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European Regulators Issue Consultation Paper on Transparency and Trading Obligations for Derivatives

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TO:

DERIVATIVES MARKETS ADVISORY COMMITTEE No. 2-15
ICI GLOBAL MEMBERS No. 1-15
INVESTMENT COMMITTEE
ICI GLOBAL TRADING & MARKETS COMMITTEE No. 1-15

RE:

EUROPEAN REGULATORS ISSUE CONSULTATION PAPER ON TRANSPARENCY AND TRADING OBLIGATIONS FOR DERIVATIVES

Recently, the European Securities and Markets Authority (“ESMA”) issued its consultation paper on draft regulatory technical standards (“RTS”) and implementing technical standards (“ITS”) on a number of areas (including for non-equity instruments) for the implementation of the revised Markets in Financial Instruments Directive (“MiFID II”) and Regulation (“MiFIR”). [\[1\]](#) The Consultation Paper follows the discussion paper that ESMA issued in May 2014. [\[2\]](#) Comments on the Consultation Paper are due by March 2, and thereafter ESMA will update the draft RTS and ITS to submit to the European Commission for endorsement. This memorandum focuses on the proposed transparency requirements and trading obligation for certain derivatives. [\[3\]](#)

Transparency Requirements

MiFIR imposes transparency requirements for non-equity instruments, including derivatives, and provides national regulators with the authority to waive the obligation to make public pre-trade information for certain non-equity instruments for which there is not a liquid market. In addition, MiFIR also permits national regulators to delay publication of transactions for which there is not a liquid market. In the Consultation Paper, ESMA

specifies the non-equity financial instruments or classes of financial instruments for which there is not a liquid market and where pre- and post- trade disclosure may be waived or deferred.

Liquidity Determination

In the Consultation Paper, ESMA proposes to use the Classes of Financial Instruments Approach (“COFIA”) rather than the Instrument by Instrument Approach (“IBIA”) to determine liquidity. In response to comments, including those of ICI Global, ESMA proposes to provide a certain level of granularity with respect to the asset classes to determine liquidity for each sub-class. The sub-classes are then evaluated based on the criteria provided under MiFIR (average frequency and size of transactions, the number and type of market participants, the average size of spreads) to determine their liquidity.

Under ESMA’s approach, altering the characterization of a sub-class of derivatives as either liquid or illiquid would require passing legislative measures (RTS), which will be a time-consuming process. Thus, if the liquidity profile of a sub-class of derivatives changed from liquid to illiquid, it would take some time for this change to be reflected in the transparency regime.

Interest Rate Derivatives

To determine the liquidity of interest rate derivatives, ESMA undertook two analyses based on data collected from trading venues and from trade repositories. The analysis based on trading venue data allowed ESMA to group instruments into sub-classes based on type of financial instrument, underlying, and time to maturity. This analysis resulted in 48 sub-classes of interest rate derivatives being characterized as liquid.

The data collected from trade repositories, on the other hand, was first used to assess whether certain broad classes of derivatives were liquid or illiquid. The subsequent step in the analysis consisted of further refining the liquid classes of derivatives into liquid and illiquid sub-classes. ESMA identifies 15 sub-classes based on underlying assets, tenor, notional currency or currency pair, and certain quantitative thresholds (average number of trades per year and notional amount per day). [\[4\]](#) The final decision, however, to characterize the sub-classes as “liquid” was based on two additional principles. First, a sub-class meeting the thresholds for only one (or few) maturities was not deemed to be liquid. Second, a 50% coverage ratio in terms of number of trades and notional amount would have to be met for the entire asset class. [\[5\]](#)

ESMA proposes two options for determining the classes of interest rate derivatives for which there is a liquid market. Option 1 includes classes included in Annex III of draft RTS 9 with tenor included over the period specified for the related sub-class. Option 2 includes classes included in Annex III with tenor that is not a broken date. [\[6\]](#) ESMA states a preference for Option 1.

Equity Derivatives

Analyzing a sample of equity derivative contracts traded over a one-year period, ESMA proposes two options for determining liquidity. Under Option 1, ESMA would consider time to maturity as a criterion for distinguishing liquid vs. illiquid equity derivatives and qualify certain contract types with a time maturity up to six months as liquid. These contracts include index options, stock options, options on a basket or portfolio of shares, dividend

index options, options on other underlying values, stock dividend options, index futures, stock futures, and futures on a basket or portfolio of shares, dividend index futures, futures on other underlying values, and stock dividend futures. Option 2 would extend MiFIR pre-trade and post-trade transparency obligations to all equity derivatives instruments available for trading on a trading venue irrespective of the time to maturity. ESMA states that it has a preference for Option 2.

Waivers from Transparency Obligations

Under MiFIR, national authorities are able to waive the obligation to make public pre-trade information for: (1) orders that are “large in scale” compared with normal market size; (2) orders held in an order management facility of the trading venue pending disclosure; (3) actionable indications of interest in request-for-quote and voice trading systems that are above a size specific to the financial instruments, which would expose liquidity providers to undue risk and takes into account whether the relevant market participants are retail or wholesale investors; and (4) derivatives that are not subject to the trading obligation and other financial instruments for which there is not a liquid market.

In addition, MiFIR permits national authorities to provide for deferred publication of the details of transactions for: (1) large in scale transactions compared with the normal market size for the financial instrument or for the asset class; (2) transactions that are related to financial instruments or to the related asset class for which there is not a liquid market; and (3) transactions that are above a size specific to that financial instrument or that class of financial instruments traded on a trading venue, which would expose liquidity providers to undue risk and takes into account whether the relevant market participants are retail or wholesale investors. In the Consultation Paper, ESMA is now taking the position that this “size specific to the instrument” deferral period will only apply to market participants that are “trading on their own account.” This means that any non-proprietary transactions concluded, for example, as agent rather than as principal would not benefit from the deferral period.

In the Consultation Paper, ESMA proposes to set the large in scale and size specific to the instrument thresholds for each asset class defined in accordance with the COFIA approach and proposes the same thresholds for the pre- and post-trade disclosure. ESMA proposes two options with respect to the thresholds. Option 1 would apply the thresholds in Annex III of draft RTS 9. Option 2 would apply the thresholds in Annex III until April 30, 2018 and then be recalculated yearly thereafter. ESMA states a preference for Option 2.

Under Option 2, the large in scale size would be determined as the greatest of (1) the trade size corresponding to the trade below which lies 90% of all the transactions executed for the class of financial instruments; (2) the trade size corresponding to the trade below which lies 70% of the total volume of the transactions executed for this class of financial instruments; and (3) the large in scale threshold floor as provided in Table 47 of Annex III of draft RTS 9 for the corresponding class. For the size specific to the financial instruments waiver and deferral regime, ESMA proposes to set the thresholds as per Annex III until April 30, 2018 and equal to 50% of the corresponding large in scale threshold.

ESMA proposes that, on the first trading day of April of each year, national authorities will ensure publication of the thresholds for each class of financial instruments and the thresholds will apply for the 12-month period starting on May 1 following publication and ending on the following April 30.

Trading Obligation

Under MiFIR, once a class of derivatives has been mandated as subject to the clearing obligation under the European Market Infrastructure Regulation (“EMIR”), ESMA must determine whether those derivatives (or a subset) should be subject to the trading obligation (i.e., only can be traded on a regulated market, multilateral trading facility, organized trading facility, or a third country trading venue deemed to be equivalent by the Commission). There also is an ability for ESMA to impose a trading obligation on its own initiative albeit ESMA is required to undertake a public consultation on the matter. Whether a class of derivatives subject to the clearing obligation should be made subject to the trading obligation is determined by two factors: (1) the class of derivatives must be admitted to trading or traded on at least one admissible trading venue; and (2) whether the derivatives are “sufficiently liquid” and there is sufficient third party buying and selling interest. In developing the draft RTS, ESMA is required to consider the class of derivatives as “sufficiently liquid” pursuant to the following criteria: (1) average frequency and size of trades over a range of market conditions; (2) the number and type of active market participants; and (3) the average size of the spreads.

According to ESMA, it will consult individually on the trading obligation for a class or subclass of derivatives in a separate draft RTS. Therefore, the Consultation Paper sets forth the broad approach that ESMA will take to assess whether a class of derivatives should be subject to the trading obligation. ESMA agrees with commenters, including ICI Global, that although the assessments for determining whether there is a liquid market under the transparency obligations and for the trading obligation should follow a similar approach, the thresholds should not necessarily be the same. ESMA states that any application of the liquidity test to a specific class of derivatives has to fit the specific characteristics of each class or subclass. ESMA therefore will apply the liquidity factors based on different weightings as they are appropriate for each class or subclass. In other words, ESMA may not always give equal weight to each criteria but will judge each case separately.

ESMA sets forth its preferred approach for evaluating the liquidity factors, taking into consideration public comments, including those of ICI Global. ESMA, however, also intends to provide for flexibility in the draft RTS for each of the factors. For average frequency of transactions, ESMA proposes to calculate this criterion based on a minimum number of trades per day and a minimum number of days on which trading took place over a specified period of time. For average size of transactions, ESMA’s approach would be the division of notional size by number of trading days during the specified period (although this will not exclude other methods of calculating this factor). For the number and type of active market participants, ESMA will assess this criterion by giving consideration to the number of members or participants of a trading venue involved in at least one transaction in a given market or where any member or participant of a trading venue has a contractual arrangement to provide liquidity in a financial instrument at least on one trading venue. For average size of spreads, ESMA proposes to use the average size of weighted spreads over different periods of time. Generally, ESMA has reserved flexibility as to assessment periods.

Finally, with respect to whether a trading obligation is suitable only for transactions below a certain size, ESMA will set the threshold taking into account the specific characteristics of the class of derivatives or subset, which will be laid out in future public consultations for the draft RTS for the relevant class of derivatives.

Commodity Derivatives Position Limits and Position Reporting

For purposes of commodity derivatives, ESMA has proposed that positions need be only aggregated in the context of corporate parent-subsidary relationships (sister-company relationships) but that individual funds within a fund complex would not, for example, be caught by the scope of the aggregation rules. Aggregation in a parent-subsidary context will be based on the concept of “control” as it appears in the Accounting Directive. Therefore, as advocated by ICI Global, ESMA’s position would not mandate aggregation across funds managed by a common investment manager (and position limits would be applied to each individual fund). Moreover, ESMA’s original proposal to apply aggregation to positions held by unconnected persons where they are acting together with a common purpose (i.e., “concert party” arrangements) has been dropped from the Consultation Paper.

Under the MiFID II position reporting regime, investment firms will be required to report not only their positions, but also the positions of the investment firm’s clients and the clients of those clients until the ultimate end client is reached. ESMA originally proposed a series of options for passing data regarding end clients’ identities up the chain of intermediaries. Although ICI Global requested that ESMA put in place one of the two proposed options to protect client confidentiality, the most recent proposals in the Consultation Paper do not give any indication as to how data on the firm’s end client should be obtained, particularly where there is a chain of intermediaries. The current approach appears to leave the solution for passing end clients’ data up a chain of intermediaries to the market rather than mandating a specific regulatory mechanism.

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endnotes

[1] Consultation Paper, MiFID II/MiFIR, available at http://www.esma.europa.eu/system/files/2014-1570_cp_mifid_ii.pdf (“Consultation Paper”); Consultation Paper – Annex B, Regulatory technical standards on MiFID II/MiFIR, available at http://www.esma.europa.eu/system/files/2014-1570_cp_mifid_ii_part_2.pdf.

[2] For a copy of ICI Global’s response to the discussion paper, see ICI Memorandum No. 28294 (Aug. 4, 2014), available at <http://www.ici.org/iciglobal/pubs/memos/memo28294>.

[3] The Consultation Paper does not cover foreign exchange (“FX”) derivatives, credit derivatives, other derivatives and contracts for difference. For these asset classes, a separate consultation paper will be published providing a similar analysis to that undertaken for the classes covered by the Consultation Paper. ESMA expects these consultations to be published in early 2015.

[4] The asset classes include forward rate agreements, swaptions, fixed-to-fixed single currency swaps, fixed-to-float single currency swaps, float-to-float single currency swaps, OIS single currency swaps, inflation single currency swaps, fixed-to-fixed multi-currency

swaps, fixed-to-float multi-currency swaps, float-to-float multi-currency swaps, OIS multi-currency swaps, bond options, bond futures, interest rate options, and interest rate futures. See Annex III of draft RTS 9 for definitions of these terms.

[5] Although ESMA does not fully explain its use of the term “coverage ratio,” it seems that within a class of interest rate derivatives that has been characterized as “liquid,” at least 50% of trades within that class (measured in number of trades and notional amount) must belong to a sub-class that also is characterized as liquid.

[6] Whether the tenor is a broken date would be calculated as the difference between the maturity date and the execution date with a tolerance of +/- 5 days.

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