FIA and FIA Europe Special Report Series: Derivatives under MiFID II - Part 1

22 January, 2015

This Special Report is the second in the FIA and FIA Europe's series covering specific areas of the European Securities and Markets Authorities ("ESMA") consultation process for the implementation of the recast Markets in Financial Instruments Directive II (2014/65/EU) and Markets in Financial Instruments Regulation (Regulation 600/2012) ("MiFIR"), which together are referred to as "MiFID II" and come into effect on 3 January 2017.

On 19 December 2014, ESMA published Final Technical Advice to the European Commission (ESMA/2014/1569), together with a Consultation Paper (ESMA/2014/1570) on MiFID II. The Consultation Paper includes draft Regulatory Technical Standards ("RTS") and Implementing Technical Standards ("ITS"), which ESMA is required to produce under MiFID II.

This Special Report provides an overview of ESMA's proposals in the Consultation Paper and the draft RTS on the trading obligation for derivatives (the "Trading Obligation") and ESMA's proposals in relation to the definition of "liquid market" in relation to the transparency requirements for derivatives.

The Trading Obligation

The European Markets Infrastructure Regulation ("EMIR") imposes a mandatory clearing obligation with respect to certain classes of Over-the-Counter ("OTC") derivatives contracts. In line with G20 requirements, MiFIR requires for the first time certain derivatives contracts (those which are both cleared through a central counterparty and deemed sufficiently liquid) to trade on a "MiFIR trading venue": that is, Regulated Markets ("RMs"), Multilateral Trading Facilities ("MTFs"), Organised Trading Facilities ("OTFs"), or a third country trading venue deemed equivalent by the European Commission.

This Trading Obligation is probably the area where some of the most important interdependencies between MiFID and EMIR may be found, as the Trading Obligation applies to certain transactions in clearing eligible and sufficiently liquid contracts when traded by counterparties subject to the clearing obligation under EMIR. The Trading Obligation is broadly similar to the "trading mandate" for swaps under Title VII of the Dodd-Frank Act.

MiFIR specifies that transactions will be subject to the Trading Obligation if both sides of the trade fall into one of two categories: financial counterparties as

defined by EMIR (these are broadly investment firms and credit institutions); and non-financial counterparties that are subject to the clearing obligation in EMIR (in summary, this is where the rolling average speculative positions over 30 working days exceed the specified clearing threshold).

As set out in EMIR, the main purpose of the Trading Obligation is to determine which of those derivatives subject to the EMIR clearing obligation should be required to be traded on the MiFIR trading venues. However, the provisions of MiFIR are vague on the details of the new obligation, placing the responsibility on ESMA to come up with draft regulatory technical standards.

In the Consultation Paper, ESMA sets out draft RTS and the reasoning behind them to determine whether a class (or subset) of derivatives should be subject to the trading obligation.

This process is different from that in the U.S., which permits the trading venues, namely swap execution facilities and exchanges, to file their analyses as to whether a swap can be "made available to trade" with the Commodity Futures Trading Commission ("CFTC"). Once filed, market participants have an opportunity to provide the CFTC with comments on the determination submitted by the trading venue.

There are two main factors determining whether or not a class of derivatives subject to the clearing obligation should also be made subject to the Trading Obligation:

- **the venue test**: the class of derivatives must be admitted to trading or traded on at least one admissible trading venue; and

- **the liquidity test**: whether the derivatives are "sufficiently liquid" and there is sufficient third-party buying and selling interest.

In the consultation paper, ESMA takes what it describes as a "broad approach" in determining whether a class of derivatives should be considered to be "sufficiently liquid" to be subject to the Trading Obligation. Accordingly, in the draft RTS, ESMA specifies that in determining whether a class of derivatives is "sufficiently liquid", it will take into account the average frequency and size of trades; the number and type of active market participants; and the average size of spreads. It will also take into account whether the liquidity of a class of derivatives (or a subset of that class) is subject to seasonal or structural factors, including historical data, which may indicate shifts in liquidity.

In relation to the average frequency of trades, ESMA has decided to set thresholds for both the minimum number of trades per day and a minimum number of days of which trading took place, over a specified period of time referred to as the "assessment reference period". ESMA wishes the approach to be flexible so that alternative approaches are possible. It believes that the assessment reference period may need to vary depending on the class of derivatives or subset and so maximum flexibility is allowed.

ESMA's approach for calculating the average size of transactions is the division of notional size by number of trading days during the specified period. The

provision in the draft RTS is drafted broadly to allow for the possibility of other options.

ESMA proposes to assess the number and type of active market participants by considering 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 in at least one trading venue.

In relation to the average size of spreads, ESMA proposes using the average size of weighted spreads over different periods of time; the size of volume weighted spreads over different periods of time; and observed spreads at different periods of time or trading sessions.

ESMA asks stakeholders to comment on whether they believe there are any other criteria that ESMA should be taking into account when assessing whether there is sufficient third-party buying and selling interest in a class (or subset) of derivatives so that those derivatives are considered to be "sufficiently liquid" to trade; and whether stakeholders have any other comments on ESMA's approach.

Transparency: Definition of "Liquid Market"

MiFIR introduces pre-trade and post-trade transparency requirements for a range of non-equity financial instruments, namely bonds, structured finance products, emission allowances and derivatives. The Consultation Paper and accompanying RTS cover a variety of matters related to these transparency requirements, including ESMA's proposal on the criteria for a definition of "liquid market" for non-equity financial instruments. This definition has an important role in determining the application of these requirements.

As set out in MiFIR, market operators and investment firms operating a trading venue are required to publish pre-trade information for non-equity financial instruments. National regulators have the power to waive this obligation for certain non-equity instruments for which there is not a liquid market. On the post-trade side, they may also authorise market operators and investment firms to provide for deferred publication in respect of transactions that are related to non-equity instruments for which there is not a liquid market.

ESMA's proposal, set out in its Consultation Paper, advocates using the "classes of financial instrument approach" ("COFIA") as the basis for the determination of the liquidity of all the various non-equity financial instruments. The COFIA approach provides for the segmentation of non-equity financial instruments into specific classes and sub-classes, defined on the basis of a set of criteria (such as maturity, currency, or underlying instrument) which varies from one asset class to another. ESMA sets out the segmentation of the classes and sub-classes it has arrived at and which constitute the framework for the transparency regime. ESMA also describes the analysis carried out across different asset classes, for the purpose of segmenting non-equity financial instruments, in order to define the sub-set of liquid classes.

ESMA considers liquidity in relation to various classes of financial instrument, including securitised derivatives, interest rate derivatives, equity derivatives and

three types of commodity derivatives: metals, energy and agricultural commodity derivatives. ESMA proposes that all securitised derivatives should be qualified as liquid. In relation to the other classes, ESMA has included detailed tables as Annex III to Section 9 of its RTS as to the precise classes of derivatives that will be considered liquid and those not having a liquid market.

For example, the table below provides an excerpt from Annex III related to forward rate agreements, which are interest rate derivatives, that will be considered liquid.

Forward Rate Agreements - Liquid Classes

INTEREST RATE	CURRENCY	TENOR	LARGE-IN-SCALE (€)	SIZE SPECIFIC TO INSTRUMENT (€)
EURIBOR	EUR	from 1 day to 1.5 months	1,000,000,000	500,000,000
EURIBOR	EUR	from 1.5 months to 3 months	650,000,000	325,000,000
EURIBOR	EUR	from 3 months to 6 months	600,000,000	300,000,000
EURIBOR	EUR	from 6 months to 1 year	525,000,000	262,500,000
EURIBOR	EUR	from 1 year to 2 years	525,000,000	262,500,000
LIBOR	USD	from 1 day to 1.5 months	725,000,000	362,500,000
LIBOR	USD	from 1.5 months to 3 months	725,000,000	362,500,000
LIBOR	USD	from 3 months to 6 months	725,000,000	362,500,000
LIBOR	USD	from 6 months to 1 year	725,000,000	362,500,000
LIBOR	USD	from 1 year to 2 years	725,000,000	362,500,000
LIBOR	GBP	from 1 day to 1.5 months	575,000,000	287,500,000
LIBOR	GBP	from 1.5 months to 3 months	450,000,000	225,000,000
LIBOR	GBP	from 3 months to 6 months	475,000,000	237,500,000
LIBOR	GBP	from 6 months to 1 year	450,000,000	225,000,000
LIBOR	GBP	from 1 year to 2 years	700,000,000	350,000,000

Note: Where a transaction meets the Large-in-Scale ("LIS") or the Size Specific to Instrument ("SSTI) thresholds, certain waivers or partial waivers of pre-trade price discovery and of post-trade reporting apply.

The post-trade transparency requirements will be considered in the next Special Report.

Next Steps

The final Technical Advice has now gone to the European Commission and will assist the European Commission in drawing up its own implementing rules. However, the Consultation on the RTS and ITS is currently open and will close on 2 March 2015. ESMA has also announced that it will hold an open hearing on the consultation on 19 February 2015. Additional information on the open hearing is available here.

Upcoming Special Reports

In the coming days, FIA and FIA Europe will issue additional special reports on the topics addressed in the Consultation Paper:

1. Derivatives - Part 2 (including post-trading issues, indirect clearing and other topics);
2. Algorithmic and High Frequency Trading;
3. Open Access;
4. Transactions Reporting;
5. Commodity Derivatives (including ancillary activities);

6. Definitions and Exemptions; and
7. Safeguarding of Client Assets.

For more information about these reports contact Will Acworth at FIA (wacworth@fia.org) or Emma Davey at FIA Europe (edavey@fia-europe.org)

Additional MiFID II/MiFIR documents are available here.

Disclaimer: This report was drafted by the London office of Covington & Burling LLP on behalf of FIA and FIA Europe. The report is part of a series of reports intended to provide factual summaries of MiFID/MiFIR on certain topics of interest to the members of FIA and FIA Europe. The reports are provided for general informational purposes only. They do not constitute legal or regulatory advice and should not be relied upon for this purpose.

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