FIA EUROPE

Whilst FIA Europe continues to analyse ESMA's final draft Regulatory Technical Standards (RTSs) with members, the below list identifies the issues that we recognised to date.

The list highlights key issues of FIA Europe and its members in relation to post-trading issues (indirect clearing and straight-through processing), commodities, market data (transaction reporting), non-discriminatory access, microstructural issues, transparency and implementation challenges. In addition, the summary highlights some of the positive outcomes and where ESMA has taken on-board FIA Europe comments.

1. **Indirect Clearing**

ESMA has not published the RTS relating to indirect clearing. Instead, ESMA announced after the publication of the RTS its plan to amend the EMIR RTS and to delay the MiFIR RTS. On the previous proposal, FIA Europe's main issues centred on insolvency and property law conflicts. Whilst indirect clearing evolved in OTC (client clearing in OTC has only been available since 1999), the issues in exchange traded derivatives (ETD) are significant due to existing contractual arrangements being affected. MiFIR can't trump insolvency law, EU recitals are not legally binding and consequently a solution for EU Direct clients needs to find its way in the main body of the text. FIA Europe will actively re-engage with ESMA during the upcoming consultation process.

2. **Straight Through Processing (RTS 26)**

It is very positive news that ESMA has taken on-board our feedback, such that where the rules of the trading venue and CCP provide certainty of clearing, then the pre-execution screening of each order on submission by the trading venue is not required. Mandatorily cleared and voluntarily cleared OTC derivatives are to be treated the same. If both parties agree, a trade that was not accepted by a CCP due to a technical or clerical error, can be resubmitted for clearing within an hour.

3. **Commodities (RTS 20 and 21)**

Drafting issues in RTS 20:

Several aspects of RTS 20 are not aligned with ESMA's Final Report. For example, the Final Report states on pages 322 and 323 that the objective is to capture the size of the firm's trading activity in Europe but it seems this is not reflected in RTS 20 Article 2.

New Main Business test for the ancillary exemption:

The new test (which had not been consulted on) proposes to look at the ratio of trading activity in commodity derivatives vs trading activity of the group in financial instruments. Members are concerned that this test does not take into account the level 1 requirements that commodity derivatives are ancillary only if they are not disproportionate to the main business of the company. Using only trading activity as indicator of the main business does not take into account a commodity

firm's main commercial business (such as owing fixed assets, e.g. power plants, pipelines, smelters, or its buying and selling of commodities, not derivatives, to consumers). The capital test proposed in the December 2014 consultation was more in line with the spirit of level 1, provided the correct parameters are used to calculate capital employed for commodity trading activity.

Risk-reducing transactions for the purposes of the threshold calculations in RTS 20:

a) Intra-group transactions with non-EU entities of the group can only be considered as being risk-reducing and thus not counting towards the threshold following an equivalence decision for the third country by the European Commission. This does not take into account the global nature of commodity markets. Most commodity firms operate on a global basis and are trading/hedging in numerous countries. Under the current wording, the activity by the third country subsidiary on behalf of the parent or another subsidiary cannot be deducted from the calculation without an equivalence decision. ESMA recognises this issue but states in its Final Report on page 332 that it is unable to provide a different solution. Our members recommend the European Commission to reconsider and to allow the deduction of all intra-group transactions irrespective of where they are located.
b) Under the current wording, trading activity of a group entity licensed under MiFID II does not count towards the threshold calculations at Recital 10 and Art. 2(2) of RTS 20, and we support this view. However, it seems activity undertaken by an entity currently licensed under MiFID I cannot be deducted. This will lead to MiFID I licensed group activity being counted towards the threshold calculations for any calculation period that includes trading activity before the application of MiFID II, e.g. the first calculation period from July 2015 to June 2016. The wording should be revised to ensure all authorised activity, whether under MiFID I or MiFID II, can be deducted.

Definition of economically equivalent in RTS 21:

The definition is of economically equivalent is extremely narrow, which is problematic for financial entities that are not able to make use of the hedging exemption in Art 57 as it will limit the number of transactions that can be netted before position limits are applied. Defining economically equivalent OTC (EEOTC) in this manner poses a risk to liquidity in EU commodity markets as financial institutions may not be able to provide financing to market participants if they are unable to hedge their resulting exposure due to having reached the position limits. Another risk is that hedging activity would need to move outside of the EU to other markets (e.g. US or Asia), again reducing liquidity in the EU. The definition should be revised to take into account proxy hedging and allow for netting of a wider range of transactions.

Aggregation of positions at group level in RTS 21:

It is unclear from the current wording, whether positions of the whole group will have to be aggregated, irrespective of their geographical location, thus including non-European parents and subsidiaries, giving the regulation extra-territorial effect (worst-case scenario: only one subsidiary is in the EU but still the positions of the entire group need to be aggregated). Further clarification is required.

4. Market Data Reporting – Transaction reporting (RTS 22)

Transmission of Orders

Whilst ESMA has provided more clarity around who should report what and when a firm transmits an order received from a client or resulting from a decision made under a discretionary mandate,

the fundamental implementation issues remain. Providing this service to ETD clients would be extremely problematic due to the large volumes of trades and clients that any system build would be required to accommodate.

Trading Capacity

FIA Europe sought to amend the definition of "Matched Principal" to clarify that for ETD use, the word "simultaneous" should be interpreted to include scenarios where the second side of a transaction (Side 1. Execution Broker vs Exchange, Side 2. Execution Broker vs Client) is not necessarily allocated to the end beneficiary at the point of execution. ESMA have not answered this question but have committed to provide further guidance on trading capacities in future ESMA guidelines.

Obligation to supply financial instrument reference data under Article 27 of MIFIR - usage of Instrument identifiers

Whilst not specifically raised as a point in FIA Europe's response to ESMA's December consultation paper, it should be noted that ESMA has confirmed that *"After reviewing all the existing industry initiatives for reference data, ESMA has decided to use ISINs to identify reference data, given the open source nature and the low cost of the solution as well as the flexibility and speed with which ISINs could be allocated to existing/new financial instruments."*
This would suggest that trading venues not currently using ISIN identifiers will be required to do so going forward.

ETD Underlying

ESMA does not appear to have addressed the comments made in the original FIA Europe response covering fields 57 & 58. Please see text from the original response covering these fields below.
Field 57: The taxonomy for this field does not work for products where the deliverable is not known at the time of execution and/or may come from a range of underlying assets such as a gilt future where the deliverable may be any of a range of gilts. We propose an additional value of "O" meaning "optional as will be determined at a future date following execution". Please see also our response to Question 222 (copied below):

FIA Europe has suggested some suggested improvements as set out in relation to Fields 57 and 58 in response to Question 218 (response for Field 57 copied below). Firms will use an ISIN where one is available as required. However, where the underlying deliverable asset is unknown at the point of execution and the list of deliverables is subject to change after the actual execution (e.g. a gilt future where a new gilt might fall into the list of deliverable underlying assets), we propose introducing an additional code to be applied to enable firms to report this information for ETDs.

Field 58: Please refer to our comments on Field 57. Where the underlying asset is not known at the point of execution (e.g. a gilt future), we propose an additional value such as "O" meaning "optional as will be determined at a future date following execution".

National ID

National ID number remains one of the options to identify the client but firms will also have to report the client's name and date of birth. In response to data protection concerns raised by FIA Europe, ESMA confirms that "confidentiality of the data will be ensured" without explanation.

In the original FIA Europe response, we suggested that an individual responsible for investment decisions or execution might be better identified by the NCA's registration number than his national ID number. However, ESMA has not adopted this idea because "*the concept of registration of traders with the CA is not established in all Member States*".

5. <u>Non-discriminatory access (RTS 15 and 16)</u>

ESMA made very few changes to the RTS. The numerous concerns that we raised in our response, in particular the unworkable nature of the "economic equivalence" assessment remain. ESMA has now given the NCAs significantly more power and discretion to decline an access request.

6. <u>Microstructural Issues (RTS 6 and 8)</u>

<u>RTS 6 Article 13 Prevention and identification of potential market abuse:</u>

It was noted in paragraph 5 the requirement that IFs should be able to "read, replay and analyse order and transaction data." The key word is "<u>replay</u>," which seems to imply that firms must store market data. However, during the CP in December, ESMA was quite clear firms were not required to store market data:

"ESMA also stated in the DP that it was considering whether the following data should be stored: i. Each parameter set up to calibrate the trading algorithm of the investment firm at any given time. ii. Market data messages that the investment firm received. 15. Respondents were strongly opposed to the above proposals. Responses argued that ESMA was exceeding its given mandate by proposing to keep record of such information, that retaining such information would be extremely costly, and that it would simply create replication of trading venue data. One respondent provided a practical example which highlighted the volume of data being discussed and the length of time it could potentially take to process this. In light of the DP feedback and practical examples provided ESMA has decided not to pursue the proposals further as it would create a burden which was disproportionate to any potential benefits."

The word "replay" should therefore be eliminated to clarify that IFs are not required to store market data and cannot be expected to replay market data.

<u>RTS 6 Annex II (Content and format of order records, field 9 [Financial instrument identification code]):</u>

ISINs are required for reporting/recordkeeping, including derivatives. This is captured within FIA Europe's issue list relating to the Reporting requirements.

<u>RTS 8 – Market making agreements and schemes -</u>

There is inconsistency with regards to obligations to enter into market making agreements and for trading venues to offer market making schemes. Investment firms have to enter into a market making agreement regarding a financial instrument if it meets the market making definition BUT trading venues are not required to have market making schemes in place except for certain instruments. This can result in a situation where a firm has an obligation to enter into a market making agreement and the continuous quoting obligations that stem from it, without there being a scheme in place to underpin this obligation. A market making scheme is an 'acknowledgment' of the

risk that market makers take and their exposure by means of a payment, rebate, or discounted clearing fee. The asymmetry identified in the RTS could lead to market makers moving from a passive to an active market making strategy, choosing not to provide liquidity on an ongoing basis as this would not be rewarded. This would risk pushing trading towards over-the-counter, which would make markets more opaque.

7. Transparency (RTS 2)

Package transaction

FIA Europe members are concerned that there are no provisions for treatment of package transaction regarding pre-trade transparency requirements which will be a day 1 issue. Whilst ESMA agrees that there should be provisions on the pre-trade side and recommends changes to Level 1, issues evolve now on how Level 1 could be opened up in time for the MiFID II application date (3rd January 2017). Package trades should be treated as transactions in their own right rather than simply as a combination of its component parts and disclosing the prices could provide misleading information. In addition, one or more legs of a package transaction are non-price forming or hedging trades. The provisions for post-trade deferrals, which is positive news, do not make sense without an appropriate pre-trade transparency regime for packages.

Equity derivatives

It is disappointing to note that equity derivatives have been given a different treatment to other classes of ETDs (all equity derivatives have been classified as liquid and therefore will not be able to use the waiver available for illiquid instruments). There is a better granularity for liquidity definition for interest rate (IR) and bond classes for example.

(i) It is also not clear from ESMA why the segmentation for equity ETDs is not done in the same way as for IR ETDs (where the subclasses are broken down into maturity buckets, and a liquidity assessment is done of each subclass before attributing the LIS for each subclass).

(ii) ESMA intends to protect high level of existing voluntary transparency operated by trading venues in equity ETDs – however, the practical consequence is that a number of single stock futures, dividend futures and less liquid indices which are currently traded entirely in a block trading/ trade reporting manner with minimum execution sizes of 1 contract will need to move to Order books for participants to execute in small sizes.

(iii) In practice, the liquidity of equity derivatives varies significantly between the front and back months, as well as serial months v quarterly expiries. Flex products also follow a very different liquidity profile to standard products.

The LIS and SSTI thresholds have been set very high, and in particular there is not much difference between the SSTI and LIS which renders the use of the SSTI largely meaningless (SSTI set at 95% of LIS in most cases). This is contrary to the purpose of the SSTI in the Level 1, which is to protect liquidity providers in RFQ and voice trading platforms. This is distinct from the purpose of the LIS or the illiquid instrument waiver. It appears that ESMA has failed to fulfil its mandate here.

For index products, the values of the LIS in notional for the liquidity bands with higher ADNA (> €100m) are set very high, and are more representative of trading of indices like DAX and EuroStoxx

50 rather than other European indices. Members informed us and provided examples as their initial analysis suggests that the change in block sizes will be between 4x and 100x of current block sizes.

It is disappointing that ESMA has changed its approach so drastically between the December 2014 consultation, and the final draft RTS without any room for market consultation (which in members' views rendered the initial market consultation ineffective). Some of the major points of difference are for example the separation of pre- and post-trade SSTIs and LISs, the drastic change to the approach of SSTI, the magnitude of the LIS sizes for products with ADNAs > €100m. Considering the serious departure from the previous approach, ESMA should undertake an additional consultation.

As a final point, it is interesting to see that for liquidity definition of equity CFDs, ESMA is relying on the liquidity of the underlying i.e. if the underlying share is liquid, the CFD will be liquid. This is very different from the approach taken for equity derivatives.

Members view positively, that ESMA is following a scaled approach to LIS based on the ADNA, and the LIS size for the least liquid ADNA classes has been set at €25,000 which would mean a block size of lots in between 1-15, which would work for most of the very illiquid names.

<u>Commodities</u>

Whilst ESMA attempted to deal with some of the issues (e.g. 10 trades per day is better than 1), we can observe a drastic change from what was initially proposed. We continue to analyse ESMA's transparency proposals for commodities with our members

<u>Golden source:</u>

More clarity is required in determining what is "traded on a venue" across 300 EEA and non –EEA trading venues.

8. Implementation challenges

The lack of time between when the final rules are in place and the compliance date of 3 of January 2017 is an issue. Firms' technology builds will only be possible once the final rules are published.

- Significant market infrastructure changes are being driven through a highly compressed timeline compounded by:

  (a) Further guidance/Q&A required for many unclear rules

  (b) Third country equivalence determinations timeline

  (c) Delays in publishing technical standards with no delays in compliance date

  (d) Potential differences and timing of NCA transposition create implementation risks

- The number and scale of changes taking place in parallel, i.e big bang:

  (a) Many industry changes going live at the same time increases risks of day 1 issues

  (b) The scale of change will brings critical resource challenges for regulators and industry alike