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Goodbye OTC Hello MiFID II and MiFIR

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New rules agreed under the recast Markets in Financial Instruments Directive (known as **MiFID II**) and the new Markets in Financial Instruments Regulation (known as **MiFIR**) are set to revolutionise trading in over-the-counter (**OTC**) derivatives markets.

Specifically, the 'trading obligation' requirements of MiFID II and MiFIR implement the commitment made by the G20 in 2009 to move OTC derivatives trading on to trading venues.

Traditional 'private' OTC trading is set to reduce significantly as more contracts are executed on trading venues and cleared through central counterparties (**CCPs**).

Although the key characteristics of OTC contracts will remain the same, the execution and clearing requirements will make them look more like futures.

They will be executed and cleared in a similar way to futures, but the fundamentals of the contracts themselves will remain the same: cleared swap contracts will remain tailored contracts, typically of fixed duration.

Traditional trading in OTC contracts will continue in a reduced form, most likely dominated by bespoke and less liquid contracts.

New margin requirements for uncleared OTC contracts (which are expected to apply from the end of 2015) are likely to further constrain activity in this market.

Execution services are likely to change, and end-users will need to reconsider how they access the market and which trading venues to use.

It is expected that market participants will need to comply with the new trading venue rules from around Q1 2017.

The precise volume of OTC derivatives trading which will move to trading venues will depend upon the European Securities and Markets Authority's (**Esma**) two-pronged test. Namely, whether the contracts are eligible for clearing under the European Market Infrastructure Regulation (**Emir**) and whether they are sufficiently liquid.

The criteria for determining liquidity will be set out in technical standards to be published by Esma. Its recent discussion paper suggested that these are likely to be based on average frequency of transactions, average size of transactions, number and type of market participants and average size of spreads.

Once established that contracts are eligible for clearing and sufficiently liquid, MiFID II imposes an obligation upon financial counterparties

and certain non-financial counterparties (both categorised under Emir) to ensure that they execute such derivative contracts "on-exchange", including when they enter into contracts with certain non-EU counterparties.

The term "on-exchange" means on a regulated market (**RM**), a multilateral trading facility (**MTF**), an organised trading facility (**OTF** – a new category of trading venue broadly akin to a US swap execution facility), and a non-EEA trading platform that would be either an RM, MTF or OTF if it was operated within the EU.

This requirement will also apply to derivative contracts that are entered into between two non-EU counterparties if those contracts have a "direct, substantial and foreseeable" effect within the EU or if the on-exchange requirement is necessary to prevent the evasion of any provision under MiFID II.

It is not yet possible to accurately forecast what proportion of OTC trades will be eligible for clearing under Emir, although market expectations suggest between two thirds and three quarters of trades over the coming years (with certain asset classes becoming predominantly cleared, others not so).

Risk-related benefits for end-users are expected to result from the break-up of vertical silos (in which the trading venue and clearing house are affiliated) under new rules on access to CCPs and trading venues under MiFID II/MiFIR.

Subject to certain exceptions, the new rules require trading venues and CCPs to provide non-discriminatory access to one another and for trading venues to provide trade feeds on a non-discriminatory and transparent basis to a CCP that wishes to clear transactions.

The new rules are expected to promote competition in trading and clearing: an end-user will be able to execute a trade on a venue of its choice and then use a clearing system of its choice. This will enable end-users to direct positions to a particular clearing system to maximise netting and make best use of margin.

What will this all mean for end-users? For the execution piece, as with futures, end-users can expect to use executing brokers and associated give-up arrangements.

Transacting through a trading venue should be risk-reducing in the sense that administrative or operational error should be reduced.

In terms of counterparty risk, it is the clearing process, not the execution process, which reduces counterparty risk, as the original contracting party faces the CCP under a cleared trade.

End-users will be able to go a step further in managing risk by being able to choose both their trading venue, and clearing system, of choice.

Good news all round? Once the dust settles – and subject to sufficient liquidity – the ayes have it.