ISDA Commentary on EC MIFIR proposals: Consolidated Tape (CT) for derivatives

Executive Summary

- ISDA and GFXD ('The Associations') believe that the creation of a CT for derivatives subject to the clearing obligation (CO) is premature, and that there is (at present) a limited use-case for a CT for derivatives. We understand that there is limited support for a CT for derivatives among market participants (in contrast to the widespread support for a CT for equities and bonds) and we don't believe that any cost-benefit analysis has been undertaken to justify a CT for derivatives.

- A CT should not be mandated until the data quality issues apparent in and resulting from the use of International Securities Identification Numbers (ISINs) - as mandated under MIFIR technical standards – are resolved. ISINs are unsuited to reporting of derivatives and their use obscures and undermines trade transparency efforts. We believe it possible that no CTP will bid to offer a CT service (if mandated), as a result.

- A further precondition should be that that derivatives liquidity providers remain protected from 'undue risk' relating to publication of information on trades above certain sizes on the CT.

- We also suggest narrowing of the scope proposed for a derivatives CT, if mandated, at least initially (with possibility of expansion if the CT is successful). Our paper further highlights sequencing issues in the text which would undermine the credibility of a CTP, making for a disorderly compliance and introductory phase unless remedied.

While a CT adds value in securities markets, it will not add value to derivatives market participants

A CT is meant to enhance the ability of investors to identify pools of liquidity, enhancing transparency across multiple venues, and reducing transaction costs. However, the nature of trading, liquidity and transparency is fundamentally different in derivatives markets to that in other financial markets.

The fact that similar derivatives contracts are traded through different trading protocols, on- or off-venue, does not mean that liquidity is fragmented. Liquidity in derivatives does not depend upon the availability of a finite pool of securities issued by a single company. Credit institutions/ Investment Firms can offer derivatives on the same underlying asset without any limitation and under different contractual conditions

The interest rate and credit derivatives covered by the proposed CT are traded by sophisticated counterparties for risk management purposes. There is little retail participation in OTC derivatives (certainly less than in equities and bonds). Sophisticated counterparties can locate liquidity and do not need a CT for this purpose.

The use-case for a derivatives CT has not been demonstrated

The Associations are not aware of evidence of support for a CT for derivatives from end users (unlike bonds and equities).

- Limited cost-benefit analysis (derivatives not covered in the Market Structure Partners study)

The EC commissioned a study by Market Structure Partners ('The Study on the Creation of of an EU Consolidated Tape'), which was delivered in September 2020. This study is the main independent, third-party study underpinning the economic case for a CT in MIFIR. However this study did not examine the case for a CT for derivatives. It looked only at bonds and equities.

- Limited support across industry for a CT for derivatives

The EC's overall Impact Assessment Report on the proposed MIFIR revision cited the means it used to gather evidence on the proposal, including the Expert Group of the European Securities Committee, stakeholder meetings, consultations and ESMA reports (as well as the above-mentioned reports). The EC's February 2020 consultation asked stakeholders to comment on the appropriate product scope of a CT. The EC Impact Assessment summarises the result, presenting the asset classes in order of preference for commenting stakeholders[1]. A majority of respondents supported a CT for shares (for pre-trade and post-trade reporting), government bonds, corporate bonds and ETFs (for post-trade reporting) ***only***. Just 48 respondents out of 106 agreed to a post-trade CT for interest rate swaps (IRS), with 43 out of 103 supporting a post-trade CT for credit default swaps (CDS). This aligns with our perception of the limited interest in a CT for derivatives in our membership[2]. It is reasonable to assume that those supporting a derivatives CT assume that the flaws inherent in derivatives instrument identification (ISINs) would require remedy before a CT becomes reality.

The use of International Securities Identification Numbers (ISINs) for transparency in derivatives markets is inappropriate and would undermine the effectiveness of a CT

The Associations maintain that ISINs – which ESMA designated (in MIFID 2/MIFIR) as the identifier for derivatives reporting - are not appropriate for the purpose of transparency in derivatives markets. The use of ISINs undermines derivatives transparency and will obscure whatever value could be obtained from a CT.

Under the current trade identification system, for example, two very similar products may have different ISINs. e.g. two 5-year IRS, with one being traded one day later than the other.

On the other hand, economically different products, with different prices will share the same ISIN. It is not possible to differentiate by ISIN between a cleared 5 year interest swap and a similar 5 year interest rate swap that is risk managed bilaterally for example, even though the two contracts will be priced differently (with pricing linked to the counterparty credit considerations and fees associated with a CCP, in the first case, and the specific Credit Support Annex (CSA) considerations relating to the bilateral counterparty on the other). While APAs'[3] reports now do enable identification of cleared transactions, they do not distinguish between similar contracts cleared at different clearing houses (which will also have different prices).

The current system also generates (unnecessarily) large amounts (over 70 million at the moment) of ISINs (relative to other asset classes), paid for by market participants.

[1] See page 74 of print version, or page 75 of online pdf: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021SC0346&from=EN

[2] Today, ISDA has over 960 member institutions from 78 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.

[3] Approved Publication Arrangements – used to comply with trade transparency requirements.

Because of the issues caused by ISINs, we are sceptical as to whether a CT for derivatives would add value for market participants. As such, we are also sceptical as to whether service providers will bid for this service.

We remain available to work with regulators to remedy derivatives instrument identification.

If a CT is mandated, liquidity providers must remain protected from 'undue risk'

- Equities, Bonds and Derivatives – fundamental differences

As mentioned, the derivatives market differs significantly from the equity market (for example) in terms of its market structure, and in the nature and composition of liquidity available for market participants. These differences in the markets should be acknowledged in considering the appropriateness of a CT for derivatives.

Equities markets comprises a limited number of wholly fungible securities, in small trade sizes and high volumes of trades. Derivatives trade as a large number of non-fungible individual contracts with large trade sizes and low volumes of trades. These differences influence how liquidity is provided in each market. While equities are primarily executed on electronic order books by matching of price-driven orders by market participants, derivatives are executed by market makers providing balance sheet liquidity to counterparties, trading through request-for-quote (RFQ) systems or bilaterally.

- Keeping extended transparency deferrals to protect from undue risk

In order for market makers to provide liquidity and enable hedging by market participants, they need, in turn, to be able to offset the risks they assume, avoiding 'undue risk', i.e. the risk that their exposure is known by other market participants who would take advantage of it with predatory behaviour (protection from 'undue risk' is recognised as the basis for waivers from pre-trade transparency and deferrals from post-trade transparency in the current MIFIR – please see the other briefing ISDA has circulated this week on the EC's trade transparency proposals, especially regarding the 'Size Specific to an Instrument (SSTI)' threshold).

Provisions to protect market makers from undue risk must be factored into post trade transparency feeding into the CT if they are to be able to continue to optimise pricing for end users. This includes, for example, volume caps, i.e. above a certain size, only a threshold size should be reported (rather than actual trade size). Furthermore, while we agree that end-users will only use the derivatives CT if data is accurate, meaningful and published shortly after transactions are made ('as close to real time as possible'), a limited time deferral is necessary for public reporting of some transactions.

Some of the provisions in the proposal on CTs already raise concern in this context. The proposed definition of 'core market data' (see Article 2.1 (36b)(a)(v) of the consolidated text under the EC proposal) includes the Market Identifier Code (MIC) identifying the execution venue. As such, APAs or SIs reporting trades executed by SIs to CTs will have to disclose the SIs' MIC. It also appears that the CT will consolidate and publish all the data provided, including the MIC identifying the SI that executed a trade (see new Article 27h(1)(d)). This exposes SIs to unnecessary risk. CTPs should publish data on trades executed by SIs in a manner that does *not* identify the SI (e.g. the current provisions of Article 27h(1)(g) require CTPs to publish "the code for the trading venue the transaction was executed on, or where the transaction was executed via a systematic internaliser the code 'SI' or otherwise the code 'OTC'").

If a CT for derivatives is mandated, the scope should be narrowed, at least in an initial phase

The Associations believe that – if a derivatives CT is ultimately mandated – the product scope should be altered to apply to IRS subject to the CO that are executed on a venue under the Derivatives Trading Obligation (with the possibility for the EC to expand the scope at a later stage to all derivatives cleared at a CCP under the CO).

In the case of both the initial and subsequent phases outlined above, it should be clear that trades between or involving counterparties that are not required to comply with the CO (e.g. intragroup trades[4] or trades involving Pension Scheme Arrangements (PSAs)) or NFCs-) should not be published to the CT.

This prudent approach would also provide an opportunity for the EC and ESMA to evaluate the success of the CT subject to a more limited product scope before (if successful) trying to broaden it.

If a CT is mandated, amendments are required to address sequencing issues which may undermine it

- ***Timing of selection process.*** Under the proposal, ESMA is required to start the selection process within three months of entry into force and select and authorise Consolidated Tape Providers (**CTPs**) within three months of initiation of the selection procedure. However:
    - it is unlikely that the EC's harmonized data standards would be ready in time for applicants to consider them when submitting a bid.
    - Applicants may want to know:
        - how clock synchronisation will work before they submit their bid (CTs, venues, investment firms and APAs must synchronise clocks under the new rules). However ESMA is only required to deliver draft RTS specifying these requirements within six months after entry into force. The final RTS may only be available several months later (after any EC amendments and Parliament and Council scrutiny).
        - how burdensome the reporting requirements will be for CTs, but ESMA is only required to deliver RTS specifying these requirements within nine months after entry into force. There could be a delay of several months before final RTS are available.
        - the content, format and terminology of the 'reasonable commercial basis' information that CTs will have to make available to the public (see also the comment below about whether these obligations apply to CTs). However, ESMA is only required to deliver RTS specifying these requirements within nine months after entry into force. There could be a delay of several months before final RTS are available.

    There is a risk that no applicant will bid without this information. It is unclear whether ESMA can start another process if the first process fails to produce a CTP for all/any class of instruments.

- ***Application of publication requirements to CTPs***. Proposed new Article 13(3) MiFIR suggests that CTPs will be subject to the same requirements as APAs and SIs as to " the content, format and terminology of the reasonable commercial basis information that [they] have to make available to the public". However, the amendments to Article 27h MiFIR mean that CTPs will not be subject to any obligation to make data available to the public on a reasonable commercial basis, although new Article 27h(1)(d) indicates that they will be subject to the harmonised data standards set by the Commission's delegated acts under new Article 22b. The text should make clear the relationship between the data standards under Article 22b and the RTS under Article 13(3) and how these apply to CTPs.

[4] See See COMMISSION DELEGATED REGULATION (EU) 2021/237 of 21 December 2020 amending regulatory technical standards laid down in Delegated Regulations (EU) 2015/2205, (EU) 2016/592 and (EU) 2016/1178 as regards the date at which the clearing obligation takes effect for certain types of contracts

If the consolidated data CTPs publish is of any value, there may also need to be some controls over CTPs' ongoing pricing as there will be no other source for consolidated data (at least if their bids or authorisation allow them price flexibility during the term of their appointment).

- ***Timing of start of contribution/consolidation of data.*** The proposed amendments to MIFIR suggest that market data contributors must start contributing data to a CT as soon as it has been authorised. This assumes that CTPs will be appointed and authorised before the delegated act (DA) on market data standards has been adopted and entered into application, but market data contributors should not be required to start contributing until the DA has been adopted and entered into application. There should also be an adequate conformance period between entry into force of the DA (after OJ publication) and its entry into application to allow contributors (and CTPs) to prepare for compliance. There should also be an initial testing period after entry into application during which market data contributors contribute data but where the CTP tests its systems, without publishing the data as a CT. There should also be a mechanism for delaying entry into application without the need for an amendment to the DA (which requires compliance with the no-objection process) to address any teething difficulties. The five-year term of the CTP should only begin to run from the expiry of the testing period.

ISDA/GFXD recommendations
ISDA and GFXD members are of the view that regulators, policy-makers and market participants should focus on the creation of a CT for equities (and bonds) and de-prioritize the creation of a CT for derivatives until a comprehensive use-case and cost-benefit analysis is available for consideration. Other preconditions to establishment of a potential CT for derivatives should include: resolving issues around instrument identification (caused by use of ISINs) and ensuring market makers remain protected from 'undue risk.

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About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 960 member institutions from 78 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 Twitter, LinkedIn, Facebook 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 23 global foreign exchange (FX) market participants, collectively representing the majority of the FX inter-dealer market[5] . 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.

[5] According to Euromoney survey