Amafi > Association française des marchés financiers
LES PROFESSIONNELS DE LA BOURSE ET DE LA FINANCE

FEDERATION BANCAIRE FRANCAISE

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ESMA Discussion Paper on the trading obligation for derivatives under MiFIR

AMAFI and FBF's response

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.

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 450 commercial, cooperative and mutual banks. FBF member banks have more than 40,000 permanent branches in France. They employ 400,000 people in France and around the world, and service 60 million customers.

AMAFI and FBF welcome the opportunity to comment on ESMA's discussion paper regarding the trading obligation (TO) for derivatives under MIFIR. Before responding to the specific questions of ESMA's consultation document, we would like to point out the following general comments.

I. – General comments

AMAFI and FBF recommend, to ensure that the TO is appropriate to the specific EU OTC derivative markets and their participants, a cautious approach in the selection of EMIR clearing eligible OTC derivative transactions subjected to this obligation.

Importantly, ESMA should use high quality data to assess whether an OTC derivative contract is "sufficiently liquid". As such, much caution should be required to avoid any double counting of transactions, inclusion of packages legs or of the fixed-to-float ISDA Fix swaps used to exercise options. Liquidity in these contracts would be overestimated otherwise.

We would also recommend that the size limit below which the trading obligation applies is set at the pre-trade SSTI level when the obligation enters into force on the dates proposed by the discussion paper. One year after EMIR clearing obligations are fully in place for all client categories on the relevant instruments, increasing this size limit could be considered. This assessment would then be based on the high quality data provided by CCPs on a comprehensive set of effectively cleared OTC derivative transactions. This is from these high quality data that ESMA should assess the appropriate

minimum size level above which the relevant instruments are no longer "sufficiently liquid". This cautious approach would ensure the most appropriate application of MiFID II trading obligation to the EU OTC derivative markets based on high quality data on already fully cleared instruments into CCPs.

Making this regime appropriate for the specific EU markets and reaching consistency between the different MiFID II provisions should be a priority well above the need to align both EU and US regimes on this issue – given the particularities of both markets. MiFID II already offers a high level of transparency on the OTC space that is not encountered elsewhere. As such, this cautious approach would not delay the benefices of the trading obligation in terms of transparency as at the date of MiFID II entry into force, OTC derivative transactions will be subject to trade transparency obligations.

We would welcome any opportunity to assist ESMA in any ways we can and to contribute to the thinking on these critical issues.

II. – RESPONSES TO THE ESMA SPECIFIC QUESTIONS

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 of granularity for the TO would you recommend and why? Would that differ by asset class and type of instrument?

AMAFI and FBF agree with ESMA's general approach considering that:

- The classes identified for the Clearing Obligation (CO) (reproduced in Tables 1 and 2) can be used as a starting point.
- The granularity of OTC derivative instruments used for calibrating the transparency regime can then complement the approach to further target the OTC derivatives that will be subject to the trading obligation.

However, we consider that the trading obligation cannot apply at the level of granularity used in the transparency regime. It is necessary to add other characteristics in order to determine the granularity of the trading obligation (TO) including the underlying (e.g. EURIBOR, LIBOR, STIBOR) as taking only the currency into account is not sufficient and maturity of the underlying.

Moreover with regards to IRS, those sharing the following non-standard characteristics should be excluded from the assessment as well as any Fixed-to-float ISDA fix swaps exclusively used to exercise options:

- Trade Start Type > t+2
- Payment Frequency or reset frequency other than quarterly, semi-annual or annual
- Not fixed Notional
- Day Count Convention other than (30 or Actual)/(360 or 365)

Q2: Do you agree that all derivatives currently subject to or considered for the CO 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.

No, we do not agree with the statement that all derivatives considered for the CO today are admitted to trading or traded on at least one trading venue. For instance interest rate swaps denominated in certain currencies are today not admitted to trade or traded on a venue.

To determine whether an OTC derivative contract is admitted to trading or traded on at least one trading venue ESMA should use data coming directly from the EU trading venues, at this stage only regulated markets and MTFs. However, the admission criteria should be further clarified – especially for the upcoming OTFs for which we recommend that a proof of effective trading on the relevant instrument is provided to ESMA prior to considering that the relevant instrument is "admitted to trading or traded 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?

We agree that the number of distinct market participants should be kept as a criterion to determine whether the instruments are "sufficiently liquid".

AMAFI and FBF consider that ESMA should use data coming from CCPs to determine the number of market participants trading in a class of derivatives.

Having said that, we are fully aware that a complete set of these high quality data would not be available before EMIR clearing is fully in place for all EMIR categories (from 1 to 4).

In the meantime, only TR data would be available to carry out this assessment. Given current shortcomings of TR data rightfully detailed in this discussion paper, it may be challenging for ESMA in the short term to get these data. This is why we recommend elsewhere in our response to adopt a cautious approach and to set the size limit below which the trading obligation applies to the current pre-trade SSTI before ESMA gets the highest quality data coming from CCPs on EMIR clearing eligible OTC derivatives.

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.

We do not have a specific number of distinct market participants to recommend, however, we would agree that a minimum of 10 distinct market participants on each trading day would reflect a sufficient liquidity level on a specific instrument as long as the granularity is as recommended in our response to questions 1 and 2.

Q5: Do you agree with this 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?

No. AMAFI and FBF consider that an increase in the number of trading venues that offer trading of a class of derivatives does not necessarily mean an increase in the effective liquidity of that class of derivatives. Only because the venue offers trading in an instrument does not mean that the instrument is de facto traded. In addition it should be noted that a very large number of trading venues could lead to fragmented markets which can make it more difficult for market participants to “navigate” liquidity.

Nevertheless, we believe that in order to identify trading venues that can effectively trade instruments subject to the trading obligation, ESMA should use data received from trading venues on the instruments that they admit to trade using the same granularity that we recommend in our response to questions 1 and 2.

Q6: On how many trading venues should a derivative or a class of derivatives be traded in order to be considered subject to the TO?

We would recommend a minimum of three trading venues able to trade these instruments to limit the risk that a market participant, who needs to hedge a specific risk for example, cannot trade the relevant instrument when need be to hedge his specific risk.

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).

AMAFI and FBF agree with ESMA approach in order to assess the total number of market makers in both phases.

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 derivative or a class of derivatives to be considered subject to the TO?

For a derivative or a class of derivatives to be considered subject to the TO, the number of market makers or other market participants under a binding written agreement or an obligation to provide liquidity should be fixed at two levels:

- per trading venue that offer trading for that derivative or class of derivatives (two market makers should be required for the venue to be counted for – see Q6);
- across all EU venues that offer trading for that derivative or class of derivatives (three independent market makers should then be required).

Q9: Do you agree with the proposed approach or do you consider an alternative approach as more appropriate?

We consider that an analysis based on TR data, eg. on post-allocation data, cannot provide satisfactory results when it comes to assessing the average size of trades or the frequency of trades, due to the frequent allocation of executed trades to multiple funds.

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 not, please specify your reasons.

Yes, the average size of spreads should receive a much lower weighting in the liquidity assessment.

Q11: Which sources do you recommend for obtaining information on the average size of spreads by asset class?

We do not provide answer on that question.
In any case, we consider that only spreads on executed transactions or executable quotes (and not indicative ones) should be taken into account in that domain.

Q12: What do you consider as an appropriate proxy in case of lack of information on actual spreads?

AMAFI and FBF are not aware of the existence of such a proxy

Q13: Do you agree with the suggested approach? If not, what approach would you recommend?

Yes, AMAFI and FBF agree with the approach to assess the possible effects on non-financial end users by using information on the number and type of market participants, average frequency and average size of transactions, i.e. not to include average size of spread.

More generally AMAFI and FBF are in favour of a gradual introduction of the trading obligation. In particular it would be useful to wait for reliable data from CCPs and trading venues to properly analyze the effects on liquidity on the transparency regime before calibrating and implementing a trading obligation.

Q14: Do you agree that trades above the post-trade large in scale threshold should not be subject to the TO? If not, what approach would you suggest? Should transactions above the post-trade LIS threshold meet further conditions in order to be ex-empted from the TO?

In consistency with our answer to question 3, we believe that the size limit above which trades should not be subject to the TO should be set at the pre-trade SSTI level at least until one year after EMIR clearing obligation on the relevant OTC derivative instruments are fully in place (when Category 4 are subject to EMIR clearing obligation).

After this transition, ESMA will get high quality data from CCPs and a comprehensive picture on the OTC derivatives that are effectively cleared to assess whether these are “sufficiently liquid”.

As such, they’ll be in a position to assess properly whether trades above the pre-trade SSTI are sufficiently liquid and consider increasing the size limit up to a level where the relevant instruments are no longer liquid.

However, we believe that the most appropriate size limit would be the pre-trade LIS (70th percentile), level above which National Competent Authorities can exempt trading venues from pre-trade transparency – one of the reasons being that there is less liquidity above this threshold and that pre-trade transparency on this size may lead to predatory behaviors. Now, in case where ESMA intends to align with the US block size (50% methodology in initial period and 67% after initial period) we would advise to use the same methodology as the US MAT but we would lose here consistency between MiFID II provisions that we believe is key.

Q15: How highly should ESMA prioritise the alignment of the TO with transparency? What would be the main consequences for the market if some instruments are covered by transparency and not by the TO or vice versa? If the two are not fully aligned, would a broader scope for the TO or for transparency be preferable, and why? In case of a broader or narrower scope for the TO (compared with transparency), how should the two liquidity thresholds relate to each other?

We do not consider alignment with transparency rules in MiFIR should be a priority as these rules seek a different objective than the trading obligation. Therefore, AMAFI and FBF would favor the first option. This doesn’t mean that consistency between different MIFID rules and with US rules should not be aimed at, but the main priority is to make the TO appropriate for the EU market.

We support the alignment of the minimum criteria for the definition of liquidity between the TO and transparency obligation. However, we note the difference between “liquid” that triggers the pre and post-trade transparency and “sufficiently liquid” that triggers the TO. Therefore, an OTC derivative can be “liquid” for transparency purpose but not “sufficiently liquid” for TO purpose.

As such, we recommend a more granular “class of instruments approach” as detailed in our response to question 1 to assess whether liquidity is sufficient. Also, the minimum criteria to determine liquidity should be kept but supplemented with additional ones such as a minimum number of days traded and

a minimum number of distinct counterparties on each day traded. The transaction size should also be taken into account as well as the number of trading venues that are able to trade the concerned instrument before considering an EMIR CO eligible OTC derivative contract as “sufficiently liquid”.

Now, in accordance with MiFIR Article 9, we agree that any OTC derivatives not subject to the TO (either because they are not subject to clearing or because they are not sufficiently liquid) and that are not liquid are exempted from the pre-trade transparency requirement. There is no inconsistency with the views we have just developed above. An OTC derivative subject to EMIR CO could be considered as “liquid” but not “sufficiently” to be subject to the TO. In such case, a systematic internaliser on this OTC derivative would not be exempted from pre-trade transparency below the pre-trade SSTI.

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?

As outlined in our answers above, we consider that an analysis based on TR data, eg on post-allocation data, cannot provide satisfactory results when it comes to assessing liquidity of a derivative or class of derivatives.

This being stated, and in accordance with our response to question 3, in the absence of high quality data coming directly from CCPs once EMIR clearing is fully in place for all EMIR categories of counterparties, the use of current TR data could be the only available option, despite shortcomings that the discussion paper rightfully details. If such data were to be used, we agree with the use of option 2 to eliminate as much duplicated trades as possible. However, what option 2 does not make possible is to eliminate packages. In packages, each leg is reported as a single transaction and therefore not eliminating these transactions would overestimate the number of transactions on a specific OTC derivative. We therefore encourage ESMA to develop a method either in order to identify packages or to have an estimation of what they represent.

Finally, as recommended in our response to question 1, we also urge ESMA to eliminate from the OTC derivatives data ISDA fix fixed-to-float swaps that are executed exclusively to exercise options as well as OTC derivatives sharing the following non-standard characteristics:

- Trade Start Type > t+2
- Payment Frequency or reset frequency other than quarterly, semi-annual or annual
- Not fixed Notional
- Day Count Convention other than (30 or Actual)/(360 or 365)

Q17: Do you agree with the approach taken with regard to calculating tenors?

We agree to the use of unbroken tenors.

As regards forward started derivatives, tenors should not be computed as the difference between the maturity and execution date. Execution date is not relevant. Instead, effective date should be used.

Q18: Do you agree with the reasons mentioned above or is there another explanation for the significant number of trades outside of benchmark dates?

We agree with ESMA analysis.

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 TO?

In consistency with our answers to questions 15, we would recommend to keep existing criteria for transparency purpose but at a greater granularity as explained in our response to question 1 as well as additional criteria to determine whether liquidity is "sufficient" on the relevant instruments. All cumulative criteria should then be:

- IRS traded on average 10 times a day over the past six months
- Average daily nominal amount depending on the nature of the instruments (50 million € for IRS)
- 95% of days with trading activity (120 days on 126 working days) over the past six months.
- At least 10 distinct counterparties on each day traded over the past six months

The transaction size should also be taken into account as well as the number of trading venues that are able to trade the concerned instrument before considering an EMIR CO eligible OTC derivative contract as "sufficiently liquid".

It is indeed challenging to determine the number of distinct counterparties based on TR data so this criterion should be added once EMIR is fully in place and that high quality data from CCPs are fully available.

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?

We consider several of these additional specifications as critical to determine TO for fixed-to-float IRS. We recommend exempting any instrument sharing the following non-standard characteristics as they would not be sufficiently liquid:

- Trade Start Type > t+2
- Payment Frequency or reset frequency other than quarterly, semi annual or annual
- Not fixed Notional
- Day Count Convention other than (30 or Actual)/(360 or 365)

Q22: Does this result reflect your assessment of liquidity in OIS? If not, please explain on which subclasses you disagree and why.

Yes. This result is consistent with our own assessment of OIS liquidity. However, to measure whether OIS 3 Months EUR are "sufficiently liquid" and not just "liquid" we recommend, in accordance with our answer to question 20, additional criteria including:

- 95% of days with trading activity (120 days on 126 working days)
- At least 10 distinct counterparties on each day traded over the past six months

Q23: What thresholds would you propose for the liquidity criteria? What minimum number of counterparties would you consider appropriate for introducing the TO?

Please see our answer to question 22.

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?

Please see our answer to question 21.

Q25: Do you agree that due to the specificities of the FRA-market, FRAs should not be considered for the TO? Do you agree that the majority of FRAs transactions serve post-trade risk reduction purposes rather than actual trades?

Yes, AMAFI agrees that FRA should not be considered for the TO.

Q26: In case you consider FRAs should be considered for the TO, which FRA sub-classes are in your view sufficiently liquid and based on which criteria? How should a TO 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 TO for FRAs and why?

Please see our answer to question 25.

Q27: Would you consider the two index CDS as sufficiently liquid for being covered by the TO?

Yes, we consider the two index CDS as sufficiently liquid for being covered by the TO. However, it must be noticed that only the on-the-run series should be identified as sufficiently liquid, as an index becomes illiquid as soon as it is off-the-run.

Q28: Do you agree that the TO 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.

Several studies tend to indicate that an index becomes illiquid as soon as it is off-the-run, which would command that the TO should not cover the first thirty working days of the most recent off-the-run series.

Q29: Apart from the tenor, which elements do you consider indispensable for specifying the TO for CDSs and why?

Q30: Do you agree with the proposed application dates? If not, please provide an alter-native and explain your reasoning.

As already detailed elsewhere, we would recommend a transitional period and set first the size limit below which the trading obligation applies at the current pre-trade SSTI until one year after EMIR clearing is fully in place for category 4. After this transitional period, ESMA will get high quality data from CCPs and a comprehensive picture on the OTC derivatives that are effectively cleared to assess whether these are sufficiently liquid. As such, ESMA will be in a position to assess properly whether trades above the pre-trade SSTI are sufficiently liquid and consider increasing the size limit as detailed in our answer to question 14.

Q31: Do you consider necessary to provide for an additional phase-in for the TO 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 counter-parties and explain your reasoning.

Please see our answer to question 30.

Q32: Which types of package transactions are carried out comprising components of classes of derivatives that are assessed for the purpose of the TO, i.e. IRD and/or CDS? Please describe the package and its components as well as your view on the liquidity of those packages.

We believe that the packages that include at least one component that is not subject to EMIR clearing obligation should be exempted from TO. These packages include but are not limited to:

- Floored swaps – fixed to float IRS with an option allowing the counterparty receiving the floating rate to fix a minimum in the level of the rate he receives.
- Cancellable swaps – an IRS and a swaption allowing a counterparty to cancel the swap at any time.
- Cap Spread CMS – 2 Caps (one against the other) with respectively a strike x% and a strike y% (y > x) in order to limit the hedging costs for counterparties.
- Curves – Two trades of different maturity that is transacted at the same time.
- Butterfly – Three trades, all of different maturities that are transacted at the same time. The middle maturity leg is twice as large as the shortest and longest legs.
- Spreadover – A spot starting FX swap transacted against an on-the-run benchmark Treasury bond.
- Compression – a series of cleared trades transacted concurrently to reduce gross outstanding notional and line items at a clearing house.
- List – a series of uncleared trades transacted concurrently.

Q33: Are there packages that only comprise components of classes of derivatives that are assessed for the purpose of the TO? Do you consider those package transactions to be standardised and sufficiently liquid?

We see two types of packages that comprise only components of classes of derivatives that are assessed for the purpose of the TO:

- Spreads: composed of 2 different swaps such as a fixed to float IRS against another fixed to float IRS.
- Flys: 2 different swaps (one against 2 or 2 against 1.)

To determine whether a package, including OTC derivatives subject to EMIR clearing only, is admitted to trade or traded on at least one trading venue, ESMA should base its assessment on data coming directly from trading venues. They should provide ESMA with a list of all the different packages strategies only comprising classes of derivatives that are assessed for the purpose of the TO that they are admitting or trading. ESMA should then assess whether liquidity is sufficient on these packages to make mandatory their trading on trading venues. If TR data do not specify when a swap is part of a package, as explained in our response to question 16, we estimate that X% of the swaps we trade are for packages – Y% of which for packages comprising only classes of derivatives that are assessed for the purpose of the TO.

Q34: Do you agree that package transactions that are comprised only of components subject to the TO should also be covered by the TO or should the TO only apply to categories of package transactions that are considered liquid? If not, please explain.

In accordance with our response to question 33, we recommend that the TO only applies to categories of package transactions that are considered as “sufficiently liquid” to be consistent with MiFIR requirement to trade OTC derivatives subject to EMIR clearing obligation that are “sufficiently liquid”.

Q35: How should the TO apply for package transactions that include some components subject to the TO, whereas other components are not subject to the TO?

In accordance with our response to question 32, we believe that the packages that include at least one component that is not subject to EMIR clearing obligation should be exempted from the trading obligation to be consistent with MiFIR requirement to trade OTC derivatives subject to EMIR clearing obligation that are “sufficiently liquid”.