Deutsches Aktieninstitut

Clear definition for bespoke derivatives is needed!

Detrimental effects on price formation process should be avoided

Comment on ESMA's consultation "MiFIR review report on the obligations to report transactions and reference data", 20 November 2020

Introduction

Deutsches Aktieninstitut (identification number: 38064081304-25) represents the entire German economy interested in the capital markets. The about 200 members of Deutsches Aktieninstitut are listed corporations, banks, stock exchanges, investors and other important market participants. Deutsches Aktieninstitut keeps offices in Frankfurt, Brussels and in Berlin. We followed the legislation process regarding MiFID II/MiFIR very closely, expressing the view of non-financial companies using derivatives in their risk management.

In our answer to ESMA's consultation "MiFIR review report on the obligations to report transactions and reference data" we comment on the re-assessment of the "Traded on a Trading Venue" concept and the proposal to depart from it.

We agree with the statement of ESMA, that bringing bespoke derivatives in the scope of the transparency regime would "introduce reporting noise for other participants rather than meaningful transparency". In this regard, we deem it as necessary to clearly define "bespoke derivatives" not covered by the proposed extension of the reference data reporting, transaction reporting and transparency regime.

Answers to selected Questions

Q5: Do you envisage any challenges in increasing the scope including derivative instruments traded through an SI as an alternative to the expanded ToTV concept? Please justify your position and if you disagree please suggest alternatives.

We re-iterate our statement made in numerous other consultations regarding MiFID issues that transparency is only useful for instruments traded on secondary markets. This is clearly confirmed by ESMA in its statement that bespoke derivative contracts should be out of the scope of the transparency regime. This should be the "benchmark" for the expansion of the transparency regime.

So far, we do not see how the link to the SI regime, as proposed by ESMA, could solve this problem. Banks could provide bespoke derivatives in their capacity as SI. This holds true for banks required to become SIs due to the crossing of the respective thresholds. The "pure" volume of derivative transactions needed for becoming a SI does not necessarily indicate that these derivatives are standardised. In addition, it is worth to mention that banks could become SI for any kind of derivative (irrespective of its degree of standardisation) in the case that the bank opts in the SI regime voluntarily.

Therefore, the SI status does not automatically exclude bespoke derivatives from the transparency regime which would contradict the above mentioned aim of ESMA. Nevertheless, bespoke derivative transactions are often used by non-financial counterparties for risk-mitigating purposes. They do not involve any type of investor who needs special protection or who benefits from transparency. On the contrary, especially for larger transactions or transactions referring to an illiquid underlying it is very likely that transparency distorts the price formation process to the detriment of the non-financial company requesting the derivative. If an order is split up into smaller parts (which is a common practice for larger and/or illiquid transactions), orders executed at a later stage will become remarkably more expensive. The reason for this is that it is unlikely that several companies demand an identical transaction at the same time. The supply side can therefore conclude that the split orders are requested from the same end-user, and can bet against him. As a result, prices will increase which makes risk management with the derivatives in question more expensive.

Therefore, in order to avoid these detrimental effects we ask ESMA to define clearly and practice proven "bespoke derivatives" as instruments which are not in the scope of the transparency regime.

Q6: Do you agree that the extension should include all Systematic Internalisers regardless of whether they are SI on a mandatory or voluntary basis? Please justify your position.

As discussed by ESMA, the extension to all SIs has pros and cons. From the perspective of companies using bespoke derivatives we see the risk that banks acting on a voluntary basis as SI are very likely to become a SI for bespoke derivatives. There are no SI thresholds involved that might indicate a certain degree of standardisation due to the huge amount of the derivative business (which of course does not exclude bespoke derivatives, as mentioned above).

This is why we deem a definition of “bespoke derivatives” as mentioned in our answer to Q5 as very important in order to avoid detrimental effects on the price formation process due to the transparency requirements.

Q7: Do you envisage any challenges with the approach described in paragraphs 45-46 on the scope of transactions to be covered by the extension? Please justify your position and indicate your preferred option for SIs under the mandatory regime explaining for which reasons. If you disagree with all of the outlined options, please suggest alternatives.

We agree with the aim to enhance transparency and to extend its scope as long as bespoke derivatives are not covered. In order to guarantee this, a definition for “bespoke derivatives” is urgently needed.

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