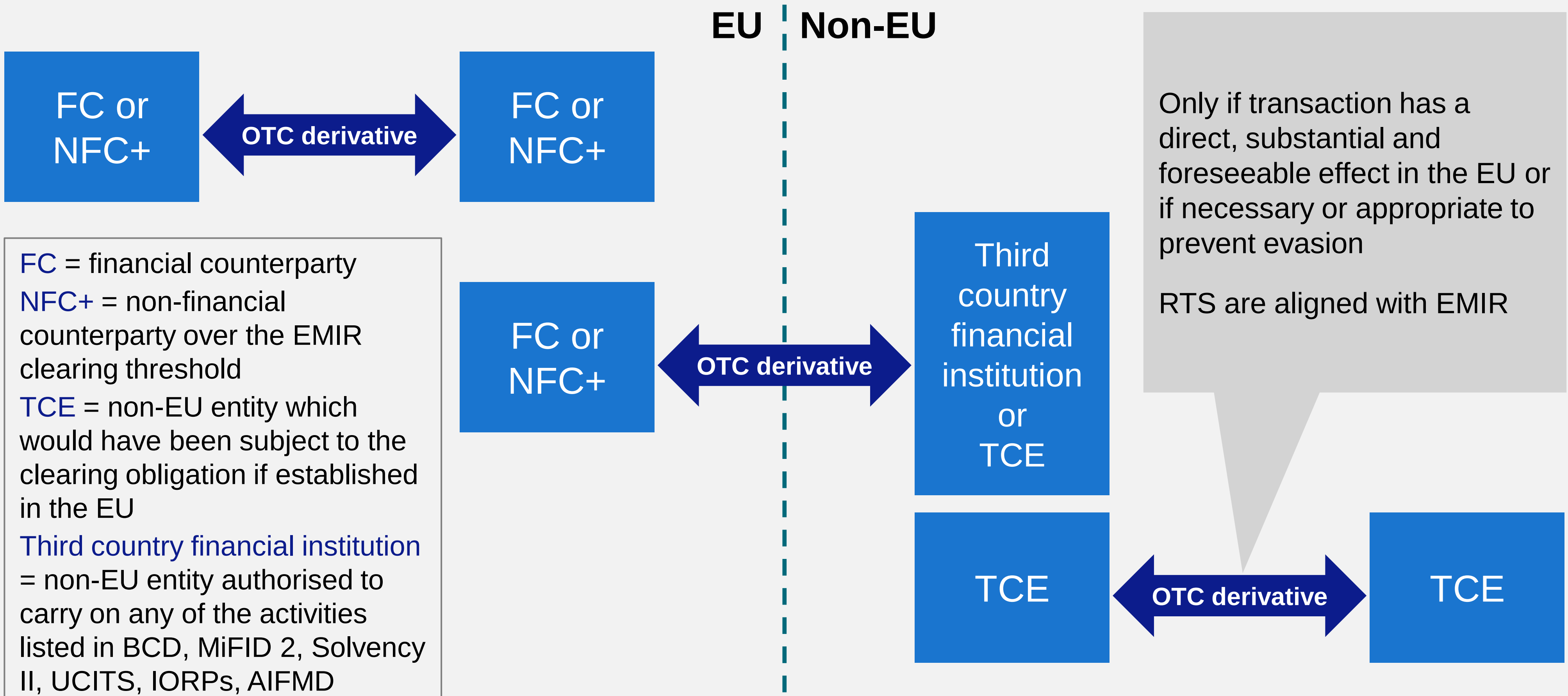

Only if transaction has a direct, substantial and foreseeable effect in the EU or if necessary or appropriate to prevent evasion

RTS are aligned with EMIR

FC = financial counterparty

NFC+ = non-financial counterparty over the EMIR clearing threshold

TCE = non-EU entity which would have been subject to the clearing obligation if established in the EU

Third country financial institution = non-EU entity authorised to carry on any of the activities listed in BCD, MiFID 2, Solvency II, UCITS, IORPs, AIFMD

Note: Exemption for duplicative or conflicting obligations.
Treatment of entities exempt under Article 1(4) or 1(5) EMIR?
Treatment of branches of non-EU entities and EU branches of non-EU entities

Duplicative and conflicting rules

	Requirement for equivalence?	Criteria for equivalence?	Who decides?	Comments
Avoiding duplicating or conflicting rules **(*Article 33 MiFIR*)**	A counterparty to a derivative will be deemed to have complied with the mandatory derivatives trading and clearing obligations under MiFIR where: - at least one counterparty is established in an **<u>equivalent non-EU jurisdiction</u>** and - the counterparties are in compliance with the relevant rules in that jurisdiction	The legal, supervisory and enforcement arrangements of the relevant third country: - are equivalent to the requirements resulting from Articles 28 and 29 MiFIR - ensure protection of professional secrecy that is equivalent to that set out in MiFIR - are being effectively applied and enforced in an equitable and non-distortive manner so as to ensure effective supervision and enforcement in that third country	- European Commission - Implement-ing act on equivalence	- The European Commission (together with ESMA) is required to monitor the laws of any jurisdiction declared equivalent, and report on at least an annual basis to the European Parliament and Council - The equivalence decision may be withdrawn

ESMA Consultation Paper on trading obligation (June 2017)

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Proposed scope of obligation:

- Specified classes of fixed-floating IRS denominated in EUR (euribor), USD (Libor), GBP (Libor) - benchmark tenors
- 5 year index CDS – iTraax Europe Main and iTraxx Europe Crossover (on the run, first of the run)
- Applying the trading venue test and liquidity test
- Not fully aligned with US classes

Proposed date of application:

- 3 January 2018
- Date clearing obligation takes effect for counterparties (if later)

No proposal to limit application for

- Transactions in large size
- Package transactions
- Alignment of liquidity tests in transparency regime

Pre- and post-trade transparency

Systematic internaliser

"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"

Article 4(1)(20) MiFID2

Systematic internalisers: proposed thresholds

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		Shares, etc.	Bonds	SFPs	Derivatives	Emission allowances
Frequent and systematic basis threshold (liquid instruments)	No. of own account * OTC transactions/ total no. of transactions in EU in same instrument/class	0.4% and at least once a day	2.5% and at least once a week	4% and at least once a week	2.5% and at least once a week	4% and at least once a week
Frequent and systematic basis threshold (illiquid instruments)	Minimum own account OTC trading frequency	at least once a day	at least once a week	at least once a week	at least once a week	at least once a week
Substantial basis threshold (Criteria 1)	Size of own account* OTC trading/firm's total volume in same instrument/class	15%	25%	30%	25%	30%
Substantial basis threshold (Criteria 2)	Size of own account* OTC trading/total EU volume in same instrument/class	0.4%	1%	2.25%	1%	2.25%

Source: Delegated act
Conditions assessed on a quarterly basis based on data from last 6 months.
For shares, etc., bonds and structured finance products (SFPs), conditions are assessed on instrument by instrument basis. For derivatives they are assessed by reference to the class or type of instrument.
* Only counts trades executed on own account when executing client orders.

Pre-trade transparency for SIs – OTC derivatives (Article 18 MiFIR)

Scope of obligations

Applies to SIs for derivatives traded on a trading venue where the SI deals in sizes at or below the size specific to the financial instrument (SSTI).

Obligations for liquid classes of OTC derivatives

SI must make public firm quotes where SI is prompted for a quote by a client and it agrees to provide a quote

- Must be made public in a manner easily accessible to other market participants on a reasonable commercial basis
- No obligation to execute with public on the basis of those quotes
- Obligation ceases if pre-trade transparency obligation of trading venue suspended because instrument falls below threshold of liquidity

However, SI must make those quotes available to its other clients and must undertake to transact with those clients on the quote

- SI must have clear standards on access to quotes but can decide on basis of commercial policy and in objective and non-discriminatory way which clients get access to quotes and may refuse to or discontinue business relationships on basis of commercial criteria, including credit status, counterparty risk and settlement
- SIs may establish non-discriminatory and transparent limits on the number of transactions they will execute pursuant to a quote

Obligations for non-liquid classes of OTC derivatives

SI must disclose quotes to clients on request if they agree to provide a quote (competent authorities can waive in some cases), but no obligation to publish those quotes or make them available for execution to other clients

TOTV – ESMA opinion (May 2017)

"ESMA is of the view that only OTC derivatives sharing the same reference data details as the derivatives traded on a trading venue should be considered to be TOTV and, hence, subject to the MiFIR transparency requirements and to transaction reporting according to Article 26(2)(a) of MiFIR."

"In this context, "sharing the same reference data details" should mean that the OTC derivatives should share the same values as the ones reported in accordance with the fields of [RTS 23] for derivatives admitted to trading or traded on a trading venue, except fields 5 to 12 (the trading venue and issuer-related fields)."

"Since the trading venue and issuer related fields are only applicable to trading venues when submitting reference data for derivatives but are not applicable for trading those contracts bilaterally outside of trading venues, ESMA considers it appropriate not to take into account these fields when determining whether an OTC derivative traded outside of a trading venue is to be considered TOTV."

"Nevertheless, ESMA is aware that what is to be considered the "same" reference data details may need to be revisited by ESMA taking into account the evolution of markets post 3 January 2018."

Pre-trade transparency for SIs – OTC derivatives (Article 18 MiFIR) (cont.)

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Obligations with respect to quotes

Quotes for liquid classes of instrument must be “firm quotes”

SIs may update their quotes at any time

SIs may withdraw their quotes “under exceptional market conditions”

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”

Quotes must be such as to ensure that 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”

Treatment of packages

Level 2 measures

Commission delegated acts:

- Specify sizes at which SI must enter into transactions with other clients
- Clarifywhat constitutes a “reasonable commercial basis” to make quotes public

Pre-trade: can you trade OTC derivatives in the dark?

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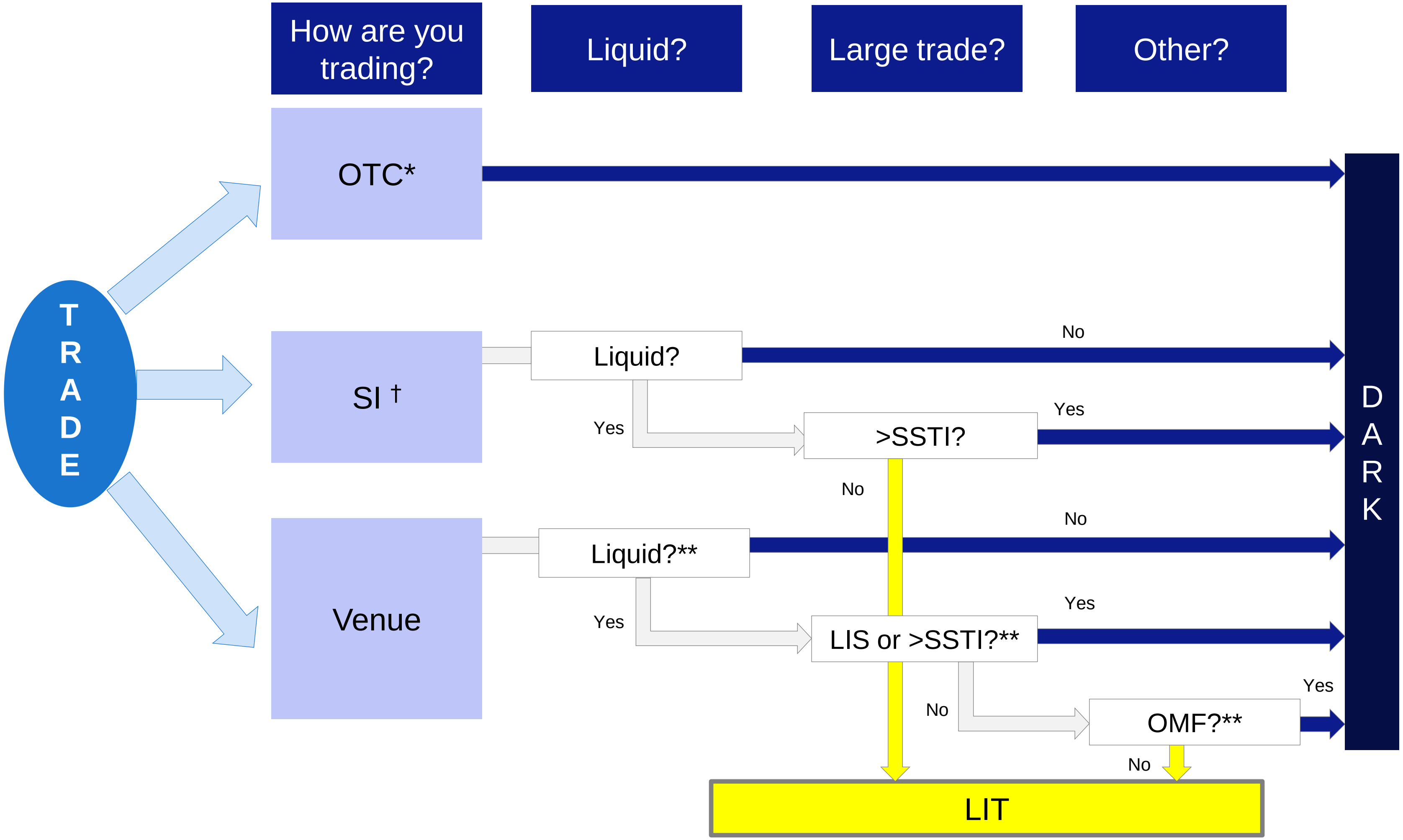

KEY

* No OTC for derivatives subject to venue trading obligation

† If instrument is also traded on a venue

** If venue has relevant waiver

SSTI – Size specific to instrument

LIS – Large in scale

OMF – Order management facility

RFQ venues may delay publication of quotes until available for execution

Venues relying on LIS waiver must publish indicative bid/offer prices close to trading interests advertised on the venue (e.g. best or simple or volume weighted average prices)

Post-trade transparency for OTC derivatives

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Publication of price, volume and time "as close to real time as technically possible"

Responsibility for disclosure is with trading venue or investment firm (via approved publication arrangement – APA)

Applies to derivatives "traded on a trading venue" including when those derivatives are traded with an SI or over-the-counter

Disclosure in any case within 15 minutes (until 1 Jan 2021) or within 5 minutes (thereafter)

Competent authorities for venue may authorise deferred publication

Where transaction is LIS, related to a derivative or class of derivatives for which there is not a liquid market or (if involves an investment firm dealing on own account not on a matched principal basis) above SSTI

"Package transaction" may also benefit from deferral if one or more of its components would be eligible for deferral

Competent authority may authorise deferred publication with publication of full details by no later than 19:00 local time on T+2 (but may request publication of details other than volume or publication of aggregated transactions during that period)

Competent authority may authorise deferred publication for extended period (up to four weeks) subject to:

Publication of all transaction details (except volume) during that period; or

Publication of several transactions executed over a week on an aggregate basis (by 9:00 on following Tuesday); and

Publication of full details of individual transactions by 9:00 on day after expiry of four week period

Questions

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