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October 14, 2016

Discussion Paper on ESMA Proposal on the Trading Obligation for Derivatives Under MiFIR

[30313]

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 55-16
EQUITY MARKETS ADVISORY COMMITTEE No. 44-16
ICI GLOBAL TRADING & MARKETS COMMITTEE No. 52-16
INTERNATIONAL COMMITTEE No. 57-16
SECURITIES OPERATIONS ADVISORY COMMITTEE RE: DISCUSSION PAPER ON ESMA's PROPOSAL ON THE TRADING OBLIGATION FOR DERIVATIVES UNDER MIFIR

The European Securities and Markets Authority (ESMA) recently published a discussion paper on how to implement the trading obligation for derivatives under the Markets in Financial Instruments Regulation (MiFIR).[1] Once a class of derivatives becomes subject to the clearing obligation under the European Market Infrastructure Regulation (EMIR), ESMA determines whether that class (or a subset of the class) should be subject to the trading obligation. If ESMA determines the trading obligation should apply to the class, those derivatives can only be traded on a regulated market (RM), multilateral trading facility (MTF), organized trading facility (OTF)[2] or a third country trading venue deemed to be equivalent by the European Commission.

The Discussion Paper provides market participants with some insights into the process that ESMA intends to use to develop regulatory technical standards (RTS) specifying which of the classes of derivatives declared to be subject to the clearing obligation also should be subject to the trading obligation. Based on the feedback received on the discussion paper, ESMA intends to publish a consultation paper proposing RTS implementing the trading obligation for derivatives in the first quarter of 2017.

Comments on the Discussion Paper are due by November 21, 2016. ICI Global intends to submit a comment letter in response to the Discussion Paper. If you have feedback on the Discussion Paper, please contact Jennifer Choi at jennifer.choi@ici.org or George Gilbert at george.gilbert@ici.org no later than Friday, October 21.

I. Standards for Applying the Trading Obligation

Under MiFIR, after a class of derivatives is subject to the clearing obligation, ESMA determines whether some or all of the derivatives in the class also should be subject to the trading obligation.[3] ESMA will make this determination primarily by considering a venue test and a liquidity test.

A. Venue Test

Under the venue test, a class of derivatives can be subject to the trading obligation only if the class is admitted to trading or traded on at least one admissible trading venue. The Discussion Paper identifies three issues that ESMA must address to determine whether a particular class of derivative satisfies this standard:

- The definition of "class" of derivative. To determine the classes of derivatives that should be considered admitted to trading or traded on a trading venue, ESMA proposes to use a subset of the classes that it established for purposes of the clearing obligation. Specifically, the clearing obligation applies to derivatives contracts with a broad range of maturities, but ESMA intends only to consider derivatives contracts with specified, common tenors for inclusion in the trading obligation *(e.g.*, ESMA therefore can find that contracts with certain tenors are admitted to trading or traded on a trading venue while the same type of derivatives contracts with other tenors are not).

- The criteria that should be used to determine whether a class of derivative is admitted to trading or traded on a trading venue. ESMA understands that all derivatives subject to the clearing obligation can be traded on or are available to trade on RMs and MTFs. However, it is not clear whether actual trading takes place and whether all tenors can be traded. Thus, ESMA requests comments on whether all derivatives and maturities subject to the clearing obligation can be considered as admitted to trading or actually traded on a trading venue for the purpose of the trading obligation.

- Scope of venues. ESMA proposes that the venue test will focus initially on products admitted to trading on regulated markets and MTFs only. Market participants can satisfy the trading obligation by transaction on an OTF, but these trading venues have not started operating, so ESMA will not initially consider OTFs for the criteria. Once OTFs start operating, ESMA would consider revising any technical standard as the new OTF category may have an impact on the liquidity of trading.

B. Liquidity Test

1. Explanation of the Liquidity Test

The liquidity test is designed to assess whether a class of derivatives is 'sufficiently liquid' to support the trading obligation. This test considers three factors.[4] First, ESMA must consider the average frequency and size of trades over a range of market conditions. ESMA generally proposes to use transaction level data reported to trade repositories (TRs), over a six-month period to assess this factor. Second, ESMA considers the number and type of active market participants in a particular class of derivatives. This criterion would take into account the number of market participants trading a class of derivatives, the ratio of market participants to products/contracts traded in a given market, the number of trading venues that have admitted to trading or are trading the class of derivatives,[5] and the number of market makers and other market participants under a binding written agreement or an obligation to provide liquidity.[6] Third, ESMA must consider the average size of spreads for the classes of derivatives that it considers for the trading obligation.[7] ESMA intends to put less weight to this criterion as compared to other criteria because of the lack of actual data on spreads.

Under the liquidity test, ESMA also can consider whether a class of derivative that is illiquid for certain transaction sizes might have sufficient liquidity to support the trading obligation at a smaller size.[8] ESMA proposes to connect this requirement to the concept of waivers and deferrals from MiFIR's transparency requirements, which aim to protect market participants from adverse price movements when disclosing their transactions to the public.[9] Under MiFIR, waivers and deferrals are available for orders/transactions in instruments: (i) for which there is no liquid market, (ii) that are above the size specific to the instrument (SSTI), and (iii) that are large in scale (LIS). ESMA proposes to exempt transactions that are above the post-trade LIS threshold from the trading obligation because it believes this would align its rules fairly closely with comparable CFTC rules.

2. Ensuring Consistency Between the Transparency Regime and the Trading Obligation

The standards for the liquidity test for the trading obligation are similar to those used for determining whether a 'liquid market' exists for transparency of non-equities under Article 2(1)(17)(a) of MiFIR.[10] In ESMA's view, "four small differences" [11] between these tests imply that the liquidity test for the trading obligation is at least as stringent—if not more so—than the determination for trade transparency purposes. Accordingly, ESMA understand that only derivatives for which there is a liquid market under MiFID II/MiFIR and that are subject to transparency should be eligible for the trading obligation.[12] Nevertheless, for the purposes of the Discussion Paper, ESMA retains the option that the liquidity test for the trading obligation can be less stringent than the test to determine a liquid market for trade transparency purposes.

ESMA notes that any possible inconsistency between the liquidity tests used for assessing the trading obligation and applying trade transparency will impact other areas of market structure, including pre-trade transparency waivers provided under MiFID.[13] ESMA proposes two options to address this possible inconsistency. The first option is to accept the inconsistencies between the transparency regime and the trading obligation as unavoidable and take no further action, but this option may result in an instrument that is deemed liquid for purposes of pre-trade transparency receiving a waiver because it does not pass the liquidity test for the trading obligation.

The second option is to make the transparency and trading obligation standards more consistent. ESMA believes this could be done by expanding the scope of instruments eligible for the trading obligation to be coterminous with the instruments that are subject to the transparency regime. ESMA notes, however, that even if the transparency and trading obligation standards are harmonized now, some divergence may develop over time because the liquidity assessment for the transparency regime is conducted annually, but trading obligation determinations are static. This means that the liquidity classification of a class of derivatives could change from one year to another for transparency purposes, causing the determinations under the trading obligation to become outdated unless EU authorities amend, suspend, or revoke the RTS conferring the trading obligation.[14]

II. Liquidity Assessment: Preliminary Analysis for Certain Derivatives

The Discussion Paper explains ESMA's preliminary liquidity analysis for interest rate and index credit default derivatives that are or will be subject to a clearing mandate in the European Union. The analysis relies on data from TRs, where possible, and includes over-the-counter (OTC) transactions, not those executed on regulated markets. After obtaining the relevant data, ESMA took steps to clean the data set by, among other things, removing duplicative reports and eliminating improperly identified counterparties.[15] This section summarizes ESMA's analysis for interest rate and credit derivatives.

A. Interest Rate Derivatives

For its preliminary liquidity assessment of interest rate derivatives, ESMA first determined which subclasses of derivatives already subject to the clearing obligation should be considered liquid on the basis of the average number of trades per day. ESMA determined that a subclass of derivatives would be considered liquid under this metric if the number of trades per day equals or exceeds the number required to have a liquid market for purposes of the MIFID II/MiFIR transparency regime. Only subclasses that passed this threshold were considered for further analysis under the following criteria:

- Average notional amount per day (EUR);
- Days traded; and
- Number of distinct counterparties.

1. Fixed-float Interest Rate Swaps (IRS)

Single currency fixed-float IRS are one of the most commonly traded derivatives and are already to a great extent subject to the clearing obligation. Fixed-float IRS in EUR, USD, GBP and JPY with tenors of 5, 10, and 30 years met all of ESMA's liquidity criteria and thus would be considered sufficiently liquid for the trading obligation.[16] ESMA's data set did not, however, provide sufficient information about other details of this subclass of derivatives for ESMA to assess whether other terms should affect the applicability of the trading obligation. For example, TR data does not provide information on payment frequency, reset frequency, day count convention, and trade start type. ESMA is seeking comments on possible sources for obtaining the necessary information as well as proposals on which specifications are considered necessary to specify the trading obligation.

2. Overnight Index Swaps (OIS)

Although one subclass of OIS—those denominated in EUR with a tenor of 3 months—met the first liquidity criterion of average number of trades per day, its trading activity was close to the threshold, suggesting that even a modest adjustment in trading patterns could alter the liquidity analysis. This subclass, however, largely met the three additional liquidity criteria, so ESMA plans to assess further liquidity criteria before taking this subclass for the trading obligation.

3. Basis Interest Rate Swaps

No subclass met the criterion of the level of 10 trades per day and thus no class is sufficiently liquid for the trading obligation at this time.

4. Forward Rate Agreements(FRA)

FRAs are covered by the clearing obligation for selected currencies; however, 90-95% of the global volume of FRAs are related to post-trade risk reduction, and only about 5% of the global volume refers to the actual transactions. Thus, ESMA does not currently consider FRAs under trading obligation.

B. Credit Derivatives

Deficiencies in TR data precluded ESMA from assessing quantitatively the liquidity of credit default swaps (CDS) that will be subject to the clearing mandate. Based on conversations with certain stakeholders, however, ESMA considers that the on-the-run series of both the iTraxx Europe Crossover index in EUR with 5Y tenor and iTraxx Europe Main index in EUR with 5Y tenor can be considered sufficiently liquid to be considered for the trading obligation.   ESMA also considers extending the trading obligation to the first thirty working days of the 1st off-the-run series, or the series that is immediately prior to the current on-the-run series.

III. Compliance Date for Trading Obligation

To ensure that the trading obligation is aligned with the clearing obligation and that mandatory trading on a class of derivatives do not apply to a category of counterparties prior to such category of counterparties being subject to mandatory clearing with respect to that class of derivatives, ESMA proposes a schedule of compliance dates.

Earliest Application Dates on Which the Trading Obligation Will Take Effect

OTC derivatives class

Category of counterparty[17]

Category 1

Category 2

Category 3

Category 4

Interest Rate Derivatives (IRD) (EUR, GBP, JPY, USD)

Jan. 03, 2018

Jan. 03, 2018

Jan. 03, 2018

Dec. 21, 2018

IRD (NOK, PLN, SEK)

Jan. 03, 2018

Jan. 03, 2018

Feb. 09, 2018

August 09, 2019

Credit Derivatives

Jan. 03, 2018

Jan. 03, 2018

Feb. 09, 2018

May 09, 2019

ESMA also acknowledges that a longer phase-in period may be necessary because counterparties that will be subject to the trading obligation may require sufficient time to update their system and procedures to comply with the trading obligation, to ensure connection to trading venues.

IV. Package Transactions

ESMA recognizes the concerns market participants have with imposing the trading obligation on package transactions when each of the components are not subject to the trading obligation.[18] ESMA does not have explicit authority to exempt transactions from the trading obligation based on their inclusion in a package, but there may be some limited room to provide a tailored approach. ESMA seeks comments on the types of packages that may be affected in view of asset classes currently considered for the trading obligation, i.e. IRD and CDS as discussed in the Discussion Paper.

Appendix: Questions Posed by the Discussion Paper

- Q1: Do you agree that the level of granularity for the purpose of the trading obligation should apply at the same level as the one used for calibrating the transparency regime of non-equity instruments? If not, which level would you recommend and why? Would that differ by asset class and type of instrument?
- Q2: Do you agree that all derivatives currently subject to or considered for the clearing obligation are admitted to trading or traded on at least one trading venue? If not, please explain which classes of derivatives are not available for trading on at least one trading venue.
- Q3: How should ESMA determine the total number of market participants trading in a class of derivatives? Do you consider it appropriate to carry out this assessment with TR data or would you recommend other data sources?
- Q4: In your view, what should be the minimum total number of market participants to consider the following classes of derivatives as sufficiently liquid for the purpose of the trading obligation? i) OTC interest rate derivatives denominated in EUR, USD, GBP and JPY; ii) OTC interest rate derivatives denominated in NOK, PLN and SEK; iii) Credit default swaps (CDS) indices? Should you consider that this assessment should be done on a more granular level, please provide your views on the relevant subsets of derivatives specified in 1.-3.
- Q5: Do you agree with [the venue test] approach? Do you consider alternative ways to identify the number of trading venues admitting to trading or trading a class of derivatives as more appropriate?
- Q6: On how many trading venues should a derivative or a class of derivatives be

traded in order to be considered subject to the trading obligation?

- Q7: What would be in your view the most efficient approach to assess the total number of market makers for a class of derivatives? Where necessary, please distinguish between: i) The phase prior to the application of MiFID II (*i.e.* before January 2018); ii) The phase after the application of MiFID II (i.e. after January 2018).
- Q8: How many market makers and other market participants under a binding written agreement or an obligation to provide liquidity should be in place for a derivatives or a class of derivatives to be considered subject to the trading obligation?
- Q9: Do you agree with the proposed approach or do you consider an alternative approach as more appropriate?
- Q10: Do you agree that the criterion of average size of spreads, in particular in case of absence of information on spreads, should receive a lower weighting than the other liquidity criteria? If no, please specify your reasons.
- Q11: Which sources do you recommend for obtaining information on the average size of spreads by asset class?
- Q12: What do you consider as an appropriate proxy in case of lack of information on actual spreads?
- Q13: Do you agree with the suggested approach? If not, what approach would you recommend?
- Q14: Do you agree that trades above the post-trade large in scale threshold should not be subject to the trading obligation? If not, what approach would you suggest? Should transactions above the post-trade LIS threshold meet further conditions in order to be exempted from the trading obligation?
- Q15: How highly should ESMA prioritize the alignment of the trading obligation with transparency? What would be the main consequences for the market if some instruments are covered by transparency and not by the trading obligation or vice versa? If the two are not fully aligned, would a broader scope for the trading obligation or for transparency be preferable, and why? In case of a broader or narrower scope for the trading obligation (compared with transparency), how should the two liquidity thresholds relate to each other?
- Q16: Do you agree with the proposed methodology to eliminate duplicated trades or would you recommend another approach? Do you agree with selecting Option 2?
- Q17: Do you agree with the approach taken with regard to calculating tenors?
- Q18: Do you agree with the reasons mentioned above or is there another explanation for the significant number of trades outside of benchmark dates?
- Q19: Does this result reflect your assessment of liquidity in fixed-float IRS? If not, please explain on which subclasses you disagree and why.
- Q20: What thresholds would you propose as the liquidity criteria? What minimum number of counterparties would you consider appropriate for introducing the trading obligation?
- Q21: What further specifications (*e.g.* payment frequency, reset frequency, day count convention, trade start type) would you consider necessary for specifying the trading obligation for fixed-float IRS? How would you determine these additional specifications?
- Q22: Does this result reflect your assessment of liquidity in OIS? If not, please explain on which subclasses you disagree and why.
- Q23: What thresholds would you propose for the liquidity criteria? What minimum number of counterparties would you consider appropriate for introducing the trading obligation?
- Q24: What further specifications (*e.g.* payment frequency, reset frequency, day count convention, trade start type) would you consider necessary for specifying the trading

obligation for OIS? How would you determine these additional specifications?
- Q25: Do you agree that due to the specificities of the FRA-market, FRAs should not be considered for the trading obligation? Do you agree that the majority of FRAs transactions serve post-trade risk reduction purposes rather than actual trades?
- Q26: In case you consider FRAs should be considered for the trading obligation, which FRA sub-classes are in your view sufficiently liquid and based on which criteria? How should a trading obligation for FRAs best be expressed? Should it be based on the first (effective date) or the second period (reference date)? Apart from the tenor, which elements do you consider necessary for specifying the trading obligation for FRAs and why?
- Q27: Would you consider the two index CDS as sufficiently liquid for being covered by the TO?
- Q28: Do you agree that the trading obligation for CDS should cover the on-the-run series as well as the first thirty working days of the most recent off-the run-series? If not, please explain why and propose an alternative approach.
- Q29: Apart from the tenor, which elements do you consider indispensable for specifying the trading obligation for CDSs and why?
- Q30: Do you agree with the proposed application dates? If not, please provide an alternative and explain your reasoning.
- Q31: Do you consider necessary to provide an additional phase-in for the trading obligation for operational purposed and to avoid bottlenecks? If yes, please provide a proposal on the appropriate length of such a phase-in for the different categories of counterparties and explain your reasoning.
- Q32: Which types of package transactions are carried out comprising components of classes of derivatives that are assessed for the purpose of the trading obligation, i.e. IRD and/or CDS? Please describe the package and its components as well as your view on the liquidity of those packages.
- Q33: Are there packages that only comprise components of classes of derivatives that are assessed for the purpose of the trading obligation? Do you consider those package transactions to be standardised and sufficiently liquid?
- Q34: Do you agree that package transactions that are comprised only of components subject to the TO should also be covered by the trading obligation or should the trading obligation only apply to categories of package transactions that are considered liquid? If not, please explain.
- Q35: How should the trading obligation apply for package transactions that include some components subject to the trading obligation, whereas other components are not subject to the trading obligation?

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endnotes

[1] European Securities and Markets Authority, Discussion Paper, The trading obligation for derivatives under MiFIR (20 September 2016), *available at* https://www.esma.europa.eu/sites/default/files/library/2016-1389_dp_trading_obligation_for_derivatives_mifir.pdf (Discussion Paper).

[2] An OTF is a type of trading venue created by Markets in Financial Instruments Directive II (MiFID II).

[3] *See* Article 32(2) of Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (MiFIR). For the trading obligation to take effect:

a. The class of derivatives pursuant to paragraph 1(a) or a relevant subset thereof must be admitted to trading or traded on at least one trading venue as referred to in Article 28(1); and
b. There must be sufficient third-party buying and selling interest in the class of derivatives or a relevant subset thereof so that such a class of derivatives is considered sufficiently liquid to trade only on the venues referred to in Article 28(1).

[4] *See* European Securities and Markets Authority, Final Report, Draft Regulatory and Implementing Technical Standards MiFID II/MiFIR (28 September 2015), *available at* https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1464_annex_i_-_draft_rts_and_its_on_mifid_ii_and_mifir.pdf (citing draft RTS on transparency requirements in respect of bonds, structured finance products, emission allowances and derivatives (RTS 2); draft RTS on criteria for determining whether derivatives should be subject to the trading obligation (RTS 4); and draft RTS on market making agreements and market making schemes (RTS 8)).

[5] ESMA considers the more trading venues offer for trading or trade a class of derivatives, the more liquid that class can be considered. *See* https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1464_annex_i_-_draft_rts_and_its_on_mifid_ii_and_mifir.pdf

[6] Article 7 of draft RTS 8 (Draft regulatory technical standards on market making agreements and market making schemes) requires trading venues to publish on their website the terms of market making schemes, the names of the firms that have signed market making agreements and the financial instruments covered by those agreements. Thus, when MiFID II is applied, the information on market makers will be available. Because MiFID II will be implemented on Jan. 3, 2018, ESMA intends to approach trading venues to obtain the market making agreements where the relevant class of derivative is admitted to trading or traded.

[7] ESMA also is considering using information on spreads provided by data vendors and trading venues and seeking comments on whether there are better sources of information.

[8] *See* Article 32(3) of MiFIR.

[9] *See* Discussion Paper at 36.

[10] Article 2(1)(17)(a) of MiFIR defines a liquid market as: (i) the average frequency and size of transactions over a range of market conditions, having regard to the nature and life cycle of products within the class of financial instrument; (ii) the number and type of market participants, including the ratio of market participants to traded financial instruments in a particular product; (iii) the average size of spreads, where available.

[11] The differences include: (i) Article 32(3)(a) refers to trades instead of transactions (however it is assumed the terms are used interchangeably); (ii) Article 32(3)(b) refers to the number and types of active market participants, "including the ratio of market

participants to products/contracts traded in a given product market" rather than "including the ratio of market participants to traded instruments in a particular product"; (iii) when referring to the use of spreads, Article 32(3)(c) does not qualify the criterion with "when available"; and (iv) Article 32(2)(b) speaks of "sufficient third-party buying and selling interest," whereas a liquid market is defined in Article 2(17)(a) as one having "ready and willing buyers and sellers on a continuous basis".

[12] *See* Discussion Paper at 38.

[13] Waivers are available for (i) large-in-scale orders and orders held in an order management facility pending disclosure; (ii) actionable indications of interest in request-for-quote and voice trading systems above a specified size that would expose liquidity providers to undue risk; and (iii) derivatives where are not required to be traded on RMs, MTFs or OTFs for which there is not a liquid market. *See* Discussion Paper at 36.

[14] *See* Article 32(5) of MiFIR.

[15] ESMA took following steps to clean out the data set: (i) Intragroup and compressed transactions were excluded to focus on price forming transactions; (ii) Only trades reported with action type "new" were taken into account. Duplicate reports were eliminated; (iii) Absolute notional values reported were taken and converted to EUR based on the average ECB exchange rates for the period; and iv. Counterparties that were identified by client's codes and not Legal Entity Identifier (LEI) were eliminated. In eliminating duplicative trades, EMSA chose to exclude all cleared trades where one of the counterparties is a CCP or a clearing member.

[16] Certain other tenors also met ESMA's criteria. A complete list of the fixed-float IRS instruments that ESMA believes are sufficiently liquid to subject to the trading obligation can be found in Table 7 on page 48 of the Discussion Paper.

[17] ESMA distinguished four categories of counterparties for the purpose of clearing obligation:
Category 1: counterparties on the date of the entry into force of the technical standard, are clearing members, for at least one of the classes of OTC derivatives subject to the clearing obligation, of a least one of the CCPs authorized or recognized before the date to clear at least one of those classes. Counterparties are included in category 1 on a per asset class approach.
Category 2: Financial counterparties and alternative investment funds (AIF)
Category 3: Financial counterparties and AIFs as defined in Article 4(1)(a) of the AIFMD that are non-financial counterparties
Category 4: non-financial counterparties.

[18] A "package transaction" is a transaction comprising of several linked and contingent components, aiming at allowing clients or investment firms to reduce transactions costs and manage execution risks. *See* Discussion Paper at 56.