Updated input on MiFIR “Non-discriminatory” Access: How to incentivise ETDs trading

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The role of exchange derivatives markets

- Over the past 20 years, financial markets have seen strong growth and innovation, and derivatives have contributed substantially to this impressive development.
- Today, exchange-traded derivatives (ETDs) markets are a main pillar of the global financial system, enabling businesses around the world to hedge risks effectively and to invest and complement the growth of capital markets. Hedging offers a reliable risk management tool against shocks, as proved during the recent Covid-19 crisis.
- ETDs markets are vibrant, offer product innovation both in regional products and in internationally active markets and, through centralised trading and diversified CCP clearing, avoid excessive risk concentration and optimise price formation.
- These characteristics are even more important within the context of a sustainable economic recovery from the Covid-19 pandemic and to address the uncertain future relationship with the UK after Brexit.
- The EU’s current political reflections on key initiatives, such as the future of the Capital Markets Union (CMU) or the international role of the Euro, are a symbol of the need to have fully operational, stable and independent market infrastructures to support the financing of their economies through their capital-raising and risk-management functions.

ETDs markets delivering on EU policy objectives around recovery, growth and competitiveness

- ETDs are unique to the regulated market on which they are admitted to trading. This is primarily because regulated markets determine the specifications of their derivative products, together with market participants who will consider the specific characteristics, like market models and functionalities, of their ecosystem. This process ensures products are appealing to clients, cater for increased liquidity and offer an effective way to hedge risk. Exchanges therefore consider ETDs trading and clearing as part of an integrated process.
- ETDs markets are essential for financial stability. The main liquid ETDs trade continuously in multilateral markets with trading rules aimed at ensuring a fair and orderly market without the intervention of dealers either in the pricing or the market structure, unlike OTC derivatives markets. In OTC derivatives markets, the dealers (i.e. large banks) are able to control pricing, by virtue of being part of the market structure, ensuring that it is dealer centric. In OTC derivatives markets, due to the fragmentation both at the trading and clearing level, there is no robust and independent price formation that the entire market can rely on.
- In the worst financial crises, deeply integrated and liquid ETDs markets act as a refuge market where prices can still be found, and markets can continue operating – a key supporting role for which OTC markets are not equipped. OTC derivatives cannot be relied upon as economic indicators because their prices are directly derived from ETDs prices. If the reliability of ETDs prices is undermined, there is a knock-on effect on instruments such as OTC derivatives and the wider economy.

- If the “Non-discriminatory” Access provisions are imposed on ETDs then some market players may deliberately fragment the EU market to degrade price formation and gain strategic power over the market structure through the use of trading venues and CCPs that they own or control. This would mean that the EU would be the only jurisdiction in the world which would move back towards dealer-dominated markets where the investment banks are the gatekeepers of the market and intermediary between buyers and sellers. The US already has become a potential profiteer in the DTO debate between UK and EU. The EU needs to be cautious not to hand over more to global competitors, and not to undermine from within.
- The EU has come a long way in increasing competition and transparency across market infrastructures. Exchanges have delivered a multi-faceted solution consistent with the CMU, including support for the international role of the Euro, without the need for any policy intervention.
- ETDs markets with deep pools of liquidity across different market segments can contribute to economic growth and employment, and act as a strong stabilising force in times of crisis by diversifying sources of finance.
- It appears counterintuitive to risk breaking Europe’s most liquid and successful derivatives markets at the very moment when the EU is trying to achieve a strong CMU, address the new realities after Brexit, enable a policy framework to support the recovery and strengthen its economic sovereignty by increasing the role of the Euro.
- In addition, the European Commission has recently announced ambitious goals in the Green Deal for Europe which can be supported by the launch of ESG derivatives.
- Last but not least, the fallout of the Covid-19 crisis continues to have a severe impact on the EU economy. The EU's multi-billion Euro reconstruction program, NextGenerationEU, is intended to address this, with the first issuance of bonds to come in mid-2021. The new Commission issuances will have a profound effect on EU and global debt markets and will act as strong tools for EU policy objectives related to energy and digital transformation. ETDs markets may support the new NextGenerationEU bonds through the development of futures - as with EU sovereign bonds - providing a functioning risk transfer and reference market, and building up liquidity in the underlying bond market.
- In sum, the EU needs to consider strong derivatives exchanges as a cornerstone of price formation and risk management, alongside its financial stability and investor protection objectives.
- With mandatory links between CCPs and TVs, and the adjacent increase in complexity and costs resulting from establishing and maintaining connectivity, we fear a risk of concentration of all ETDs clearing activities with only a small number of sufficiently large clearing members. This would effectively reduce intra-EU competition, contribute to concentration of risk in one CCP as well as concentration at clearing member level, and effectively slow down innovation. This runs counter to policy-makers’ objective to contain systemic risk.

ETDs markets as the lighthouse for price formation and liquidity in other markets

- Transparent and resilient trading on lit order books is the prerequisite for the most liquid ETDs which serve as a benchmark (reference price) both for a broad range of underlying assets (e.g. bonds, shares and commodities) and a large number of related products (including the relevant ETDs and OTC derivatives). As such, ETDs markets provide leading information to OTC markets and are hence central to the wider price formation process in cash, physical, ETDs and OTC markets.
- The relationship between ETDs and OTC markets is not always adversarial. Indeed, the two depend on each other for liquidity and management of residual risk exposures, i.e. an established futures market benefits from a strong OTC market and vice versa (and both can benefit from a strong cash market). For instance, when an OTC dealer executes

a large OTC transaction it often turns to the exchange market for a cost-effective hedge, if the exchange possesses the adequate ETDs markets. This means ETDs ought to remain viable, effective, and efficient.

- ETDs are often the natural and organic result of an evolutionary process. From explorative and exotic OTC contracts to standardised and well-established exchange-traded contracts. Users want new products and access mechanisms in order efficiently to manage risks or take positions; enhancing products and access is thus an exchange priority. By creating better instruments and greater convenience, an exchange can strengthen activity and deepen liquidity.

Products examples:

Futurisation

Examples of futurisation relate to exchange-traded products launched by exchanges which 'mimic' swap products once they are sufficiently liquid or where the exchange can bring sufficient efficiency gains.

For example, Eurex has successfully transformed the OTC dividend swap market into an almost completely exchange-traded listed, centrally-cleared market through the launch, in 2013, of dividend futures addressing the counterparty risk in this market but also providing much more efficiency than the multiple ISDA agreements place.

Another example of futurisation was when Eurex launched a futurised version of bilaterally traded Total Return Swaps in 2016, i.e. the Total Return Futures (TRF) on the EuroStoxx50 index to convert equity and equity index swaps to the listed market. Since its launch, Eurex has managed to migrate 50% of the OTC swap market to the regulated environment.

The effectiveness and process efficiency has been convincing for the market to move towards these futurised equity derivative products.

Sustainable derivatives

Exchanges contribute to the increased focus on sustainable investing by creating sustainable derivatives. Examples of these are: the Euronext Eurozone ESG Large 80 index Future (information available here) which follows the Euronext Eurozone ESG Large 80 Index, tracking the performance of 80 Eurozone large cap companies selected for their ESG and energy transition. These products provide investors with effective hedging tools while offering the opportunity to take exposure in the Eurozone sustainable economy, benefitting from the advantages of clearing efficiencies at the portfolio level.

- The most prominent case observed where the ETDs markets serve as a lighthouse has been the sovereign bond markets, which are OTC, very opaque and fragmented in the EU. In these markets, most participants use ETDs as benchmarks to manage their exposures to Euro area sovereign debts (German Bund Future, French OAT, Italian BTP, Spanish BONO).
- Functioning ETDs markets are also key for the proper conduct of monetary policies as Interest Rate Derivatives are key indicators as to how markets expect rates set by central banks to evolve and therefore have an indirect impact on the underlying product.
- It needs to be taken into consideration that the development of new products is generally a time-consuming and expensive process that relies on months, or even years, of research and development based on market analysis, end-user consultation, pricing/analytics development, technology programming and support, advertising and marketing, and so forth. Though expensive in terms of time and resources, exchanges can offer standardised and competitive contracts.

What measures should be introduced to incentivise ETDs trading?

Delete the "Non-discriminatory" Access provisions under MiFIR

- The "Non-discriminatory" Access provisions under MiFIR constitute a serious risk to the EU financial stability and competitiveness as they undermine the ability of market infrastructures to ensure transparent and orderly trading, liquidity and clearing when applied to ETDs.
- We very much welcomed ESMA's no action letter and the delay of the entry into force of the MiFIR provisions by an additional year, until 4th July 2021, in respect of ETDs, which was included as part of the finalisation of the CCP Recovery and Resolution dossier in order to preserve financial stability in the Union.
- This temporary relief, however, will soon elapse and will not solve the inherent Level 1 risks that the provisions will create, if applied in July 2021.
- An additional extension to the exemptions should be adopted to allow for a thorough consideration of the Level 1 framework, particularly on the relevance of maintaining the scope on ETDs.
- In our view, in the upcoming review of the MiFIR framework, ETDs should be removed from the "Non-discriminatory" Access provisions.
- The provisions were advocated by the UK and the London Stock Exchange which are no longer part of the EU Single Market. In this respect, on 5th May the UK Treasury announced that the open access (i.e. "Non-discriminatory" access) regime for ETDs is not suitable in a UK-only context and that it will remove it when parliamentary time allows.
- We believe that, instead of weakening European ETDs markets by way of implementing the "Non-discriminatory" access provisions, trading on transparent, multilateral ETDs markets could be further incentivised. The following measures could be taken into account when assessing how to create an even deeper ecosystem in line with the EU policymakers' policy objectives:

Ensure a proportionate calibration of the capital requirements for market-making firms

- Market-making firms play a specific role within ETDs markets, and generally find themselves trading frequently throughout a day in order to facilitate end-user interest. This function creates sufficient liquidity for other investment firms to transfer risk in order to achieve their financial objectives. Art. 17 and 48 of MiFID II mandate the binding presence for market-making firms in the most liquid futures contracts. This acknowledges just how vital firms like this are in ensuring that financial markets are liquid in all market conditions.
- It is therefore essential to safeguard well-calibrated prudential requirements to ensure that these firms would not be harmed by a possible, disproportionately high capital burden. We encourage policymakers to strengthen further the principle of proportionality when it comes to the actual calibration of capital requirements. Should capital requirements be set at disproportionate levels for proprietary trading firms, such firms will encounter difficulties in being able to continue to provide liquidity under MiFID II/R, thereby reducing the ability of EU ETDs markets to thrive in a global setting.

Enhance investor' access to ETDs markets

- The homogeneity on ETDs markets due to standardisation leads to a greater critical mass of liquidity, meaning the cost of arranging a hedge or speculative position can be lower than in the OTC markets.
- EU financial regulation has rightly set investor protection as one of its most important political objectives. Nevertheless, the investor protection regime may work as a market entry barrier for new products and assets catering for retail as well as professional investors' needs (e.g. ETDs in relation to risk management and hedging purposes). Rather, a prudent and nuanced approach should be favoured when assessing the need to

take supervisory action against certain products. As an important principle, the well-conceived and highly integrated safeguards and organisational requirements for regulated trading venues - as established by MiFID II - should be considered as a differentiating factor, as regulated markets ensure high levels of trade transparency, strict trading rules and independent market surveillance.

Amend and simplify the pre-trade transparency regime

- The current pre-trade transparency regime needs to be simplified and made more coherent for the derivatives market. In the broader context, waivers shall support the transfer of products traded OTC to central infrastructures, as envisaged by the G20 in 2009. A reasonable step to support the simplification of the pre-trade transparency regime generally is removing the SSTI waiver. Package order waivers and OMF waivers should be kept available to complement LIS and IL waivers, which are the most essential to mitigate adverse effects in the order book from large sizes.
- With respect to the ETDs markets, we support ESMA's approach which aims to increase the proportion of lit trading while preserving the needs of market participants for pre-arranged transactions based on an analysis of the instruments' liquidity. However, for certain ETD products or sub-asset classes, the current LIS thresholds have detrimentally impacted the liquidity of these products. In the respective products, higher thresholds for off-book on-exchange trading, compared to pre-MiFID II conditions, have moved trading volumes away from exchanges and into the OTC market.
- Therefore, the recalibration – possibly lowering - of LIS thresholds for ETDs should address in particular the launch of new products on trading venues, and the time and measures needed to establish exchange trading as viable alternative to the OTC market, where these or similar products might currently be traded.

Facilitate third country investment firms' access to the EU market

- Derivatives markets are global in nature and market participants are global as well. The more participants, the stronger and more liquid the market for those seeking to hedge risks. This improves competition, keeps costs affordable for customers and grows the economy.
- In this context, access for market participants, in particular liquidity providers, to derivatives exchanges in the EU is vital. The MiFID equivalence regime has recently been adapted with the IFR framework becoming applicable in summer 2021. However, in the absence of a MiFID equivalence decision for third country investment firms, and a subsequent ESMA register of these firms, national rules regulate their access to European markets. National legislation, however, might diverge, and some national requirements might be relatively burdensome to fulfil. As a result, the firms, key to provide liquidity, might prefer to trade in other jurisdictions. While we understand the supervisory needs of national authorities and the importance of national rules until there is a MFID equivalence decision taken, access for third country firms should not be impeded.

Broaden the scope of the EMIR clearing obligation

- The EMIR clearing obligation requires that certain OTC derivatives contracts be cleared through authorised EU central counterparties (CCPs) or recognised third country CCPs. It is a key part of EMIR, aiming to increase financial stability and to enhance OTC market resilience. Centralised clearing offers, at least potentially, a series of economic and risk-mitigating benefits, both for participants and for the system as a whole. It enables, in particular, the simplification and transparency of traditionally opaque markets characterised by bilateral relations.
- Currently, the clearing obligation applies to specific classes of interest rate (IR) and credit OTC derivatives but not to equity derivatives. In recent years, there has been a

strong and consistent growth in clearing rates for IR and credit derivatives[1]. It would be beneficial, therefore, to ensure that equity derivatives become clearable in the near future.

Case study: Eurex Bund Future

A successful example of ETDs market and proof of the competition between exchanges is the Eurex Bund Future. With the emergence of the Eurozone and the creation of the Eurex futures and options exchange, the German 10-year Bund futures contract quickly became one of the world's most liquid derivative products. There was clearly a need for such a contract: the underlying cash market was one of the biggest in the world, yet it did not have a proper hedging instrument.

In 1998, trading on German Bund futures moved from LIFFE (an open outcry exchange) to Eurex (an electronic exchange). Lower access costs due to the operational efficiencies of an electronic market apparently attracted additional business (from the United States), which narrowed the liquidity cost differential further throughout the course of 1997. When the liquidity differential was nearly closed by the end of that year, Eurex was positioned to win with its fee cut (Hilary Till, 2015[2]). According to Cantillon and Yin[3] (2007), the move of the Bund market to Eurex (the so-called "Battle of the Bund", as this episode became known) serves "to illustrate that financial markets can tip and thus, implicitly, that competition is feasible and that there is a role for firms strategies". The main source of differentiation between the two exchanges was their product portfolio and Eurex was more dynamic and successful than LIFFE in trading products that also attracted Bund traders.

[1] ESMA Annual Statistical Report 2020 on EU Derivatives Markets (here)
[2] Hilary Till 'Case studies on the success or failure of futures contracts', 2015 (here)
[3] Estelle Cantillon and Pai-Ling Yin 'How and when do markets tip? Lessons from the Battle of the Bund', 2007 (here)

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