

**12 March 2021**

**ESMA Consultation Paper - MiFID II/ MiFIR review report on Algorithmic Trading**

**Final ISDA response**

ISDA welcomes the opportunity to respond to the ESMA consultation paper on the MiFID II/ MiFIR report on algorithmic trading.

ISDA members generally think that the MiFID II framework for algorithmic trading has worked well and that the regulatory approach should be about fine-tuning certain provisions rather than proposing significant changes to the scope and to the general architecture of the regime.

**Specific answers**

**Definitions and legal framework of Algorithmic trading, High-Frequency Trading and Direct Electronic Access**

***Q1: What is your overall assessment of the MiFID II framework for algorithmic trading, HFT and DEA?***

Overall, ISDA members believe that the MiFID II framework for algorithmic trading, High Frequency Trading (HFT) and Direct Electronic Access (DEA) has greatly facilitated the mitigation of the potential risks that those market access / trading techniques can induce such as the "*risks of the overloading of the systems of trading venues due to large volumes of orders, risks of algorithmic trading generating duplicative or erroneous orders or otherwise malfunctioning in a way that may create a disorderly market, risk of overreaction to market events exacerbating volatility and risk of market abuse behaviors*" (Paragraph 24 of ESMA CP).

Nevertheless, ISDA members recommend introducing further proportionality in the applicability of the whole set of RTS 6 obligations.

Beyond the distinction between low latency algorithms and HFT, it would be necessary to adapt requirements by considering:

1. the level of sophistication of the algorithms’ functionalities

and;

1. the level of systemically related risks of the markets where algorithms are used.

On the first element, ISDA members note that dealers are using algorithms with three main functionalities from a low to a high sophistication level and with static vs. dynamic parameters:

* **The RFQ functionality** where algorithms are only used for automated responses to clients’ RFQs on trading venues (i.e., holding a low level of sophistication and static parameters).
* **The execution functionality** that optimises order execution processes by automated generation and submission of orders or quotes to trading venues and by automated execution of the orders, once the trading decision has been taken with a human intervention (i.e., holding a low to medium level of sophistication and static parameters); and
* **The liquidity provider functionality**   which allows the algorithm to make trading decisions on a fully automated basis with no human intervention. The trading occurs based on a multitude or sophisticated parameters set within the algorithm. Order-execution is also fully automated and synchronous with the trading decision (medium to high sophistication level and dynamic parameters).

ISDA members note that the level of risk induced by an algorithm is correlated with the level of sophistication of its functionalities. Therefore, ISDA members would consider it appropriate that RTS 6 allows enough flexibility to investment firms when applying obligations to algorithms with the least sophisticated functionalities. Conditioned with an appropriate level of transparency in the algorithms’ documentation, the investment firms’ obligations relating to the testing, controlled deployment, stress testing, and self-assessment should be proportionate to the differing level of sophistication of the algorithms’ functionalities.

Conversely, obligations on the mandatory model review could be introduced for algorithms with a liquidity provider functionality, notably relying on existing obligations in the US (under SR 11-7).

ISDA members also consider that the higher the turn-over into an algorithm, the higher the risks induced by an algorithm. The level of risks is also correlated with:

1. the number of participants on a multilateral venue,
2. the primary liquidity of the financial instrument traded through the algorithm on a venue; and
3. the volume in nominal traded by using an algorithm on a venue.

From this perspective, ISDA members recommend that those three dimensions are properly considered when applying RTS 6 obligations.

***Q2: In your views, are there risks other than the one mentioned in MiFID II or impacts on market structure developments due to market electronification/ algorithmic trading that would deserve further regulatory attention? Please elaborate.***

***Scope of Algorithmic Trading***

***Q3: Do you consider that the potential risks attached to algorithmic trading should also be given consideration in other trading areas? Please elaborate.***

As described in Article 17 of MIFID II, the characteristics of algorithmic trading are not the same as for other areas of trading and hence the potential risks differ. These risks are most pronounced in multilateral trading scenarios, i.e. trading on venue, which is the current scope of the framework. ISDA members do not support an extension of the requirements of the algorithmic trading framework to OTC trading in general.

***Q4: Do you agree with this analysis? If not, please explain why.***

A majority of ISDA members agree with ESMA’s analysis.

***High Frequency Trading***

***Q5: Did you encounter any specific issue with the definition of HFT? Do you consider that the definition should be amended? Do you have any suggestion to replace the high message intraday rates with other criteria or amend the thresholds currently set in Level 2? Please elaborate and provide data supporting your response where available.***

ISDA members note that High Frequency Trading (HFT) is rarely used for the trading of derivatives instruments, especially OTC derivatives.

They however note, in the context of Foreign Exchange derivatives where, some firms are using HFT, that ESMA proposes to introduce a requirement for non-EU firms to be authorised as an Investment Firm when they qualify as a firm using HFT on an EU trading venue. ISDA members believe that such a requirement would fragment liquidity, as most non-EU firms will not want to register as an Investment Firm.

***Direct Electronic Access***

***Q6: Based on your experience, is sub-delegation of DMA access a frequent practice? In which circumstances? Which benefits does it provide to the DEA user and to the sub-delegates? Are you aware of sub delegation arrangements in the context of Sponsored access? If so, please elaborate.***

***Q7: (for DEA Tier 1clients) Do you sub-delegate direct electronic access? If so, are your Tier 2 clients typically regulated entities/investment firms? Are they EU-based or third-country based?***

ISDA is not in a position to answer this question in the name of all members.

However, ISDA members would call for a clarification from ESMA concerning the use of sub-delegation for intra-group entities.

The requirements within Articles 19 – 23 RTS 6 sufficiently address material risks associated with typical DEA arrangements. However, ISDA notes that the current definition of DEA does not exclude intra-group arrangements whereby one affiliated entity permits another to submit orders to a trading venue using its membership code. The abovementioned requirements are not appropriate for such intra-group arrangements. ISDA members therefore would welcome clarification from ESMA that these arrangements should not be defined as DEA. This clarification should also provide that registration is not required of any entities beyond the DEA provider.

**Q8: Do you agree with this analysis? If not, please explain why. Do you consider that further clarification is needed in this area? If so, what would you suggest?**

***Scope of Algorithmic Trading – Proposed Amendments***

***Q9: Do you agree with ESMA’s proposal? If so, do you consider that the requirements considered above relevant? Should there be additional ones? If you disagree with ESMA’s proposal, please explain why.***

ISDA members note that algorithmic trading enables order management for specific highly liquid products with a high degree of automation. Algorithmic trading is technology driven (including streaming and often high volume on a specific segment). The service provided by Systematic Internalisers is different as it is quote management, often applied to the whole asset class at the legal entity level along with some manual trading i.e. voice, RFQ. SI are also used for the trading of non-liquid derivatives.

ISDA members also note that one of the key objectives of ESMA RTS 6 is to limit and minimise the disorderly trading risk (i.e. operational, and conduct risk) where algorithmic trading is deployed. This risk is not intrinsic to trading with SIs.

In some instances, there can be an overlap between algorithmic trading and SIs but this is not frequent, and in OTC trading is not inherent to one of the counterparties being an SI.

ISDA members believe, for the above outlined reasons, that the relative risk posed by the use of algorithmic trading on SIs is much lower than on trading venues.

Many ISDA members operate as SIs and therefore would be impacted by a change of scope of algorithmic trading if extended to SIs. They recognise that the listed requirements for governance, controlled deployment, and kill-switches are reasonable for algorithmic trading activity, whether multilateral or OTC. ISDA members consider that it is not necessary to amend the scope of algorithmic trading in order to achieve changes that are largely focussed on firms' systems and controls.

ISDA members do not support ESMA's proposal to subject SIs’ and any OTC investment firms’ OTC automated trading processes to identical (i) governance arrangements for trading systems and trading algorithms, (ii) controlled deployment of algorithms (iii) risks controls as for algorithms used for trading on trading venue.

We would further note that such an extension, especially if followed by in depth and granular requirements, may well entail firms implementing additional processes, which will inevitably increase the cost of business. Given the already high costs attributable to MIFID II regulation, this may deter firms from continuing with certain business activities. This potential reduction in execution venue choices may in turn run counter to the EU's wider aims of developing a Capital Markets Union.

***Direct Electronic Access – Proposed Amendments***

***Q10: Do you agree with ESMA’s proposals above? Please elaborate.***

ISDA members agree with ESMA that DEA users should not require authorisation. However, they do not support ESMA’s proposals to require all HFT firms to be authorised under MiFID II*.*

As ESMA acknowledges in the CP, authorisation triggers a wide range of requirements and costs for firms, and it is not clear that all such costs and obligations are necessary or proportionate to address the specific risks ESMA is considering in respect of the algorithmic trading framework. Concerns about organisational requirements for high frequency/low latency market participants could better, and more proportionately, be addressed in a more targeted manner by amending recordkeeping requirements, specifying granularity of timestamping or by requiring trading venues to have robust access requirements covering the testing and deployment of algorithms with specific requirements for HFT firms as deemed necessary.

**Organisational requirements for investment Firms**

***Notifications to NCAs, exchange of information and on-going supervision***

***Q12: Do you see merit in ESMA developing a template for notifications to NCAs under Articles 17(2) and 17(5) of MiFID II? If not, please justify your position.***

ISDA members support ESMA’s proposal to develop a template for notifications in order to make the notification process simpler. ISDA members would also support that ESMA establishes a central repository for notifications.

***Q13: Do you agree that it would be useful to clarify that notifications should be done ‘without undue delay’?***

It would be useful to clarify that notifications provided without undue delay should not impose an unreasonable burden on firms. ISDA members do not think it is necessary to further specify exact timelines.

***Q14: Do you agree with ESMA’s approach for the exchange of information between NCAs? If not, please justify your position.***

ISDA members believe that the introduction of a standardised template could realise greater benefits and efficiencies for firms if it was only required to be submitted once, with venues/NCAs then in turn required to share with other impacted NCAs.

***Application of RTS 6***

***Q15: What is your view on clarifying the definition of algorithmic trading? If you deem it beneficial to refine the definition and account for further types of algorithms or algorithmic trading strategies, please provide your suggestion as well as underlying rationale.***

ISDA members believe that the definition provided in Article 4(1)(39) of MIFID II Directive describes algorithmic trading well and should be maintained. Any attempt to make this more specific or granular would likely lead to confusion.

ISDA members would argue that there is a conceptual difference between i) algorithms that in effect employ machine learning that make automated decisions and ii) automated order execution processes where the trader decides the parameters and order strategy.  Manual intervention at the start in the 'parent' order means that these order types (VWAPs; TWAPs; iceberg etc) have a reduced risk and should therefore be excluded from the definition.

***Q16: Do you think there should be specific requirements for different type of algorithms or algorithmic trading strategies in RTS 6? Please explain.***

***Q17: What is your experience with testing environments? Are they used frequently? If not, why? Do you see a need for any improvements?***

***ISDA members see room for improvements in testing environments, in particular the provision of fully populated order books and that is very closely calibrated to production environments.***

***Q18: Do you agree that the definition of “disorderly trading conditions” should be clarified? If yes, how would you define such trading conditions?***

If ESMA is considering providing some further guidance on what is meant by the term “disorderly trading conditions”, ISDA members believe that it should be carefully constructed to ensure that it is practical and workable across all potential in scope products, markets and systems.

However, ISDA members believe that the proposals made in the consultation paper would not contribute to an improved understanding of the term ‘disorderly trading conditions’.

In particular, ISDA members do not support that ESMA provides scenario analysis, as any particular scenario for disorderly trading does not happen twice. Instead, ISDA would encourage ESMA to improve the tools available, in particular the test symbols in the testing environment, which could contribute to market participants having better testing systems in place.

***Q19: Do you agree that ESMA should provide additional guidance on the expectations concerning the checks and testing to be done, in particular for testing on disorderly trading conditions?***

ISDA members do not believe that it is possible to develop comprehensive guidance for checks and testing that will be appropriate for all markets due to the variety and complexity of different markets covered by the requirements. There is a risk that unless it is tailored to different markers, such guidance may be incomplete and potentially confusing. Consequently, if ESMA provides such guidance, it should ensure that any proposed changes are practical and workable before proceeding.

***Q20: Would you agree that it could be beneficial if ESMA develops a prescribed format for the self-assessment foreseen in Article 9 of RTS 6?***

As noted in paragraph 120 of the consultation paper, “*a minority of NCAs currently request this self-assessment for review*”. This suggests that a majority of NCAs do not make such request. ISDA member would then recommend that ESMA undertake a full cost-benefit before making any formal proposal.

ISDA members also note that any self-assessment will have to take into account the nature, scale and complexity of the way a firm operates. A rigid prescribed assessment form that every firm would have to follow would not allow firms to adequately reflect the way they operate.

***Q21: Do you agree with the changes proposed to the self-assessment of Article 9 of RTS 6?***

ISDA members generally recognise that annual stress testing is a ‘best practice’, notably given the occurrence of market volatility.

However, some members note that, given the associated administrative burden of such tests, a formal assessment should only be required bi-annually.

Generally, ISDA members consider that firms should diligently perform the self-assessment and that NCAs should be able to request the self-assessment at any time they deem necessary, rather than requiring firms to submit self-assessments on a systematic basis.

ISDA members also consider that the proposed changes concerning test environments would add further complexity for reporting firms and NCAs.

***Q22: Would you propose any other targeted legislative amendments to RTS 6? Please include a detailed explanation of the proposed amendment and of the underlying issue that this amendment would aim to tackle.***

**Organisation requirements for Trading Venues**

***Capacity and resilience of Trading Venues***

***Q23: Do you agree with ESMA’s proposal to harmonise and create a clear structure for the performance of the self-assessment?***

ISDA members support the proposal for a harmonised template, which will in turn help to ensure that a more consistent set of questions are submitted by venues to their members. Currently questionnaires are received which contain similar but not identical questions when compared between venues.

***Q24: Do you agree with limiting the self-assessment to every two years and to require trading venues to share it with their relevant NCA?***

ISDA members agree with the suggestion of sharing the self-assessment with NCAs. They also consider that it would be helpful for trading venues to be required to share the date of their most recently submitted report with all clients, in order to help with the clients’ due diligence.

***Testing of algorithms***

***Q25: Do you agree with ESMA’s analysis about the overlapping requirements between RTS 6 and 7? Are those overlaps considered beneficial, should they be removed or are there any gaps? Are there any further points that should be clarified?***

A majority of ISDA members consider that it would be helpful to clarify that venues are responsible for ensuring their members have carried out the required conformance testing.

Some other members however believe that the ESMA guidelines around this subject were carefully calibrated to ensure that all market participants of the trading chain bore their respective responsibility for testing.

***Q26: What is your view with regards to the testing of algorithms requirements? Do you agree that more robust testing scenarios should be set?***

ISDA members would recommend that ESMA proceeds to implement standardised templates and conduct an analysis of the first results submitted through these templates to determine whether further guidance should be provided.

***Q27: Are the testing environments available for the testing of algorithms appropriate for this purpose?***

As stated in our response to Q17, we see room for improvement in how closely testing environments are set up to mirror production.

***Circuit Breakers***

***Q28: Do you agree with ESMA’s analysis that the circuit breaker mechanism achieved its objective to avoid significant disruptions to the orderliness of trading?***

While ISDA members report that their observation of the effectiveness of circuit breakers aligns with the ESMA findings in terms of avoidance of significant disruptions, they believe that transparency from venues on how such circuit breakers are specified and calibrated is critical and that improvement is required.

***Q29: Do you agree that the requirements under Article 48(5) of MiFID II complemented by RTS 7 and the guidelines on the calibration of circuit breakers and publication of trading halts under MiFID II remain appropriate? If not, what regulatory changes do you deem necessary?***

As per our response to Q28, ISDA members would like to see greater transparency and detail from venues on how their circuit breakers are designed and applied.

***Co-location and fee structure***

***Q30: Do you agree that the co-location services and fees structures are fair and non-discriminatory? Please elaborate.***

ISDA members generally agree that the co-location services and fees structures are fair and non-discriminatory.

However, ISDA members also highlight that trading venues transparency practices could be improved. See our response to question 31.

***Q31: Do you think that the disclosures under RTS 10 made by the trading venues are sufficient or should they be harmonised among the different entities? Please explain.***

ISDA members believe the disclosures are sufficient but that they could benefit from more harmonisation.

For instance, certain members note that the assessment and comparison between the costs of colocation can be challenging because of heterogeneous valuation and formatting practices amongst trading venues. They note that certain trading venues are charging every single element composing a colocation (e.g. electricity, square meters used, connectivity and market data not directly related to the colocation services) while others are showing a unique fee for the whole colocation.

These members would then support standardization of the way colocation services fees are presented. They would also support that market data is priced separately from the colocation services and that trading venues have a client interface where users could download the invoices related to the different and separated colocation, market data and execution fees.

***Orders to Transactions Ratio (OTR)***

***Q32: Do you agree with ESMA’s proposal to set out the maximum OTR ratio, calibrated per asset class?***

ISDA members are of the view that the regulation of Order-Transaction-Ratios is counterproductive to the stated regulatory intention of increasing liquidity and market efficiency.

Neither a trading venue nor a market maker can manufacture transactions at a specified rate because transaction requires two parties to agree.

ISDA members highlight that price transparency improves if a larger number of products have tighter bid-ask markets. Liquidity, as measured by the cost per unit of transaction, increases when bid-ask spreads decreases.

A reduction in mandated order-to-transaction ratio has two direct impacts on the market:

a) market-makers must reduce the number of orders that they send because it is the only quantity that they can control;

b) for a market maker, to reduce the number of orders while ensuring that his orders are economically viable, the market maker must increase the bid-offer spread between those orders.

Therefore, any limitation on OTR is destructive to a tight, liquid, efficient and transparent market. If trading venues and regulators want to provide good incentives for participants to become registered market makers, they should state that restrictions on OTR apply to all HFTs that are not registered market makers.

***Q33: Do you agree that the maximum limits are not frequently exceeded? Please explain any potential underlying issues in this respect that should be recognised.***

***Q34: Do you agree with the consequences as described of exceeding the maximum limits or should there be a more convergent approach? Please provide any comment or suggestion regarding the procedures in place by trading venues in case of a member exceeding the prescribed limit.***

***Monitoring of compliance with trading venues’ rules***

***Q35: Do you agree with the need to improve the notification process in case of IT incidents and system outages? Beyond the notification process between NCAs and ESMA, which improvements could be done regarding communication of incidents to the public?***

ISDA members note that, although the incidents highlighted by ESMA were not predominantly in respect of OTC derivative venues, the issues which would be relevant for all venues.

Notifications to market participants should be improved and timelier. All market participants should receive consistent information at the same time. Information should include realistic estimates of expected downtime, set expectations for when next updates will be provided, and refer where necessary to key times and updates related to any cutover to alternative facilities.

**Tick size, market making, asymmetric speedbumps and trade feeds**

***Tick-size regime applicable to shares, third-country shares and ETFs***

***Q36: Do you believe any initiative should be put forward to ensure there is more continuity on trading in case of an outage on the main market, e.g. by requiring algo traders to use more than one reference data point?***

***N/A***

***Q37: Do you agree with the view that the tick size regime had overall a positive effect on market depth and transaction costs?***

***N/A***

***Q38: Is there any further issue you would like to highlight regarding tick size regime?***

***N/A***

***Q39: Do You agree with the proposal not to amend the tick size regime for third country shares? Please explain.***

***N/A***

***Q40: Do you agree with the proposal to widen the scope of the tick size regime to all ETFs? Would this pose challenges in your view? Please explain.***

***N/A***

***Tick-size regime for non-equity instruments***

***Q41: Do you agree with the proposal not to widen the scope of the tick size regime to non-equity instruments? Please explain.***

ISDA members find negligible value in any part of the tick-size regime. They therefore agree with ESMA’s proposal to maintain a narrow scope.

***Market making agreements***

***Q42: Do you agree with ESMA findings and assessment of the current MiFID II market making regime?***

ISDA members do not believe that the provisions of the market-making regime improve liquidity, or that the suggested amendments will do. We suggest that ESMA considers wholesale changes to the provisions as suggested in the response to Q43.

***Q43: What do you think of ESMA proposals and suggested amendments to RTS 8? In your view, what other aspects of the market making regime require to be amended and how?***

ISDA members note that the regulation has the stated intention of increasing the resilience of liquidity. However, they also note that the requirements can have the opposite effect, i.e. reduce liquidity and the number of liquidity providers.

ISDA members would therefore propose that RTS 8 focuses on the market-making agreements but should simply state that a venue must offer the same uniform incentives to any entity which exceeds a threshold of market-making activity.  That would incentivize participants to aligncorrectly with objective and prevent unequal treatment of participants. ISDA members note that fair and equal treatment of market makers by venues should be at the heart of RTS 8.

Regarding incentives to improve liquidity in stressed or disorderly Markets, ISDA members note that participation in stressed and disorderly markets will invariably produce significant, and often bad, market risk for market makers.

Fee incentives will not incentivise market makers to take on bad market risks because the losses due to market risks are much larger in magnitude than fee incentives.

Therefore, the focus of regulation should be to:

* define stressed and disorderly markets,
* minimise the occurrence of stressed and disorderly markets,
* recognise that it is critical to have the largest and most diverse pool of market-makers participating in a product,
* recognise that RTS 8 Article 1 is contrary to these objectives as are all highly-prescriptive limitations on electronic and high-frequency trading activity, such as order-to-trade ratio requirements, from which market-makers should certainly be exempt.

***Q44: What are market participants views regarding the flexibility left in the MiFID II market making regime? Would you agree with ESMA further clarifying certain relevant concepts? If yes, which ones?***

***Q45: Could you please describe how Primary Dealers agreements are designed (number of designated Primary Dealers, transparency about investment firms having signed such agreements, typical obligations contained, etc…). Do you consider that Primary Dealers should be exempted from the Article 1 of RTS 8? Do you consider that this can introduce a regulatory loophole?***

ISDA members note that Primary Dealers have specific agreements with specific Debt Management Offices (DMOs) and, in this context, are subject to certain obligations, which differ depending on the country, for the auctions, placing of Government bonds and maintaining of a liquid secondary market by making bid-offer prices.

The question therefore relates to bond markets and has no implications for derivatives markets.

***Speedbumps in financial markets***

***Q46: Do you think that venues which introduced asymmetric speedbumps provide enough information regarding the mechanism used? If not, what additional information would be useful to disclose to market participants?***

ISDA members note that the effect of asymmetric speedbumps is quite different between equity and derivatives markets. For derivatives markets, that are largely based on the intervention of liquidity providers, the example of Eurex shows that the introduction of an asymmetric speedbump has a positive impact on the market microstructure, and hence on the quality of execution for end-clients.

By protecting passive orders from high speed arbitragists such as certain HFT firms, asymmetric speedbumps  make it possible (i) for some liquidity providers that would otherwise not be able to stay in the market to provide quotes (as their access technology cannot compare with the one deployed by most advanced HFT firms, they need time to adjust their quotes when necessary before being tapped by those HFT firms) and (ii) for liquidity providers collectively, as the more market participants on a venue, the tighter the bid-offer spread, as liquidity providers do no longer have to integrate a protection against low-latency arbitragists.

ISDA members hence believe that the introduction of asymmetric speedbumps on derivatives markets per se delivers benefits for end users by protecting traditional liquidity providers against the most advanced HFT firms. From that perspective, tighter market making requirements due to the introduction of asymmetric speedbumps are not justified.

***Q47: Reflecting on those mechanisms which allow liquidity providers to provide quotes that can be filled only against retail order flow, do you think that such mechanisms are beneficial in terms of market quality? Is there any specific aspect that you think should be further taken into account, also considering the type of instruments traded? Please specify the venue of reference and the type of arrangement discussed.***

***Q48: Do you think that venues which introduce asymmetric speedbumps should set tighter market making requirements? Please explain why and how tight those new requirements should be.***

***Q49: Do you agree on the conclusion that speedbumps might not be a well-suited arrangement for equity markets? If yes, do you think that such arrangements for equities should be prohibited in Level 1? Please explain.***

***Q50: Do you think that the introduction and functioning of speedbumps should be further regulated? If yes, which specific requirements would you like to be included in EU legislation?***

***Q51: Is there any specific issue you would like to highlight about speedbumps?***

**Asymmetry of private and public feeds**

***Q52: What are your views on the relative timing of private fill confirmations and public trade messages? If you are a trading venue, please provide in your answer an explanation of the model you have in place.***

***Q53: Do you consider information on the sequencing of these two feeds at trading venues to be easily available? If you are a trading venue, please provide a link to where this information can be found publicly.***

***Q54: Do you think there should be any legislative amendments or policy measures in respect of these feed dynamics?***