Amafi > Association française des marchés financiers
FINANCIAL MARKET PROFESSIONALS

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ESMA Consultation on Draft Regulatory Technical Standard on package orders for which there is a liquid market

AMAFI's contribution

Association française des marchés financiers (AMAFI) is the trade organisation working at national, European and international levels to represent financial market participants in France. It acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI's members operate for their own account or for clients in different segments, particularly organised and over-the-counter markets for equities, fixed-income products and derivatives, including commodities. Nearly one-third of members are subsidiaries or branches of non-French institutions.

AMAFI welcomes the opportunity to comment on ESMA's Consultation Paper on draft Regulatory Technical Standard on package orders for which there is a liquid market (CP).

Before responding to the specific questions of ESMA's consultation document, AMAFI would like to point out the following general comments.

It must be noticed that AMAFI, as a trade association, is not in a position to comment on part 6 of the CP (request for input for the cost-benefit analysis) which is relevant for trading venues and individual firms trading packages.

I. – General comments

We welcome co-legislators' decision to tailor pre and post-trade transparency regimes for package orders under MiFID II/MiFIR and agree with ESMA's proposal for Article 18.1 of MiFIR to apply to Systematic Internalisers (SIs) only when the package order has "a liquid market as a whole".

Identification of packages orders that should be considered as having a liquid market as a whole

AMAFI is aware that it is a very complex area and is concerned that the proposed approach in the CP could end up with a situation where packages are defined as liquid when they actually aren't. Indeed, the subject is so complex that, in the US, the CFTC US Commodity Futures and Trading Commission (CFTC) so far did not find a proper way to implement its regime for packages and has been issuing "no action relief" for certain package transactions since February 2014. The latest, published on November 1, extends relief for new issuance bond package and futures package transactions until 15 November 2017.

With this in mind, AMAFI would like to focus on several areas of risk.

The first one is about the situation when a package could be qualified as liquid while one at least of its components is not.

From a principle standpoint, MIFIR Level 1 provision (Article 9.1(e)(i)) seems to indicate that, even when a component of the transaction is illiquid, a package transaction could be found as having a liquid market as a whole. We understand that ESMA does not have the capacity to draft a Regulatory Technical Standard which would not be in line with Level 1. Nevertheless, our analysis is that there is no actual situation where a package would be liquid as a whole when one of its components is illiquid. In order to solve this difficulty we suggest ESMA to consider the following proposals:

- to put in place a phase in period where, at the beginning, only package orders without any illiquid component would be deemed as having a liquid market as a whole ; and/or
- to establish that only package orders with no more than one illiquid component could be considered as liquid as a whole ; and/or
- to use additional quantitative criteria (e.g. number of transactions) when assessing the liquidity of package orders with at least one illiquid component.

In any case, should a package transaction with an illiquid component be found “liquid as a whole”, a deep analysis of the actual liquidity of this package should be carried out by ESMA prior to releasing this finding.

Besides this specific topic, AMAFI suggests ESMA to consider the following additional criteria which we see as critical and that should be taken into consideration cumulatively:

- All components in the package should be OTC derivatives (options excluded). Packages with at least one non-derivative leg (such as a corporate bond) should not be considered as standard and liquid.
- All components in the package should be denominated in the same currency (EUR, USD or GBP).
- The maximum number of components in the packages should be limited to three (or four when all the components are equity derivatives), as a package with more components would not be standard but bespoke and not frequently traded.
- Packages in cross-asset classes should not be considered as standardised and liquid as a whole. In fact, even if the individual components are admitted to trade on a trading venue, such packages are often bespoke and traded only OTC and do not fulfill the requirements of being “standardised and frequently traded”. A cross asset class regime would probably also need to be quite complex taking into account that the components will have different pricing models and regimes for calculating SSTI, liquidity, SI thresholds etc.

<u>Package orders and SI regime</u>

We are very concerned by ESMA’s proposed definition of an SI on packages and of packages‘ SSTI which we believe would make SIs run undue risks at the detriment of the liquidity of the packages market.

With regards to the definition of SIs on packages and packages’ SSTI, we object to the interpretation that:

(i) Article 18.1 of MiFIR applies if the firm is SI on at least one of the components.

(ii) All components of the package should be above SSTI in order to benefit from exemption specified in Article 9.1 of MiFIR.

Both of these proposals would in our opinion extend the SI obligations beyond the Level 1 text, in a way that significantly increases the risks incurred by SIs when providing quotes in packages. The risk is that most entities acting as SIs on certain of the package's legs would end up being qualified as SI on pretty much all packages they trade, and even on packages that they do not trade frequently or substantially. Therefore, AMAFI members are of the view that – unless it opts in –, an entity should be qualified as an SIs on packages only if it is an SI on all the package's legs (by opt-in or by exceeding the thresholds as specified in Delegated Regulation published on 25 April 2016) and not on at least one leg. Also, it should be sufficient that one of the components in the package is above SSTI in order for the obligations not to apply on the package as a whole.

If not amended, these provisions would disincentive sell-side entities from providing quotes, which in turn would have a negative impact on the liquidity of the packages market at the detriment of end-users' ability to trade/hedge a specific risk in an efficient and cost effective way.

II. – RESPONSES TO THE ESMA SPECIFIC QUESTIONS

Q1. Do you agree with ESMA's proposal to apply the SI obligations at the package order level where the investment firm is an SI in at least one component instrument of the package order? If not, please explain why and propose an alternative.

No, we do not agree. An investment firm should be SI on packages when it is SI on all components in a package (by opt-in or by exceeding the thresholds as specified in Delegated Regulation published on 25 April 2016). Otherwise, most SIs on packages' components would end up being SI on pretty much all packages they trade even those they are not trading frequently and substantially.

We believe that ESMA's proposal would significantly increase the risks incurred by SIs when providing quotes in packages. This would disincentive SIs from providing such quotes and maybe from becoming SIs in instruments which are commonly used as components in packages. This could in turn have a negative impact on the liquidity of the packages market at the detriment of end-users' ability to trade/hedge a specific risk in an efficient and cost effective way that such a market offers.
On top of this, AMAFI does not agree with ESMA that all components should be above SSTI to benefit from the exemption specified in Article 9.1 of MiFIR. In our view, it should be sufficient that one of the components is above SSTI in order for the exemption to apply. This would disincentive otherwise SIs from providing such quotes which in turn would have a negative impact on the liquidity of the packages market at the detriment of end-users' ability to trade/hedge a specific risk in an efficient and cost effective way that such a market offers.

Consequences of the proposals regarding package orders on the application of other parts of MiFIR should also be considered. For example, it should be clarified which firm shall publish post-trade information when two SIs trade with each other, taking into account that they each can be SI for all or different components of the package order and that different APAs can be involved which do not have any information on the status of the firm's counterparty.

Q2. Do you agree with the proposed methodology based on qualitative criteria? Do you consider an alternative methodology as better suited for identifying liquid package orders as a whole?

Yes. AMAFI is supportive of qualitative criteria to define a package that is "liquid as a whole". In this respect, we recommend the following cumulative criteria:

- All components in the package should be OTC derivatives, options excluded as no single strike price can be considered liquid (i.e. the number of possible combinations across the most simple options strategies is huge).

- Packages with at least one bond leg should not be considered as standard and liquid. In case ESMA insists to keep packages with at least one bond included in scope, we suggest that this is limited only to government bonds that are liquid as per Delegated Regulation published on 14 July 2016.

- All components in the package should be denominated in the same currency (EUR, USD or GBP).
- The maximum number of components in the packages should be limited to three or four when all the components are equity derivatives, as a package with more components would not be standard but bespoke and not frequently traded.

However, there is a risk that using exclusively qualitative criteria will cause some packages to be defined as liquid when they actually aren't. We urge ESMA to carefully take into consideration the liquidity of the package's legs, based on quantitative criteria as set out in Delegated Regulation published on 14 July 2016, for identifying liquid package orders as a whole.

In particular, MIFIR Level 1 provision (article 9.1(e)(i)) does not allow establishing automatically that, when a component of the transaction is illiquid, a package transaction cannot be considered as having a liquid market as a whole. We understand that ESMA does not have the capacity to draft a Regulatory Technical Standard which would not be in line with Level 1. Nevertheless, our analysis is that there is no actual situation where a package would be liquid as a whole when one of its components is illiquid. In order to solve this difficulty we suggest ESMA to consider the following proposals:

- to put in place a phase in period where, at the beginning, only package orders without any illiquid component would be deemed as having a liquid market as a whole ; and/or

- to establish that only package orders with no more than one illiquid component could be considered as liquid as a whole ; and/or

- to use additional quantitative criteria (e.g. number of transactions) for package orders with at least one illiquid component.

Should a package transaction with an illiquid component be found to be liquid as a whole, a deep analysis of the actual liquidity of this package should be carried out by ESMA prior to releasing this finding.

Q3. Do you agree with the general criteria for identifying package orders that may be eligible for being liquid as a whole? Do you consider necessary to add further criteria or to remove any of the criteria proposed? Please explain.

Yes. We agree but would only specify in final RTS the following criteria:

- All components in the package should be OTC derivatives traded on a trading venue as defined by Delegated Regulation published on 14 July 2016. A package with at least one component not sharing these characteristics should not be considered as "liquid as a whole".

- Also, for the avoidance of doubt, it could be clarified both in the CP and the RTS that all the criteria are cumulative.

Q4. Do you consider it necessary to further specify the first criterion on the standardisation of components? If yes, which characteristics should be considered to specify the standardised components of packages?

Please see our answer to question3.

Q5. Do you agree with the proposed interest rate derivatives specific criteria? If not, please explain why and present your preferred approach. Do you consider it necessary to add further criteria? If yes, please explain.

Yes. We agree.

Q6. Do you consider that derivative components in other currencies (e.g. other EEA currencies, JPY) should be included? If yes, which ones?

No. We do not consider that OTC derivatives in JPY and other EEA currencies are standard and liquid.

Q7. Do you agree that only packages with derivative components with the above mentioned benchmark dates should be considered liquid? If not, please explain. Which other or additional benchmark dates do you suggest?

No. Liquid tests should be performed on each derivative component with the benchmark dates (time to maturity buckets) mentioned in point 53. based on the methodology specified in Delegated Regulation published on 14 July before considering these components as liquid.

Q8. Do you consider that for certain types of packages derivative components that have broken dates (e.g. invoice spreads) or which are traded on IMM and MAC dates (e.g. rolls) have a liquid market?

No. Packages with derivative components that have broken dates should not be considered to have a liquid market.

Q9. Do you consider it necessary to specify criteria for non-derivative components of packages? If yes, which criteria would you suggest and why?

AMAFI believes that packages including at least one non-derivative component should not be considered as standard and liquid as a whole. Even if the individual components are admitted to trade on a trading venue, such packages are often bespoke (so not standard and frequently traded).

A cross-asset class regime would probably also need to be quite complex taking into account that the components will have different pricing models and regimes for calculating SSTI, liquidity, SI thresholds etc.

Also, packages with at least one bond leg should not be considered as standard and liquid as a whole and particularly if such bond(s) are not traded on a trading venue and liquid as defined in Delegated Regulation published on 14 July 2016.

Q10. Do you agree with the proposed equity derivatives specific criteria? If not, please explain why and present your preferred approach. Do you consider it necessary to add further criteria? If yes, please explain.

Yes, we agree with the criteria but propose to add an additional criterion: all components in a package need to be denominated in the same currency (EUR, USD or GBP) in order for the package to be defined as standardised and liquid. See also Q5.

Q11. Do you consider that derivative components in other currencies (e.g. other EEA currencies, JPY) should be included? If yes, which ones?

No. We do not consider that OTC derivatives in JPY and other EEA currencies are standard and liquid.

Q12. Do you consider it necessary to specify that all components of the package order should have the same underlying? If yes, please explain.

No. Equity package transactions will often consist of derivatives based on different equities or equity indexes.

Q13. Do you agree with the proposed credit derivatives specific criteria? If not, please explain why and present your preferred approach. Do you consider it necessary to add further criteria? If yes, please explain.

Yes. We agree.

Q14. Do you agree that derivative components in USD, EUR or GBP should be considered sufficiently liquid for the purpose of this RTS? Do you consider that derivative components in other currencies (e.g. other EEA currencies, JPY) should be included? If yes, which ones?

No. We do not consider that OTC derivatives in JPY and other EEA currencies are standard and liquid.

Q15. Do you consider it necessary to further specify the indices that are eligible? If yes, please specify which specific indices should be included. Do you consider it necessary to specify the maturity dates of the underlying indices?

No comments.

Q16. Do you agree with the proposed commodity derivatives specific criteria? If not, please explain why and present your preferred approach. Do you consider it necessary to add further criteria? If yes, please explain.

No comments.

Q17. Do you consider that derivative components in other currencies (e.g. other EEA currencies, JPY) should be included? If yes, which ones.

No comments.

Q18. In which types of contracts do package orders in commodity derivatives mostly occur? Do you consider it necessary to provide for asset class specific criteria that take option and future/forward contracts into account? If yes, please explain.

No comments.

Q19. Do you consider it necessary to develop criteria at a more granular level (e.g. energy derivatives, agricultural derivatives) to better reflect the particularities of package orders in the different sub-asset classes? If yes, please explain.

No comments.

Q20. Do you consider it necessary to specify that all components of the package order should have the same underlying? If yes, please explain at which level this concept of "same underlying" should apply (e.g. same asset class, same sub-asset class, same sub-class – as per Annex III of RTS 2 – or at or more granular level).

No comments.

Q21. Are there package orders in other derivative asset classes that are in your view standardised and frequently traded and which should be eligible for having a liquid market as a whole? If yes, what asset class specific criteria do you suggest for those?

No comments.

Q22. Do you agree with the approach proposed for FX derivatives or do you consider it necessary to include an asset-class specific approach for FX derivatives?

No, we do not consider it necessary to include an asset-specific approach for FX derivatives.

In order to have a common approach as regards package orders in FX, further guidance is needed on what is a FX derivative as opposed to “a mean of payment” (Article 10 of the Delegated Regulation MiFID II). In our opinion, the requirements in Article 10 are cumulative and need to be fulfilled on a specific contact level. The intention of Article 10 is to exclude means of payments that fulfill these requirements, and in particular, are entered into for the purpose of facilitating payments of goods services and investments, i.e. FX transactions that have no speculative purposes. Thus, an OTC contract should be able to be considered as a mean of payment in a specific situation even if the same type of contract is traded on a venue somewhere in the EU where it is considered as a financial derivative. Moreover, FX forward transactions (which are entered into in order to hedge an underlying commercial exposure) are a mean of payment between the investment firm and the non-financial counterparty, indeed entered into in order to facilitate payment for identifiable goods, services or direct investments and should therefore not be considered financial instruments in this context. Physically settled FX forwards are basically not different from FX spot transactions except that the maturity is longer.

Q23. How should ESMA deal with cross-asset class package orders? Should ESMA develop cross-asset class specific criteria? If yes, please specify those. Alternatively, should cross-asset class package orders be allocated to only one asset class? If yes, how?

Cross-asset class package orders should not be considered liquid as a whole. In fact, even if the individual components are traded on a trading venue, such packages are often bespoke and traded only OTC, i.e. do not fulfil the requirements of being “standardised and frequently traded”. Therefore, AMAFI takes the view that cross-asset class packages should not be considered as having a liquid market as a whole. Moreover, we believe that any specific cross-asset class regime would probably also need to be quite complex taking into account that the components will have different regimes when it comes to pricing models, calculating SSTI, liquidity, SI thresholds etc.

If ESMA nevertheless wishes to develop criteria for assessing packages in cross-asset classes traded on a trading venue, AMAFI believes that it is important to clarify that such packages which contain illiquid instruments should not be considered as having a liquid market as a whole. Specifically, packages with a bond leg should not be considered as liquid if the bond leg is illiquid.

Also for cross-asset class packages, we take the view that only USD, GBP and EUR and not JPY or other EEA currencies should be included. Also, one additional criterion should be added: all components in a package need to be denominated in the same currency (EUR, USD or GBP) in order for the package to be defined as standardised and liquid. A consistent approach on currencies is important.

Q24. Do you agree that package orders where all components are subject to the trading obligation for derivatives should be considered to have a liquid market as a whole? If not, please explain.

AMAFI has no objection *per se* to the proposal that packages where <u>all</u> the components are subject to the trading obligation are included.

Q25. Do you consider that package orders where at least one component is subject to the trading obligation and all other components are subject to the clearing obligation should be considered to have a liquid market as a whole? If not, please explain.

No, we firmly disagree. For package orders where at least one component is subject to the *trading obligation* (under MiFIR) and where all other components are subject to the *clearing obligation* under EMIR to be considered as “liquid as a whole”, we believe that liquidity tests should be performed on the other EMIR clearing subjected components, in order to assess whether they are liquid or not according to Delegated Regulation published on 14 July 2016. Then all other cumulative criteria specified above should be taken into consideration before stating this package is liquid as a whole.

Otherwise, packages including derivatives which are not liquid but subject to EMIR clearing obligation will be considered as “liquid as a whole” if only one component is subject to the trading obligation. As an example, a package composed of a fixed-to-float interest rate swap denominated in euro and maturing in 10 years (trading obligation) and a fixed-to-float interest rate swap denominated in euro but maturing in 43 years (not liquid but subject to EMIR clearing obligation) would be considered as “liquid as a whole”.

Q26. Do you agree that the categories of packages above should be considered as standardised and frequently traded for the purpose of this RTS empowerment? If not, please explain.

Yes, we agree but insist on the need to respect additional criteria to consider these packages as liquid as a whole for the purpose of Article 18.1 of MiFIR.

Q27. Are there any categories of packages missing in the above asset classes that should be considered for the purpose of this RTS empowerment? Are there in your view categories of packages in other asset classes that ESMA should consider?

No. We believe that this list is comprehensive.

Q28. Do you agree with the draft RTS in annex IV? If not, please explain.

Yes, we are generally supportive of the draft RTS in annex IV but would like to suggest the following changes:

- To our understanding cross-asset class packages cannot be considered as liquid as a whole under the RTS at this stage, which AMAFI supports.
- The scope of General Requirements should be aligned with the transparency requirements, i.e. “admitted to trade or traded on a trading venue” in Paragraph 50 of the CP should be identical to “traded on a trading venue” in Articles 9 and 18 MiFIR.
- It could be considered to insert an “and” between (a) and (b) in Article 3.1 to clarify that the criteria are cumulative.