Darine Al Koblawi
Financial Conduct Authority
12 Endeavour Square
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30 September 2024

Sent via email : cp24-14@fca.org.uk

Dear Darine,

Response to FCA CP24/14: Consultation on the derivatives trading obligation and post-trade risk reduction services

The International Swaps and Derivatives Association, Inc. (**ISDA**) welcomes the opportunity to respond to the FCA's CP24/14.

Overview and summary

We welcome the opportunity to respond to this very helpful and positive consultation and highlight that:

- Our members consider that 12Y SOFR products should not be brought within the scope of the DTO.
- Members call for a six-month implementation period for both the implementation of bringing SOFR into DTO scope and for changes to apply to risk reduction services.

<u>Changes to the classes of derivatives subject to the derivatives trading obligation</u>

Question 1: Do you agree with the liquidity analysis set out above?
If not, please explain why and provide supporting data where possible.
We agree with the liquidity analysis set out.

Question 2: Do you agree with our proposal to bring into scope the stated SOFR derivative products? If not, please explain why and provide supporting data where possible. In particular, do you have views as to whether 12-year SOFR products should be brought into scope?

We agree with the proposal to bring into scope the stated SOFR derivative products, save for 12Y SOFR. 12Y SOFR is less liquid than the rest of the tenors and therefore our members consider that 12Y SOFR products should not be brought into scope.

To the extent that 12Y SOFR products are brought into scope, we agree with including the same tenors within the DTO that are in scope of the CFTC's US trading mandate, i.e. the made-available-to-trade (MAT) determination for certain SOFR OIS. We emphasise the importance of international consistency in the scope of derivatives used. As you have identified, there is no ICE Swap Rate published for 12Y SOFR – 12Y has borderline liquidity for inclusion in the DTO. We note that the EU has yet to opine on such matters and hope that they will also consider international consistency in their deliberations. We observe that the CFTC, in its MAT determination, has made the 12-year SOFR product subject to its trade execution requirement for spot starting swaps and IMM swaps with a par fixed rate, but not for IMM swaps with a standard coupon rate.

We also agree that the analysis should not have focused on benchmark tenors greater than 30 years. As set out in ISDA's response to the FCA's CP23/32 – Improving transparency for bond and derivatives markets – ISDA data shows that anything beyond 30 years is generally illiquid.[1]

Question 3: Do you agree with the implementation timeframe, for the amendment of the scope of the DTO to enter into effect 3 months after the publication of our policy statement?

If not, please explain what transition period is needed and why.

As already stated in our response to CP22/26 Chapter 3 (amendments to the DTO), the industry needs an implementation period of at least six months to implement any DTO scope adjustments in order, for example, to adjust all relevant internal trading and control systems, external trading venues and third-party dependencies, internal front-office trading and external client communication/set-up.

Exemptions for post-trade risk reduction services

Question 4: Do you agree with the descriptions provided for portfolio compression, portfolio rebalancing, and basis risk optimisation? If not, why not?

Regarding the description of portfolio rebalancing, we would note that portfolio rebalancing can also/or involve amending or terminating existing transactions, as well as inserting new transactions, the same as portfolio compression. It is possible to rebalance counterparty risk either by only introducing new transactions, or by a combination of terminating existing transactions and creating new transactions. In the interest of not adding unnecessary notional in portfolios, combining terminations and new transactions is a good strategy.

As with the description of portfolio compression, portfolio rebalancing should be described as not *materially* changing market risk.

Perhaps the descriptions of each type of PTRRS would be better reframed to focus on target/objective instead of the methodology, for example, in rebalancing the target is to reduce counterparty risk exposures (while, for example, constraining the amount of new notional).

[1] https://www.isda.org/a/XhsgE/ISDA-Response-to-FCA-on-Transparency-in-Derivatives-Markets.pdf

Regarding the description of basis risk optimisation, we would recommend referencing derivatives, as against swaps, as this works better across all the products. We note that UK Finance has suggested refining the description and we would look to support that, as follows:

4.23 Derivatives, such as swaps, forward and options are highly customisable but generally have structures with varying durations, expiry or reference rates, periodic payments and fixings of cash flows or settlement on a transaction-by-transaction basis. Over time, the accumulation of price and timing mismatches due to the accumulation of trades leaves second and third order risks in a trading book which require hedging. Examples include basis risk, reset risk and strike risk.

4.24 Multilateral risk hedging works to efficiently reduce these risks. An independent third-party vendor brings together multiple parties and identifies mutually beneficial trades which are executed at mid-market and hence are not price forming.

4.25 These services do not materially change the overall market risk of a portfolio, but efficiently hedge second and third order risks. The efficiency increases with the level of participation.

We agree with the description of portfolio compression.

Question 5: Do you agree that eligible post-trade risk reduction services should not be subject to the best execution, the obligation to seek authorisation as a trading venue, and the derivatives trading obligation? If not, please explain why.

We agree that these eligible post-trade risk reduction services should not be subject to the best execution, the obligation to seek authorisation as a trading venue, and the derivatives trading obligation.

We agree with CP 24/14 that PTTR services do not compete on the basis of price, volume or time of transactions. The application of best execution or trading venue requirements (such as those related to transparency, electronic trading, circuit breakers and suspension) would therefore not be meaningful to the operation of risk reduction services.

Further, new technical transactions that are created by PTRR exercises are market-risk neutral, and non-price forming. The derivatives trading obligation – which is primarily aimed at improving transparency to enhance price formation and strengthen market integrity – is therefore not suited to PTRR services.

Overall, keeping PTTR services within scope of these obligations pollutes the data which can best be used to ensure a clear and workable transparency regime in the UK. They also remove barriers to a wider range of market participants using PTRR services.

Linkage with the derivatives clearing obligation

The derivative trading obligation is closely linked to the clearing obligation (CO) under the UK European Market Infrastructure Regulation (EMIR). We believe that there should also be an aligned exemption from the UK EMIR clearing obligation for trades resulting from post-trade risk reduction services. While the Financial Services and Markets Act 2023 has given powers to the Bank of England to introduce an exemption, there has been no indication – including through the latest Regulatory Initiatives Grid – that a consultation from the Bank is forthcoming. We would urge the Bank to set out its plans, should they require further consultation.

As has been seen in several recent stress events, not least Covid-19 and the disturbances in the UK LDI market, liquidity risk is of increasing concern to everyone in the market, regulators and market participants alike. Our members advocate very strongly for the EMIR exemption because of the risk reducing impact it can have on derivative portfolios. As a result of these risk reductions, the exemption can significantly reduce liquidity required as a result of margins, to the benefit of all.

Question 6: Do you agree with the three characteristics identified to determine eligible post-trade risk reduction services? If not, please explain why.

We agree with the three characteristics identified to determine eligible post-trade risk reduction services.

Question 7: Are there any additional characteristics we should consider including for "eligible post-trade risk reduction services"? If yes, please explain which characteristics and why.

Members did not have any additional characteristics to propose for consideration.

Question 8: Do you agree portfolio compression, portfolio rebalancing and basis risk optimisation are eligible post-trade risk reduction services? If not, please explain why.

We agree portfolio compression, portfolio rebalancing and basis risk optimisation are eligible post-trade risk reduction services.

In our response to IOSCO's PTTRS consultation, ISDA reinforced the point that PTRRS are being developed and improved continuously, and it should be expected that the demand for new types of PTRRS will arise. Although the PTRRS definition needs to be specific enough to give regulators comfort, it needs to be principles-based to allow for further development and improvement of PTRRS over time.

Question 9: Do you agree with the conditions included for providers of eligible risk reduction services to fulfil for the definition of an eligible agreement if using the exemptions in Article 31 UK MiFIR? If not, please explain why.

We agree with the conditions included for providers of eligible risk reduction services to fulfil for the definition of an eligible agreement if using the exemptions in Article 31 UK MiFIR.

Question 10: Do you agree with the condition that providers of posttrade risk reduction services shall maintain complete and accurate records of all risk reduction exercises they organise or participate in, and for such records to be made promptly available to the FCA upon request? If not, please explain why.

We agree with the condition that providers of post-trade risk reduction services shall maintain complete and accurate records of all risk reduction exercises they organise or participate in, and for such records to be made promptly available to the FCA upon request.

Question 11: Do you agree with maintaining a form of public disclosure for PTRR services? If not, please explain why.

We agree with maintaining a form of public disclosure for PTRR services.

Question 12: Do you agree with the information required to be disclosed under the proposed condition of public disclosure by providers of PTRR services? If not, please explain why? Please include any additional information you consider necessary for inclusion in our public disclosure requirement.

We agree with the information required to be disclosed under the proposed condition of public disclosure by providers of PTRR services.

Question 13: Do you agree with our proposal to introduce a notification requirement for firms operating a PTRR service as laid out above? If not, please explain why.

We agree with the proposal to introduce a notification requirement for firms operating a PTRR service. In the event that some members may prefer to notify the FCA earlier than waiting for the implementation time to pass, we ask the FCA to accept notifications as soon as practicable after the publication of the Policy Statement and final rules.

Question 14: Do you agree with our proposed implementation timeline for the changes in Handbook to apply to risk reduction services? If not, please explain why. Please include any additional factors you would like us to consider.

Our members do not agree that a three-month proposed implementation timeline allows adequate time for all the changes that need to be made. Our members recommend a six-month implementation timeline – if there are new types of trades to be excluded from post trade transparency then three months is challenging.

FCA power to suspend or modify the derivatives trading obligation

Question 15: Do you agree that we should use our UK MiFIR Article 28a power of direction to achieve an outcome equivalent to that achieved by the TTP as outlined above? If not, please explain why.

We agree that the FCA should use its UK MiFIR Article 28a power of direction to achieve an outcome equivalent to that achieved by the TTP, as outlined in the CP. It is important that UK DTO relief is kept exactly as it is today. We understand that the Statutory Instrument required by HM Treasury to bring this provision into force is outstanding – it is essential that this is delivered in time to ensure a smooth transition after the TTP expires on 31 December 2024.

We note that the FCA is considering setting out the direction in the FCA Handbook using new powers exercised under the Smarter Regulatory Framework. This would cease the requirement to publish a statement every 6 months setting out the purpose of the direction. We request that – if the FCA is unable to give the required statement – the industry will be given a reasonable period of notice to adjust and comply with the relevant rules.

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About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 76 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on LinkedIn and YouTube.