

MEMO# 30753

June 23, 2017

EU Consultation Paper on the Obligation to Trade Derivatives on a Regulated Venue

[30753]

June 23, 2017 TO: Derivatives Markets Advisory Committee
Equity Markets Advisory Committee
ICI Global Regulated Funds Committee
ICI Global Trading & Markets Committee
Securities Operations Advisory Committee RE: EU Consultation Paper on the Obligation to Trade Derivatives on a Regulated Venue

The European Securities and Markets Authority (ESMA) recently published a consultation paper on 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 comment period on the Consultation Paper closes on July 31, 2017. ICI Global will hold a member call to discuss the Consultation Paper on **Thursday, June 29 at 11:00 a.m. (Eastern Time)**. Please contact Helenia Walker at helenia.walker@ici.org to receive a dial-in number for the call.

I. Overview of the Proposed New Legal Requirements

The Consultation Paper proposes to apply the trading obligation to two types of index credit default swaps (CDS) as well as certain fixed-float interest rate swaps denominated in euro (EUR), US dollars (USD), and British pounds (GBP).^[3] The Consultation Paper would apply the trading obligation more narrowly than the Discussion Paper, reflecting ESMA's view that the trading obligation should apply initially only to the most liquid classes of derivatives.^[4] ICI Global advocated for ESMA to take a deliberate approach to trading obligation determinations, given the significant data quality issues that ESMA encountered in assessing the liquidity of the derivatives market in the Discussion Paper.^[5]

ESMA notes that its proposal would apply the trading obligation in the EU to a smaller set of instruments than the trading obligation in the US and requests comment on whether market participants would prefer closer alignment of these obligations.

The trading obligation would take effect on the later of: (1) January 3, 2018 (the date that MiFIR and MiFID II take effect) or (2) the date from which the clearing obligation for derivatives take effect, as described in the table below:

Proposed Application Date for the Trading Obligation

OTC derivatives class	Category of counterparty	Category 1	Category 2	Category 3	Category 4
Interest Rate Derivatives (EUR, GBP, USD)	Jan. 3, 2018	Jan. 3, 2018	Jun. 21, 2019	Dec. 21, 2018	Credit Derivatives
	Jan. 3, 2018	Jan. 3, 2018	June. 21, 2019	May 9, 2019	

II. Standards for Proposing to Apply the Trading Obligation

Under MiFIR, after a class of derivatives becomes 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.^[7] 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. In considering whether a particular class of derivatives meets this standard, ESMA proposes to consider only a subset of the classes of derivatives that are subject to the clearing obligation. Specifically, although the clearing obligation applies to derivatives contracts with a broad range of maturities, ESMA chose to evaluate only 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).^[8]

B. 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 that ESMA assessed to make its proposed trading obligation determination.

- **Factor 1: Average frequency and size of trades over a range of market conditions.** ESMA used transaction level data from trade repositories and MTFs from July-December of 2016 to assess this factor.
- **Factor 2: The number and type of active market participants in a particular class of derivatives.** This criterion takes 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, and the number of market makers and other market participants under a binding written agreement or an obligation to provide liquidity.
- **Factor 3: Average spread size.** ESMA placed less weight on this criterion as compared to other criteria because of the lack data on spreads.

MiFIR's liquidity test also requires ESMA to determine whether liquidity in a class of derivatives is adequate to support the trading obligation only in transactions below a certain size.[\[9\]](#) In the Discussion Paper, ESMA proposed to connect this assessment to the concept of waivers and deferrals from MiFIR's transparency requirements. These waivers and deferrals aim to protect market participants from adverse price movements when disclosing their transactions to the public. 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, and (iii) that are large in scale (LIS). In the Discussion Paper, ESMA proposed to exempt transactions that are above the post-trade LIS threshold from the trading obligation because it believed this would align its rules fairly closely with comparable CFTC rules. ICI Global strongly supported this aspect of the proposal.

Unfortunately, ESMA now believes there is no need to systematically exempt transactions about a certain size from the trading obligation. According to ESMA, the waivers/deferrals from pre- and post-trade transparency requirements will provide adequate protection for purposes of the trading obligation.[\[10\]](#)

The standards for the liquidity test for the trading obligation are similar, but not identical, to those used for determining whether a "liquid market" exists for transparency of non-equities under Article 2(1)(17)(a) of MiFIR. In the Discussion Paper, ESMA sought feedback on whether to align these standards. ICI Global took the view that some differences are appropriate because an instrument may be sufficiently liquid for transparency purposes but not liquid enough for purposes of the trading obligation. ESMA agrees that these standards do not need to be harmonized but plans to monitor closely the application of the trading obligation and the transparency regime. Should any major inconsistencies arise between the two regimes, ESMA may consider reopening this issue.[\[11\]](#)

III. No Authority to Suspend the Trading Obligation

ESMA has determined that it lacks authority to create an emergency procedure to suspend the trading obligation in the event of a significant liquidity disruption but believes that the approach of applying the trading obligation only to the most liquid classes of derivatives reduces the risk of such a disruption.[\[12\]](#) This approach generally aligns with ICI Global's recommendation that ESMA use a high liquidity threshold and impose the trading obligation on a narrower group of instruments until EU authorities can agree on an emergency mechanism for suspending the trading obligation.

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.[\[13\]](#) ESMA has determined that it lacks authority to exempt transactions from the trading obligation based on their inclusion in a package, so it proposes no relief for transactions executed as part of a package.[\[14\]](#) ESMA notes that it is working on a number of questions and answers to provide more certainty on packages.[\[15\]](#)

V. Public Register

MiFIR requires ESMA to publish and maintain on its website a public register for the trading obligation for derivatives.[\[16\]](#) The Consultation Paper states that the register should "specify in an exhaustive and unequivocal manner":

- The derivatives that are subject to the trading obligation;

- The venues on which the derivatives are admitted to trading or traded; and
- The dates from which the obligation takes effect.[\[17\]](#)

The Consultation Paper explains that ESMA intends to comply with this obligation by following a similar approach to the one it follows for the clearing obligation. The Consultation Paper explains the specifications that ESMA will include to identify the classes of interest rate and credit derivatives subject to the trading obligation and explains that certain other elements of the register—including the part of the register specifying the venues on which a derivatives contract is available for trading—will need to be maintained on a best-efforts basis because ESMA does not have access to all relevant information.[\[18\]](#)

Appendix

Part 1: Proposed Scope of Trading Obligation

Fixed-to-float interest rate swaps denominated in EUR

Trade start type Settlement

Currency Floating reference

rate with term Fixed leg

payment frequency Fixed rate

day count Floating leg

reset frequency Benchmark tenor

+/- 5 days spot starting (T+2) EUR Euribor 3M Annual 30/360 ACT/360 Quarterly 2Y, 3Y, 4Y, 5Y, 6Y, 7Y, 10Y, 15Y, 20Y, 30Y spot starting (T+2) EUR Euribor 6M Annual 30/360 ACT/360 Semi-annual 2Y, 3Y, 4Y, 5Y, 6Y, 7Y, 8Y, 9Y 10Y, 12Y, 15Y, 20Y, 30Y

Fixed-to-float interest rate swaps denominated in USD

Trade start type Settlement

Currency Floating reference

rate with term Fixed leg

payment frequency Fixed rate

day count Floating leg

reset frequency Benchmark tenor

+/- 5 days spot starting (T+2) USD Libor 3M Semi-annual 30/360 ACT/360 Quarterly 2Y, 3Y, 4Y, 5Y, 7Y, 10Y, 30Y IMM USD Libor 3M Semi-annual 30/360 ACT/360 Quarterly 5Y, 6Y, 30Y spot starting (T+2) USD Libor 3M Annual 30/360 ACT/360 Quarterly 2Y, 3Y, 4Y, 5Y, 7Y, 10Y, 30Y IMM USD Libor 3M Annual 30/360 ACT/360 Quarterly 5Y, 6Y, 30Y

Fixed-to-float interest rate swaps denominated in GBP

Trade start type Settlement

Currency Floating reference

rate with term Fixed leg

payment frequency Fixed rate

day count Floating leg

reset frequency Benchmark tenor

+/- 5 days spot starting (T+0) GBP Libor 6M Semi-annual ACT/365F Semi-annual 2Y, 3Y,

4Y, 5Y, 6Y, 7Y, 10Y, 15Y, 20Y, 30Y spot starting (T+0) GBP Libor 3M Quarterly ACT/365F
Quarterly 2Y, 3Y, 4Y, 5Y, 6Y, 7Y, 10Y, 15Y, 20Y, 30Y

Index CDS

Type Sub-type Geographical

zone Reference

index Settlement

Currency Series Tenor Index CDS Untranch index Europe iTraxx Europe Main EUR on-
the-run series first off-the-run series 5y Index CDS Untranch index Europe iTraxx Europe
Crossover EUR on-the-run series first off-the-run series 5y

Part 2: Questions Posed by the Consultation Paper

- Q1: Do you agree with ESMA's assessment and proposed way forward for the criteria assessing the number and types of active market participants? If not, please explain your position and how you would integrate these elements into the liquidity test.
- Q2: Do you agree with the revised proposal not to exempt post-trade LIS transactions? If not, please explain and present your proposal
- Q 3: Do you agree with this proposal? If not, please explain why and provide an alternative proposal for ESMA to populate and maintain the register.
- Q 4: Do you agree with this proposal? Would you add other parameters e.g. day count convention of the floating leg, notional type (constant vs. variable), fixed rate type (MAC vs. MAC)? If yes, please explain why and provide the parameters.
- Q 5: For each Case, specify if you agree with the proposal of qualifying the sub-classes as liquid for the purpose of the trading obligation and if not, please explain why and provide an alternative proposal.
- Q 6: Would you also consider any of these possible sub-classes as liquid? Which other combinations of fixed leg payment frequency and floating leg reset frequency specifically would you consider to be sufficiently liquid?
- Q 7: For each Case, specify if you agree with the proposal of qualifying the sub-classes as liquid for the purpose of the trading obligation and if not, please explain why and provide an alternative proposal.
- Q 8: Would you also consider any of these possible sub-classes as liquid? Which other combinations of fixed leg payment frequency and floating leg reset frequency specifically would you consider to be sufficiently liquid?
- Q 9: For each case, specify if you agree with the proposal of qualifying the sub-classes as liquid for the purpose of the trading obligation and if not, please explain why and provide an alternative proposal.
- Q 10: Would you also consider the possible sub-classes here below as liquid? Which other combinations of fixed leg payment frequency and floating leg reset frequency specifically would you consider to be sufficiently liquid?
- Q 11: Do you agree with this proposal? If not, please explain why and provide an alternative proposal.
- Q 12: Do you agree with this proposal? If not, please explain why and provide an alternative proposal.
- Q 13: Do you agree to the proposed timeline? If not, please explain why and present your proposal.

Associate General Counsel

George M. Gilbert
Counsel

endnotes

[1] European Securities and Markets Authority, Consultation Paper, The trading obligation for derivatives under MiFIR (19 June 2017), *available at* https://www.esma.europa.eu/sites/default/files/library/esma70-156-71_cp_trading_obligation.pdf (Consultation Paper). The Consultation Paper follows an ESMA discussion paper on the MiFIR trading obligation in 2016. 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); see ICI Memorandum No. 30313 (October 14, 2016), *available at* <https://www.iciglobal.org/iciglobal/pubs/memos/memo30313>. ICI Global commented on the Discussion Paper in November 2016. See ICI Memorandum No. 30410 (November 21, 2016), *available at* <https://www.iciglobal.org/iciglobal/pubs/memos/memo30410> (Trading Obligation Comment Letter).

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

[3] The appendix to this memorandum contains a complete list of the classes of derivatives that would become subject to the trading obligation under the Consultation Paper.

[4] The liquidity analysis in the Consultation Paper relies on data from trade repositories and MTFs. See Consultation Paper at 15-18 and 32-46.

[5] See Trading Obligation Comment Letter at 5.

[6] ESMA distinguished four categories of counterparties for the purpose of clearing obligation:

- Category 1: Clearing members, for at least one of the classes of OTC derivatives subject to the clearing obligation, of at 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) that are not clearing members and belong to a group having at least €8 billion of average aggregate month-end notional exposure, as calculated for purposes of the clearing requirement for derivatives.
- Category 3: Financial counterparties and AIFs that are not included in Category 1 or Category 2.
- Category 4: Non-financial counterparties.

[7] 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. 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).

[8] ICI Global's comment letter in response to the Discussion Paper urged ESMA to enhance the venue test by requiring a class of derivatives to be actively traded on at least two trading venues before becoming subject to the trading obligation. See Trading Obligation Comment Letter at 9. ESMA declined to adopt this suggestion, noting that in some circumstances, liquidity might be concentrated on a single trading venue, so "it may not be necessary to require that at least two trading venues make a derivative available to trading." Consultation Paper at 20.

[9] See Article 32(3) of MiFIR.

[10] See Consultation Paper at 24.

[11] See Consultation Paper at 25.

[12] This approach is broadly consistent with ICI's Global's recommendation that ESMA employ the trading obligation judiciously, until it has a mechanism to suspend the obligation in the event of a drop in liquidity. See Trading Obligation Comment Letter at 12.

[13] 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.

[14] ESMA notes that although the CFTC has temporarily exempted some components of package transactions from the trading obligation in the United States, it has reduced the scope of this relief over time, so any inconsistency between the US and EU trading obligations should be limited.

[15] See Consultation Paper at 29.

[16] See Article 34 of MiFIR.

[17] See Consultation Paper at 29.

[18] See Consultation Paper at 32.

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