

February 7, 2018

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Re: MiFID II – Market Practices that are Undermining OTC Derivatives Reforms & Technical Advice to Remedy Identified Deficiencies

The implementation of MiFID II is a landmark achievement for EU financial markets. As a significant participant in these markets, Citadel LLC¹ is a firm supporter of reforms designed to improve market transparency, efficiency, and stability. With respect to the OTC derivative markets, MiFID II implements the G-20 commitments to increase market transparency and to move the trading of standardized OTC derivatives onto open and competitive trading venues – reforms that are critical to transforming a previously opaque market that proved a significant source of systemic risk during the financial crisis.

However, notwithstanding the clear letter and intent of MiFID II and its implementing measures, certain market practices have emerged in the first month of implementation that threaten to undermine these essential reforms. We would like to take this opportunity to highlight the problems we see, and offer technical advice on how to remedy identified deficiencies. We summarize six specific issues in the following two pages, followed by a detailed issue-by-issue description in the remainder of this letter. In each case, we believe prompt action from regulators and policymakers is warranted to protect the strong foundations of MiFID II.

Providing Meaningful OTC Derivatives Market Transparency

MiFID II aims to increase pre-trade and post-trade transparency for market participants. Increasing transparency leads to meaningful benefits for end investors by removing information asymmetries and facilitating more accurate assessments of execution quality. However, we have already witnessed a number of market practices that are hindering greater transparency in the OTC derivatives market. These same practices will also likely impair market supervision and oversight by regulators.

¹ Citadel is a global financial firm built around world-class talent, sound risk management, and innovative market-leading technology. For more than a quarter of a century, Citadel's hedge funds and capital markets platforms have delivered meaningful and measurable results to top-tier investors and clients around the world. Citadel operates in all major asset classes and financial markets, with offices in the world's leading financial centers, including Chicago, New York, San Francisco, Boston, London, Dublin, Hong Kong, and Shanghai.

Issue 1 – Access to Data: APAs and Trading Venues are failing to publish the required OTC derivatives data free of charge in an accessible and usable manner

MiFID II specifically requires “approved publication arrangements” (“APAs”) and trading venues to provide transparency data to the public *free of charge* 15 minutes after publication. Nevertheless, APAs and trading venues are adopting a variety of practices that are inconsistent with this requirement, such as publishing data for only seconds before it is then deleted or publishing data in unusable formats. These practices appear motivated in part by a desire to compel market participants to subscribe to expensive data packages in order to obtain MiFID II transparency data that should be provided free of charge.

Issue 2 – Making Sense of the Data: The current ISIN creation process is harming market transparency for OTC derivatives

Under MiFID II, International Securities Identification Numbers (“ISINs”) were extended to OTC derivatives. However, due to inadequate controls over certain ISIN fields, it appears that as many as 5 different ISINs are often being created *each day* for the identical OTC derivative instrument. In addition, even though ESMA specifically included a field to specify the term (or length) of an OTC derivative contract, this field was not included as part of the ISIN. Both of these issues are undermining market transparency by making it difficult to link a specific OTC derivative instrument to a single ISIN.

Issue 3 – Scope of the Transparency Regime: The concept of “traded on a trading venue” is being interpreted too narrowly, undermining transparency for off-venue OTC derivatives

In order for an OTC derivative instrument executed off-venue to be subject to MiFID II transparency requirements, it must be an instrument that is also considered “traded on a trading venue” (“ToTV”). However, reference data field inconsistencies and the existence of a one-day lag when assessing which instruments are ToTV are both significantly reducing the scope of MiFID II transparency. As a result, only a limited number of off-venue OTC derivatives transactions executed by systematic internalisers are currently covered by transparency requirements.

Issue 4 – Exceptions from the Transparency Regime: The transparency waivers and deferrals are miscalibrated for OTC derivatives

Of the OTC derivatives currently subject to the MiFID II transparency regime, it appears from publicly available data that nearly all transactions are eligible for a waiver from pre-trade transparency and a deferral from post-trade transparency, even derivatives subject to the trading obligation. In order to ensure that these waivers and deferrals are calibrated in a more granular manner when the transitional transparency calculations are next updated in April 2019, it is critical that EU regulators have complete and accurate data from APAs and trading venues. However, this requires addressing the ToTV issues detailed above and ensuring that trading activity on equivalent third-country trading venues is not excluded.

Transitioning OTC Derivatives Onto Open and Competitive Trading Venues

The MiFID II derivatives trading obligation implements a key G-20 reform that is designed to promote market stability and integrity while improving conditions for investors through increasing market transparency and competition. However, the success of this reform depends on market liquidity successfully transitioning onto trading venues that facilitate competition among liquidity providers. Two issues warrant further attention.

Issue 5 – Material trading volumes in OTC derivatives subject to the trading obligation appear to be occurring off-venue

Initial observations from publicly available data shows that *more than 60% of dealer-to-customer trading activity in OTC derivatives subject to the trading obligation may still be occurring off-venue.*² This suggests that “Category 3” financial counterparties (which are not yet subject to the trading obligation) account for far more trading activity than previously estimated and, therefore, that caution should be exercised when proposing permanent exemptions from the clearing and trading obligations for these entities, as is currently being discussed as part of EMIR Refit.

Issue 6 – Trading Venues are adopting inconsistent approaches with respect to complying with certain regulatory requirements

Greater consistency should be promoted across EU trading venues with respect to complying with key regulatory requirements, such as non-discriminatory access and straight-through-processing. We have observed practices that are inconsistent with MiFID II requirements and ESMA guidance.

Respectfully,

/s/ Stephen John Berger

Managing Director, Government & Regulatory Policy

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² “Tradeweb and Bloomberg MTF Market Share” (Feb. 6, 2018), Clarus Financial Technology, available at: <https://www.clarusft.com/tradeweb-and-bloomberg-mtf-market-share/>.

Annex: Summary of Recommendations

Issue 1 – Transparency Regime: Access to Data

1. Review how APAs and trading venues are publishing the required transparency data, including whether the required transparency data is being published (a) correctly and (b) free of charge in an accessible and usable manner.
2. Provide additional guidance to APAs and trading venues where necessary to promote consistency.
3. Longer-term, consider removing the ability of APAs and trading venues to charge for regulatory-required transparency data at all.

Issue 2 – Transparency Regime: Making Sense of the Data

1. Engage with ANNA-DSB to standardize how the “Delivery Type” and “Reference Rate” fields are completed in order to prevent duplicate ISINs from being created for the identical OTC derivative.
2. Add the “IR term of contract” field to the ISIN so that market participants and regulators are able to distinguish between spot-starting and forward-starting interest rate swaps.
3. Longer-term, consider removing the “expiry date” field from the ISIN and instead assign a single ISIN to each OTC derivative based on tenor (e.g. a 10-year interest rate swap).

Issue 3 – Transparency Regime: Scope

1. Standardize the reference data fields used for determining ToTV, including “Instrument Full Name,” “Delivery Type” and “IR term of contract.” Do not require matching of the ISIN field.
2. Address the issues caused by market participants employing a one-day lag to assess which instruments are ToTV.
3. Longer-term, assess the amount of trading activity in OTC derivatives (both in terms of daily trade count and daily volume) that is not considered to be ToTV and consider whether the concept should be re-interpreted or removed.

Issue 4 – Transparency Regime: Waivers and Deferrals

1. Assess the percentage of trading activity in OTC derivatives (both in terms of daily trade count and daily volume) that is granted either a transparency waiver or deferral.
2. Ensure EU regulators have complete and accurate data for the next liquidity assessments. This includes (a) addressing the interpretation of “traded on a trading venue” and (b) considering trading activity on equivalent third-country trading venues.
3. Longer-term, restrict overly broad waivers and deferrals by (a) taking into account trading activity data from CCPs, TRs, and ARMs, (b) limiting extended deferrals to instruments that are illiquid, and (c) considering derivatives subject to a clearing obligation to be liquid for transparency purposes.

Issues 5/6 – Trading Obligation: Counterparty Scope and Trading Venue Compliance

1. Assess the percentage of trading activity in OTC derivatives subject to the trading obligation (both in terms of daily trade count and daily volume) that is continuing to occur off-venue. This will assist in better quantifying the trading activity of “Category 3” counterparties.
2. Promote consistency across trading venues with respect to compliance with key regulatory requirements, including non-discriminatory access and STP.

Issue 1 – Access to Data: APAs and Trading Venues are failing to publish the required OTC derivatives data free of charge in an accessible and usable manner

Compelling market participants to pay for MiFID II transparency data that is required to be published free of charge increases costs for investors and exacerbates existing information asymmetries.

Ensuring market participants have access to the MiFID II transparency data

In order for MiFID II to successfully increase market transparency as intended, market participants must be able to access the data that is required to be published by APAs and trading venues. For this reason, APAs and trading venues are specifically required to publish transparency data to the public *free of charge* 15 minutes after publication.³ While MiFID II permits APAs and trading venues to charge for *real-time data* on a “reasonable commercial basis,” these entities are prohibited from charging for MiFID II transparency data once it has been delayed for 15 minutes.

Unfortunately, APAs and trading venues are seeking to circumvent this requirement to provide the MIFID II transparency data free of charge by adopting a variety of practices designed to impair access to, and use of, any freely available data. These practices include:⁴

- Deleting data shortly after it has been published (sometimes in less than a minute).
- Publishing data in a format that prevents the data from being used by market participants, such as by disabling ‘search’ and ‘copy’ functionality or by publishing data as picture files.
- Failing to publish any data and instead requiring market participants to submit search queries in order to access limited portions of the data (e.g. ISIN-by-ISIN searches). Given the number of ISINs being generated daily, requiring manual ISIN-by-ISIN searches makes it nearly impossible for market participants to access all of the transparency data that should be available.

These practices are inconsistent with the regulatory obligation to publish data free of charge. Transparency data should be accessible by market participants for a reasonable period of time (e.g. for at least a day at the very minimum, though ideally historical data should also be available⁵) and should be published in a format that is usable (e.g. can be downloaded). Otherwise, market participants will be compelled to subscribe to expensive data packages in order to have access to

³ See Article 13(1) of MiFIR (for trading venues) and Article 64(1) of Directive 2014/65/EU (for APAs). In addition, under Commission Delegated Regulation (EU) 2017/571, APAs are specifically required to publish data in “machine readable” format that facilitates the consolidation of the information with similar data from other sources.

⁴ Also see the article from Clarus, a third-party data analytics firm, “MiFID II Data – Interest Rate Swaps on D2D Venues” (Jan. 24, 2018), available at: <https://www.clarusft.com/mifid-ii-data-interest-rate-swaps-on-d2d-venues/>.

⁵ We note in the U.S., for example, that the DTCC swap data repository real-time dissemination dashboard – which performs an analogous function in making regulatory required transparency data freely available to the public – publishes minute-by-minute data files throughout a given day, posts cumulative daily data files for the past 30 days, and provides historical search functionality. See: <https://rtdata.dtcc.com/gtr/dashboard.do>.

any usable information, effectively undermining the transparency reforms by increasing costs for investors and exacerbating existing information asymmetries.

In addition to the practices above, we have observed certain trading venues failing to publish the required transparency data at all. Greater oversight is required to ensure that APAs and trading venues adopt accurate and consistent approaches to applying available waivers and deferrals from transparency requirements, including, for transactions that receive a post-trade deferral, publishing weekly aggregate volumes as well as full trade details after expiration of the deferral, as required.

Please see Exhibit 1 immediately below for a full list of relevant APAs and trading venues for OTC derivatives and the problematic practices witnessed thus far.

Longer-term considerations

Permitting APAs and trading venues to charge for real-time data prior to the expiration of the 15 minute delay period provides an incentive for them to decrease the quality of the data they later publish free of charge. Depending on the extent of oversight that is required to ensure that APAs and trading venues comply with the requirement to publish transparency data to the public free of charge on a delayed basis, it may be appropriate to remove their ability to charge for regulatory-required transparency data at all. This would be consistent with the approach taken in other jurisdictions, where transparency data relating to OTC derivatives is required to be immediately available to market participants free of charge.

Recommendations for EU Regulators/Policymakers:

- Review how APAs and trading venues are publishing the required transparency data, including whether the required transparency data is being published (a) correctly and (b) free of charge in an accessible and usable manner.
- Provide additional guidance to APAs and trading venues where necessary to promote consistency.
- Longer-term, consider removing the ability of APAs and trading venues to charge for regulatory-required transparency data at all.

Exhibit 1: Issues encountered with the publication of OTC derivatives transparency data

APA/Trading Venue	Publishing Website and Issues Encountered
<i>APAs</i>	
Bloomberg	https://www.bloombergapa.com/ <ul style="list-style-type: none"> Data is deleted after 60 seconds
Tradeweb	https://www.apa.tradeweb.com/ <ul style="list-style-type: none"> Data is provided as an image that is not machine readable, with 'search' and 'copy' capabilities disabled Only the last 100 records appear before they are deleted
<i>Trading Venues</i>	
Bloomberg MTF	https://data.bloombergmft.com/transparency <ul style="list-style-type: none"> Data is deleted after 60 seconds
Tradeweb Europe Limited MTF	https://www.apa.tradeweb.com/ <ul style="list-style-type: none"> Data is provided as an image that is not machine readable, with 'search' and 'copy' capabilities disabled Only the last 100 records appear before they are deleted
Tradeweb OTF	
Trad-X MTF	http://apa.abide-financial.com/home/search (Tradition is using NEX to publish transparency data) <ul style="list-style-type: none"> No data is published and instead market participants must initiate ISIN-by-ISIN searches to determine whether any information is available Does not appear to be publishing the required transparency data under MiFIR Article 11
Tradition OTF	
iSwap Europe MTF	https://www.tpicapmifidiidata.com/login <ul style="list-style-type: none"> No data is published and instead market participants must initiate ISIN-by-ISIN searches by venue to determine whether any information is available Does not appear to be publishing the required transparency data under MiFIR Article 11
Tullet Prebon Europe MTF	
Tullet Prebon Europe OTF	
ICAP Securities OTF	
ICAP WCLK MTF	
ICAP Global Derivatives Limited MTF/SEF	
BGC Brokers OTF	https://regdata.fenicsmd.com/login <ul style="list-style-type: none"> Does not appear to be publishing the required transparency data under MiFIR Article 11
GFI Brokers Limited OTF	

Issue 2 – Making Sense of the Data: The current ISIN creation process is harming market transparency for OTC derivatives

Current practices are making it difficult to link a single OTC derivative instrument to a single ISIN, which undermines the utility of the MiFID II transparency data.

Two issues require urgent attention: (a) multiple ISINs are being created each day for the identical OTC derivative instrument due to inadequate controls over how certain ISIN fields are populated and (b) the ISIN inexplicably omits a key field that was included in ESMA’s regulatory technical standards.

Preventing duplicate ISINs from being created each day for the same OTC derivative instrument

It appears that *as many as 5 different ISINs are often being created each day for the identical OTC derivative instrument*, based on the current ANNA-DSB process for creating ISINs. The existence of duplicate ISINs for the same instrument significantly undermines market transparency, as the transparency regime only applies where a given ISIN is deemed to be “traded on a trading venue.” Thus, even for an OTC derivative instrument that has traded on-venue and therefore should be in-scope for transparency, it is possible for market participants to use an ISIN that has not been deemed “traded on a trading venue” and avoid transparency requirements. In addition, duplicate ISINs make it extremely difficult to determine aggregate trading activity for any given OTC derivative instrument.

In Exhibit 2 on the next page, we provide an example showing 5 ISINs that were created for the same EUR 5Y interest rate swap (“IRS”) traded on January 17th. The number of duplicate ISINs results from a lack of standardization in the ISIN creation process with respect to the following fields:

- **Delivery Type.** Market participants can choose “cash” or “physical” in the ‘delivery type’ field. However, this field has no economic significance for many instruments, such as fixed-to-float IRS, since there is no “delivery” in practice. The input for this field should therefore be standardized to avoid the creation of duplicate ISINs for the same instrument.
- **Reference Rate.** Market participants can choose to specify the publisher of an otherwise identical reference rate in the ‘reference rate’ field, which is an overly granular approach as there can be multiple publishers of the exact same reference rate. For example, “3-month Euribor” is a reference rate, but can be sourced from a Reuters webpage or a Telerate webpage. Allowing separate ISINs to be created based on the reference rate publisher leads to significant ISIN duplication. The values for the ‘reference rate’ field should be limited to the standard index name used by the International Organization for Standardization (ISO).

Exhibit 2: Duplicate ISINs for the same OTC derivative instrument

Instrument	Fixed-to-Float Interest Rate Swap
Currency	EUR
Tenor	5Y
Reference Rate	Euribor 3M
Trade Date	17/1/2018 (meaning the expiry date is 19/1/2023 since the effective date is T+2)

ISIN	Delivery Type	Reference Rate
EZVR9G5B91L9	Cash	EUR-EURIBOR-Reuters
EZ6T3B8NH8F6	Cash	EUR-EURIBOR-Telerate
EZ1LXZYZHZW2	Cash	EUR-EURIBOR-Reference Banks
EZ1BN1NHGPW6	Physical	EUR-EURIBOR-Reuters
EZ6MP74YGWH8	Physical	EUR-EURIBOR-Reference Banks

Adding a necessary field to the ISIN – Term of Contract

The ISIN currently contains a field for the “expiry date” of an OTC derivative instrument, but does not contain any information regarding either (i) the date on which the contractual obligations begin (the “effective date”) or (ii) the length of the contract following the effective date (the “tenor”). This means that there is currently no way to differentiate between spot-starting and forward-starting IRS with the same expiry date. For example, a 2-year spot-starting IRS traded today will have the same expiry date as a 1-year IRS traded today that is forward-starting by 1-year (meaning that it only goes into effect in a year). Using the same ISIN for these two very different OTC derivative instruments undermines market transparency, and complicates the ability of EU regulators to monitor market activity and compliance with the regulatory requirements, such as the derivatives trading obligation (since only the 2-year spot-starting IRS is subject to the trading obligation, not the 1-year forward-starting 1-year IRS).

Interestingly, ESMA specifically included an “IR Term of contract” field as part of the required reference data to be submitted for interest rate derivatives.⁶ If included as part of the ISIN, this field would have provided the necessary information on the tenor of a particular OTC derivative to address the issue above. However, despite the ISIN incorporating almost every reference data field required by ESMA, this particular field was inexplicably excluded. It is imperative that this field be added to the ISIN so that both market participants and regulators are able to distinguish between spot-starting and forward-starting IRS.

⁶ See Field 41 of Table 3 of Commission Delegated Regulation (EU) 2017/585, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0585&from=EN>.

Longer-term considerations

Addressing the two issues identified above is a critical first step to ensure that, on any given day, an OTC derivative instrument only has one ISIN. However, it is important to note that as long as the “expiry date” remains a field in the ISIN, a new ISIN will still have to be created *each day* for the same interest rate derivative instrument (i.e. a 10-year IRS traded today has a different expiry date than a 10-year IRS traded tomorrow). This means that the number of ISINs will continue to increase over time, with negative impacts for overall market transparency and costs for investors.⁷ For example, to determine the aggregate trading activity in a standard 10-year IRS over the course of a month, a market participant or regulator would have to track the new ISIN used each day for that instrument and then consolidate available data across each such ISIN. This task will only increase in complexity over time. Separately, in the first month of MiFID II implementation, ANNA-DSB has already increased user fees by 73%, costs that can be expected to be passed-down to all market participants.⁸ In light of the above, EU regulators and policymakers should consider removing the “expiry date” field from the ISIN and instead assign a single ISIN to each OTC derivative based on tenor or term of contract (e.g. a 10-year IRS) that can remain constant day-by-day.

Recommendations for EU Regulators/Policymakers:

- Engage with ANNA-DSB to standardize how the “Delivery Type” and “Reference Rate” fields are completed in order to prevent duplicate ISINs from being created each day for the identical OTC derivative.
- Add the “IR term of contract” field to the ISIN so that market participants and regulators are able to distinguish between spot-starting and forward-starting IRS.
- Longer-term, consider removing the “expiry date” field from the ISIN and instead assign a single ISIN to each OTC derivative based on tenor (e.g. a 10-year IRS) that can remain constant day-by-day.

⁷ See “MiFID II- Why ISINs for OTC Derivatives Are Bad for Transparency” (Jan. 10, 2018), Clarus Financial Technology, available at: <https://www.clarusft.com/mifid-ii-why-isins-for-otc-derivatives-are-bad-for-transparency/>.

⁸ “Isin service increases annual fees by 73%”, (Jan. 25, 2018), Risk.net, available at: <https://www.risk.net/regulation/5387771/isin-service-increases-annual-fees-by-73>.

Issue 3 – Scope of the Transparency Regime: The concept of “ToTV” is being interpreted too narrowly, undermining transparency for off-venue OTC derivatives

The MiFID II transparency regime is covering far fewer off-venue OTC derivatives transactions than intended.

Under MiFID II, an OTC derivative instrument executed off-venue will only be subject to transparency requirements if it is an instrument that is also considered “traded on a trading venue” (“ToTV”). ESMA has interpreted this phrase to mean that an instrument must share the *exact same* reference data details as an instrument that has been admitted to trading on a venue (i.e. all reference data fields must “match”).⁹ This strict interpretation considerably narrowed the scope of OTC derivatives subject to transparency requirements under MiFID II. However, following MiFID II implementation, this scope has been narrowed even further due to (a) inconsistencies with how certain reference data fields are being populated and (b) market participants employing a one-day lag to assess which instruments are ToTV. We recommend that EU regulators and policymakers address these issues as a matter of priority.

Reference data inconsistencies

Requiring the following reference data fields to perfectly “match” is resulting in the exclusion of standardized OTC derivatives that should be subject to transparency requirements:

- **Instrument Identification Code (ISIN).** As detailed in Issue 2, as many as 5 different ISINs are often being created each day for the same OTC derivative instrument, leading to otherwise identical OTC derivative instruments failing to match.
- **Instrument Full Name.** There are inadequate controls over how this free text reference data field is completed, and different names are being used for the exact same instrument. This results in identical OTC derivative instruments failing to match. The more standardized “financial instrument short name” field should instead be used.
- **Delivery Type.** As detailed in Issue 2, for many OTC derivative instruments there is no “delivery” in practice, meaning that this reference data field has no economic significance. Allowing market participants to nevertheless choose “cash” or “physical” results in identical OTC derivative instruments failing to match.
- **IR term of contract.** As detailed in Issue 2, this field is currently not part of the ISIN but is separately reported as a reference data field. Based on ESMA’s Financial Instruments Reference Data System (“FIRDS”), it does not appear that this field is being reported in a consistent manner. In particular, trading venues appear to be reporting the reset period of the reference rate (i.e. “3 months” for 3-month Euribor) instead of the term, or length, of the contract. Inconsistent reporting of this reference data field results in identical OTC derivative instruments failing to match.

These fields should either be standardized or excluded from consideration for purposes of determining ToTV status for OTC derivative instruments. Further, in no event should the ISIN be

⁹ See <https://www.esma.europa.eu/press-news/esma-news/esma-clarifies-traded-trading-venue-under-mifid-ii>.

required to match if an ISIN has not yet been assigned to the instrument when the pre-trade ToTV assessment is conducted. Separately, we note that certain fields appear to be blank in many FIRDS entries, such as the “expiry date” field, which may also result in failures to match.

The problems with employing a one-day lag to assess which instruments are ToTV

Market participants are currently using the ESMA FIRDS database to determine whether a specific OTC derivative instrument is ToTV. However, the FIRDS database is only updated on a T+1 basis, meaning that an ISIN first traded on-venue today will only appear as ToTV in the FIRDS database tomorrow. Since a new ISIN is created *each day* for the same interest rate derivative (as its “expiry date” changes each day), this one-day lag in assessing whether an instrument is ToTV means that interest rate OTC derivatives will be excluded from the MiFID II transparency regime when executed off-venue by systematic internalisers unless trading venues pre-load ISINs and reference data into the FIRDS database in advance.

We urge EU regulators and policymakers to address this topic to avoid a lack of transparency for standardized interest rate OTC derivatives executed off-venue by systematic internalisers. Possible solutions include (i) facilitating a more real-time assessment of ToTV, (ii) requiring trading venues to pre-load future ISINs and reference data for the standardized interest rate derivatives listed on their platforms, or (iii) modifying the ToTV assessment criteria so that the daily change to the expiry date does not result in interest rate OTC derivatives being excluded from the transparency regime when executed off-venue.

Longer-term considerations

Given the issues identified above, we urge EU regulators to conduct an assessment regarding the percentage of trading activity in OTC derivatives (both in terms of daily trade count and daily volume) that is not considered to be ToTV and is therefore exempt from MiFID II transparency requirements. We note that, in other jurisdictions, public transparency requirements apply to all OTC derivatives, not just those that are considered to be “traded on a trading venue.”

Recommendations for EU Regulators/Policymakers:

- Standardize the reference data fields used for determining ToTV, including “Instrument Full Name,” “Delivery Type” and “IR term of contract.” Do not require matching of the ISIN field for ToTV purposes.
- Address the issues caused by market participants employing a one-day lag to assess which instruments are ToTV.
- Longer-term, assess the amount of trading activity in OTC derivatives (both in terms of daily trade count and daily volume) that is not considered to be ToTV and consider whether the concept should be re-interpreted or removed.

Issue 4 – Exceptions from the Transparency Regime: The transparency waivers and deferrals are miscalibrated for OTC derivatives

In order to ensure that transparency waivers and deferrals are calibrated more accurately when updated in April 2019, it is critical that EU regulators have complete and accurate data.

Assessing the current regime

Due to the ToTV issues identified in Issues 2 and 3, the current MiFID II transparency regime covers on-venue, and only a limited number of off-venue, OTC derivative transactions. Of these, based on initial observations from publicly available data, it appears as though *nearly every OTC derivatives transaction* is eligible for a waiver from pre-trade transparency and a deferral from post-trade transparency, even transactions in derivatives subject to the trading obligation. While this outcome was expected given that ESMA’s transitional transparency calculations deemed most OTC derivatives to be illiquid for transparency purposes on an interim basis, we nevertheless urge EU regulators to conduct an assessment regarding the percentage of trading activity in OTC derivatives (both in terms of daily trade count and daily volume) that is granted either a pre-trade transparency waiver or a post-trade transparency deferral. This will help to inform future policy decisions relating to the calibration of the transparency regime.

Improving the calibration of the transparency regime in 2019

Under the MiFID II framework, the current transitional transparency calculations will be updated and replaced in April 2019.¹⁰ Both market participants and regulators expect that these updated liquidity assessments will be more accurate and result in a more meaningful transparency regime for OTC derivative transactions, given the expectation that a broader and more robust data set will be available. However, it is becoming increasingly clear that unless identified data deficiencies are remedied, the April 2019 updates to the transparency calculations may not improve conditions. MiFID II contemplates that EU regulators will rely on data provided by APAs and trading venues for the updated liquidity assessments.¹¹ Unfortunately, this data will not provide a complete and accurate representation of the liquidity in a particular OTC derivative instrument unless the following two issues are addressed.

A. The “traded on a trading venue” issues detailed in Issue 3 must be resolved

For OTC derivatives that are not subject to the derivatives trading obligation, most trading activity continues to be executed off-venue. However, APAs only have access to data regarding off-venue transactions in OTC derivatives that are considered to be ToTV. Due to the current interpretation of ToTV, APAs will only have very limited data regarding this important segment of the market. It is therefore critical that the issues around ToTV are addressed to provide complete and accurate data regarding trading activity in OTC derivatives not subject to the trading obligation.

¹⁰ See Article 13(17) of Commission Delegated Regulation (EU) 2017/583, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0583&from=EN>.

¹¹ See Article 22(1) of MiFIR.

B. Trading activity on equivalent third-country trading venues should be considered

It does not appear trading activity on equivalent third-country trading venues is considered as part of the liquidity assessments. As an example, the equivalence agreement reached between the EU and U.S. with respect to the derivatives trading obligation allows EU investment firms to trade on U.S. swap execution facilities (“SEFs”) instead of EU MTFs or OTFs. However, this activity will not show up in the data that EU regulators receive from EU trading venues and APAs, and therefore, liquidity may be understated.

This problem is compounded as currently all third-country trading venues, regardless of jurisdiction, are deemed to be equivalent for post-trade transparency purposes.¹² As the equivalence process for post-trade transparency continues to be considered, the impact on future liquidity assessments must also be addressed. An accurate liquidity assessment requires taking into account all of the trading activity of EU investment firms, including trading activity that may occur on third-country venues.

Longer-term considerations

Addressing the issues above will more accurately calibrate the MiFID II transparency regime. However, it may be necessary to take additional steps to ensure that overly broad waivers and deferrals are not granted to liquid OTC derivatives. First, liquidity assessments should take into account additional sources of data in order to ensure accuracy and completeness, including data from CCPs, trade repositories, and ARMs. Second, use of extended deferrals should be limited to instruments that are determined to be illiquid. Finally, OTC derivatives that have satisfied the liquidity assessment under EMIR in order to be subject to a clearing obligation should be categorized in a consistent manner under MiFID II. In particular, derivatives subject to a clearing obligation should be considered liquid for transparency purposes and should not be eligible for extended deferrals of 4 weeks. We note that, in other jurisdictions, all OTC derivatives are reported in real-time, with a maximum deferral of 15 minutes for large-size transactions.

Recommendations for EU Regulators/Policymakers:

- Assess the percentage of trading activity in OTC derivatives (both in terms of daily trade count and daily volume) that is granted either a transparency waiver or deferral.
- Ensure EU regulators have complete and accurate data for the next liquidity assessments. This includes (a) addressing the interpretation of “traded on a trading venue” and (b) considering trading activity on equivalent third-country trading venues.
- Longer-term, restrict overly broad waivers and deferrals by (a) taking into account trading activity data from CCPs, TRs, and ARMs, (b) limiting extended deferrals to instruments that are illiquid, and (c) considering derivatives subject to a CO to be liquid.

¹² ESMA Opinion on “Determining third-country trading venues for the purpose of transparency under MiFID II / MiFIR”, available at: https://www.esma.europa.eu/sites/default/files/library/esma70-154-165_smsc_opinion_transparency_third_countries.pdf.

Issue 5 – Trading Obligation: Material trading volumes in OTC derivatives subject to the trading obligation appear to be occurring off-venue

This suggests that “Category 3” counterparties account for far more trading activity than previously estimated. It is therefore important that the clearing and trading obligations be fully implemented as intended.

At the moment, the trading obligation only applies to the largest “Category 1” and “Category 2” financial counterparties. Previous analysis from ESMA predicted that these counterparties should account for over 97% of total trading activity in cleared interest rate OTC derivatives.¹³ However, this analysis occurred prior to the clearing or trading obligations going into effect.

Initial observations from publicly available MiFID II data shows that **more than 60% of dealer-to-customer trading activity in OTC derivatives subject to the trading obligation may still be occurring off-venue.**¹⁴ This suggests that “Category 3” counterparties account for far more trading activity than previously estimated. We urge EU regulators to conduct an assessment as a matter of priority regarding the percentage of trading activity in OTC derivatives subject to the trading obligation (both in terms of daily trade count and daily volume) that is continuing to occur off-venue.

This updated analysis is also critical for purposes of finalizing EMIR Refit, which proposes to permanently exempt certain “Category 3” counterparties from both the clearing obligation and trading obligation. Any permanent exemptions should be appropriately tailored to not undermine the G-20 objectives of moving trading activity in standardized OTC derivatives into central clearing and onto open and competitive trading venues. A better understanding of the magnitude of trading activity that may be eligible for a permanent exemption will assist in properly calibrating the final legislation.

Recommendations for EU Regulators/Polymakers:

- Assess the percentage of trading activity in OTC derivatives subject to the trading obligation (both in terms of daily trade count and daily volume) that is continuing to occur off-venue. This will assist in better quantifying the trading activity of “Category 3” counterparties and appropriately calibrating any permanent exemptions from the clearing and trading obligations.

¹³ See ESMA Consultation Paper on the Clearing Obligation for Financial Counterparties with a Limited Volume of Activity (July 13, 2016) at page 19, available at: <https://www.esma.europa.eu/press-news/consultations/consultation-clearing-obligation-financial-counterparties-limited-volume>

¹⁴ “Tradeweb and Bloomberg MTF Market Share” (Feb. 6, 2018), Clarus Financial Technology, available at: <https://www.clarusft.com/tradeweb-and-bloomberg-mtf-market-share/>.

Issue 6 – Trading Obligation: Trading venues are adopting inconsistent approaches with respect to complying with certain regulatory requirements

Certain trading venue practices relating to non-discriminatory access and STP appear to be inconsistent with MiFID II requirements and ESMA guidance.

MTFs and OTFs are designed to be open and competitive trading venues. However, it is critical that these trading venues adopt consistent approaches for complying with key regulatory requirements, such as non-discriminatory access and straight-through-processing (“STP”).

Non-discriminatory access

Discriminatory access barriers limit trading venue membership to select market participants. These barriers prevent investors from accessing all of the available sources of liquidity for OTC derivatives traded on-venue and make it extremely difficult for new liquidity providers to enter the market since they are blocked from accessing necessary pools of liquidity for pricing and hedging purposes. As a result, MiFID II requires that MTFs and OTFs establish non-discriminatory rules governing access and ESMA provided specific examples of discriminatory access barriers that should no longer be permitted.¹⁵ Unfortunately, several trading venues for cleared OTC derivatives do not appear to be following this ESMA guidance and instead are attempting to limit membership to self-clearing members and to maintain “enablement” mechanisms that allow trading venue members to selectively “turn-off”, or otherwise restrict trading with, certain other members.

Please see Exhibit 3 below for a full list of issues related to non-discriminatory access identified thus far.

Straight-through-processing

The MiFID II STP requirements for cleared OTC derivatives traded on MTFs and OTFs include (i) pre-trade credit checks against clearing member limits to ensure available capacity, (ii) prompt submission to, and acceptance or rejection by, the clearinghouse, and (iii) clear rules in the rare event a trade is rejected by the clearinghouse. These requirements are designed to reduce market risk, credit risk, and operational risk by ensuring a robust execution-to-clearing workflow. In addition, they ensure that bilateral counterparty credit risk is not introduced when trading cleared OTC derivatives, thereby removing the need to negotiate complex and costly bilateral trading and credit support documentation.

However, several trading venues for cleared OTC derivatives do not appear to be fully implementing these requirements. Examples include failing to support pre-trade credit checks and failing to clearly articulate the treatment of cleared OTC derivative transactions not accepted for clearing.

¹⁵ ESMA Q&A on MiFID II and MiFIR market structure topics, Section 5.1, Question 3, available at: https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-38_qas_markets_structures_issues.pdf

Please see Exhibit 4 below for a full list of issues related to STP that have been identified thus far.

Recommendations for EU Regulators/ Policymakers:

- Promote consistency across trading venues with respect to compliance with key regulatory requirements, including non-discriminatory access and STP.

Exhibit 3: MTF/OTF provisions that are inconsistent with non-discriminatory access requirements

1. Limiting membership/participation to self-clearing members of a CCP.

This is prohibited under MiFID II Article 18(3), as specifically clarified in ESMA Q&A.¹⁶

- i-Swap Europe Limited MTF
 - Rule 4.1.6 requires a Participant to be a direct clearing member
- BGC Brokers OTF
 - BGC has stated that only self-clearing members will be able to access the electronic trading platform for cleared OTC derivatives that is part of the OTF. This restriction is not specified in the rulebook.

2. Implementing enablement mechanisms for cleared OTC derivatives, whereby a trading venue member can decide to selectively “turn-off”, or otherwise restrict trading with, certain other members.

This is prohibited under MiFID II Article 18(3), as specifically clarified in ESMA Q&A.¹⁷

- i-Swap Europe Limited MTF
 - Rule 8.4 allows Participants to input credit settings to selectively “turn-off” or refuse to trade with certain other members in accordance with a “Bilateral Credit Methodology”.
 - Rule 9.1 requires a Participant to “turn off” trading with another member if bilateral documentation is not in place (even though bilateral documentation is not required for cleared OTC derivatives).
 - Market Appendix #1, Rule 7.1 and Market Appendix #2, Rules 5.12 and 5.13 establish additional enablement mechanisms for the Order Book and Targeted Streaming Market.
- BGC Brokers OTF
 - BGC has stated that participants on the OTF will be able to selectively “turn-off” or refuse to trade with certain other members, including for cleared OTC derivatives. This functionality is not specified in the rulebook.

¹⁶ See Section 5.1, Question 3(a) at https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-38_qas_markets_structures_issues.pdf.

¹⁷ See Section 5.1, Question 3(b) at https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-38_qas_markets_structures_issues.pdf

Exhibit 4: MTF/OTF provisions that are inconsistent with STP requirements

1. Not facilitating the required pre-trade credit checks for cleared OTC derivatives.

Article 2(2) of Commission Delegated Regulation (EU) 2017/582 requires a trading venue to provide the tools to ensure pre-trade screening on an order-by-order basis against limits set by the relevant clearing member for its client.

- i-Swap Europe Limited MTF
 - Rule 17.11 assumes each Participant is a CCP self-clearing member and is therefore providing its own clearing limits. It should be amended to accommodate the screening of limits provided by a clearing member for its client, as required by Commission Delegated Regulation (EU) 2017/582.
- BGC Brokers OTF
 - BGC has stated that, since each Participant is required to be a CCP self-clearing member to access the electronic trading platform for cleared OTC derivatives, pre-trade credit checks will not be provided. This is alluded to in Rule 5.4(a), which sets forth conditions for clients to trade cleared OTC derivatives that cannot be satisfied without the existence of pre-trade credit checks.

Additional Notes

- This issue is linked to non-discriminatory access. Since a trading venue for cleared OTC derivatives is not permitted to limit participation to self-clearing members, it must also facilitate pre-trade credit checks for client transactions under Commission Delegated Regulation (EU) 2017/582.
- *It should be clarified to trading venues that cleared OTC derivatives are unable to qualify for the exemption from pre-trade checks in Article 2(1) of Commission Delegated Regulation (EU) 2017/582. ESMA was clear in the Final Report that this exemption was only intended for exchange-traded derivatives on Regulated Markets, which already benefit from clearing certainty.*¹⁸
- *It should also be confirmed that trading venues are applying the pre-trade credit check requirements in Article 2(2) across all of the trading protocols offered by the venue, including “negotiated” or “processed” trades that are discussed off-venue pursuant to the rules of the venue but then are concluded on the venue.*

¹⁸ See page 390 at: https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1464 - final_report - draft_rts_and_its_on_mifid_ii_and_mifir.pdf.

2. Failing to clearly and accurately designate which cleared derivative transactions are concluded electronically for straight-through-processing requirements.

The clearing submission timelines in Commission Delegated Regulation (EU) 2017/582 are determined by whether the transaction was entered into electronically. For example, Article 3(2) of Commission Delegated Regulation (EU) 2017/582 requires cleared derivative transactions that are concluded on a trading venue electronically to be sent to the CCP within 10 seconds from the conclusion of the transaction.

- Tullet Prebon (Europe) Limited MTF
 - Section 9 of the Market Segment Appendix for Interest Rate Derivatives provides that all cleared OTC derivatives are deemed executed on a non-electronic basis. However, Section 6 of the same Appendix provides that the only trading protocols are electronic. We would expect all transactions on the MTF are concluded electronically, given the available trading protocols.
- BGC Brokers OTF
 - BGC has stated that they are considering all cleared OTC derivatives transactions to be deemed executed on a non-electronic basis. This is even though they have an electronic platform within the OTF for trading these instruments.
- Tullet Prebon (Europe) Limited OTF / ICAP Securities Limited OTF
 - Section 10 of the Market Segment Appendices for Interest Rate Derivatives and Credit provides that all cleared OTC derivative transactions are deemed executed on a non-electronic basis. However, Section 8 of the same Appendices provides that electronic trading protocols are available on the OTF.

3. Failing to clearly articulate the treatment of cleared OTC derivative transactions not accepted for clearing.

Articles 5(1) and 5(2) of Commission Delegated Regulation (EU) 2017/582 provide that if a cleared OTC derivative transaction is not accepted by the CCP, (a) the trading venue shall void the contract if it was concluded electronically, and (b) otherwise, the treatment of the transaction shall be governed by the rules of the trading venue. It is important from a risk perspective that the rulebook clearly specifies what would happen in such a scenario as contemplated by Article 5(2).

- Tullet Prebon (Europe) Limited MTF / Tullet Prebon (Europe) Limited OTF / ICAP Securities Limited OTF
 - These rulebooks do not specify what happens if an executed transaction (either electronic or voice) fails to be accepted for clearing.
- BGC OTF
 - For cleared OTC derivatives that are not executed electronically, Rule 5.4(e) requires Participants to “identify an alternative mechanism to clear the transaction outside the venue” if it is rejected from clearing. There is no indication of what that means.