ICI Global's Responses to ESMA's
MiFID II/MiFIR Addendum Consultation Paper

Introduction

ICI Global[1] appreciates the opportunity to provide comments on the Addendum Consultation Paper issued by the European Securities and Markets Authority ("ESMA") on draft regulatory technical standards for the implementation of transparency requirements for foreign exchange derivatives, credit derivatives, other derivatives and contracts for difference pursuant to Regulation (EU) No 600/2014 of the European Parliament and of the Council on Markets in Financial Instruments ("MiFIR"). Our members include regulated funds in jurisdictions around the world (collectively, "Regulated Funds").[2]

ICI Global appreciates the opportunity to provide input to ESMA on its deliberations, which will have a major impact on the derivatives markets and their participants, including Regulated Funds and their investors. We understand that ESMA believes it would be most helpful for market participants to respond to the specific questions that are posed in the Consultation Paper rather than to submit a narrative comment letter. We provide below our answers to certain of those questions in the Addendum Consultation Paper.

In addition, we have two general comments. First, we urge ESMA to adopt a regulatory approach that is flexible and able to adapt to changing market conditions. In particular, we are concerned about classifying certain instruments as "liquid" based on data collected over only a three-month period and incorporating the results of this liquidity analysis into regulatory technical standards that can only be amended by a relatively lengthy legislative process. Second, ESMA should provide an explanation for imposing certain methodologies and thresholds in the proposals. Specifically, we note that ESMA has not fully explained how it determined the different thresholds (*i.e.,* average number of trades per day and average notional amount traded per day) as being appropriate for each sub-class, or the rationale for

[1] The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US$19.0 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

[2] For purposes of this letter, the term "Regulated Fund" refers to any fund that is organized or formed under the laws of a nation, is authorized for public sale in the country in which it is organized or formed, and is regulated as a public investment company under the laws of that country. Generally, such funds are regulated to make them eligible for sale to the retail public, even if a particular fund may elect to limit its offering to institutional investors. Such funds typically are subject to substantive regulation in areas such as disclosure, form of organization, custody, minimum capital, valuation, investment restrictions (*e.g.*, leverage, types of investments or "eligible assets," concentration limits and/or diversification standards). Examples of such funds include: US investment companies regulated under the Investment Company Act of 1940 ("Investment Company Act"); "Undertakings for Collective Investment in Transferable Securities," or UCITS, in the European Union; Canadian mutual funds; and Japanese investment trusts.

the size specific to the instrument threshold being set at 50% of the large in scale threshold for all instruments. It is extremely difficult for market participants to provide meaningful comments on certain aspects of the proposals because there is at times little explanation of ESMA's approach.

Q1. Do you agree with ESMA's proposal for the definition of a liquid market? Please provide an answer detailed per asset class identified (deliverable forwards, non-deliverable forwards, options, swaps, spread betting contracts and futures) addressing the following points:

(1) Would you use different qualitative criteria to define the sub-classes? Please also specify if you agree in distinguishing or not distinguishing between deliverable and non-deliverable contracts. If you would distinguish between deliverable and non-deliverable contracts for other classes besides forwards, please provide your feedback as specific as possible with regard to the sub-classes that should be deemed liquid for deliverable contracts and those for non-deliverable contracts, pointing out the differences between the two sub-groups.

(2) Would you use different parameters or the same parameters (i.e. average number of trades per day and average notional amount traded per day) but different thresholds in order to define a sub-class as liquid?

(3) Would you define some specific classes declared as liquid in ESMA's proposal as illiquid (and vice versa)? Please provide reasons for your answer.

In general, ICI Global agrees with ESMA's use of the Classes of Financial Instruments approach or "COFIA" to assess liquidity for derivatives because it is likely to be simpler to apply than the alternative Instrument by Instrument approach or "IBIA."

One of the liquidity tests proposed by ESMA is that the instrument must have been traded on at least 80% of available trading days over the relevant period. ICI Global is of the view that instruments should only be treated as liquid if they trade <u>at least</u> every day. A lower threshold may not account for periods of low liquidity during which the application of full transparency requirements could prove damaging.

We also agree that different thresholds (*i.e.,* average number of trades per day and average notional amount traded per day) should apply to define a sub-class of assets as liquid. The Consultation Paper, however, does not explain how ESMA determined the different thresholds as being appropriate for each sub-class. Unless ESMA provides an explanation for applying a particular threshold to a sub-class for determining liquidity, it is extremely difficult for market participants to evaluate whether appropriate thresholds are being used (and to provide useful feedback to ESMA). Although we do not underestimate the enormity of ESMA's task in drafting Level 2 technical standards under MiFID II

and MiFIR, we believe that it would be both good policy and practice to provide market participants with a rationale for proposing to adopt particular thresholds for each sub-class.

ICI Global also supports the additional tests that ESMA has proposed to confirm the liquidity of each sub-class of foreign exchange derivatives, including the requirement for a coverage ratio to be met for the entire asset class (*i.e.,* in terms of number of trades and notional amount) before the relevant instruments will be treated as liquid. We recommend, however, that ESMA increase this coverage ratio to ensure that illiquid instruments are not incorrectly classified as liquid. Misclassification of illiquid instruments would not be mitigated by the availability of waivers and deferrals for large in scale or the size specific to the financial instrument ("SSTI") transactions, and it is vital that misclassifications and "false positives" be minimised to the greatest extent possible.

Finally, ESMA analysed the classes of instruments in the Consultation Paper on the basis of data collected over only a three-month period (from 1 March 2014 to 31 May 2014). This period appears to us to be relatively short and may not reflect a range of trading conditions, ignoring, for example, seasonal fluctuations in liquidity. In our view, ESMA's proposed approach of building the results of its liquidity analysis into the draft regulatory technical standards ("RTS") is problematic for this reason. If a short look back period is to be used, ESMA should ensure that the results of the liquidity analysis are regularly updated and reviewed to keep pace with changing market conditions. Under ESMA's current approach, however, altering the characterisation of a sub-class of instruments as either liquid or illiquid would require adopting a new RTS, which can be a time-consuming process given scrutiny periods built into the passage of EU legislation. ICI Global therefore recommends that the draft RTS include the framework (*i.e.,* criteria) for assessing liquidity rather than the results of the liquidity assessment. This approach would be similar to the one ESMA proposed in relation to the derivatives trading obligation, in which a general framework for assessing liquidity was incorporated into the draft RTS ("RTS 11: Draft regulatory technical standards on criteria for determining whether derivatives should be subject to the trading obligation," set out in Annex B of ESMA's MiFID II/MiFIR Consultation Paper).

We believe that the asset or sub-asset classes should be reassessed based on these criteria on a periodic (at least yearly) basis with the results of the liquidity analysis published separately (*e.g.,* on ESMA's website). ESMA also should ensure that it has in place an effective strategy for monitoring the ongoing liquidity of instruments so that it can consider changing their liquidity profile for the purposes of transparency as soon as possible where there are indications that it is likely to change.

Q2. Do you agree with ESMA's proposal for foreign exchange derivatives? Please specify, for each sub-class (non-deliverable forwards (NDF), deliverable forwards (DF), FX options, FX swaps, spread betting and FX futures) if you agree on the following points providing reasons for your answer and, if you disagree providing ESMA with your alternative proposal:

(1) deferral period set to 48 hours

(2) **size specific to the instrument threshold set as 50% of the large in scale threshold**

(3) **volume measure used to set the large in scale and size specific to the instrument threshold as specified in Annex II, Table 3 of draft RTS 9**

(4) **pre-trade and post-trade thresholds set at the same size**

(5) **large in scale thresholds: (a) state your preference for the system to set the thresholds (i.e. annual recalculation of the thresholds vs. no recalculation of the thresholds) (b) in the case of a preference for a system with no recalculation (i.e. option 1), provide feedback on the thresholds determined. In the case of a preference for a system with recalculation (i.e. option 2), provide feedback on the thresholds determined for 2017 and on the methodology to recalculate the thresholds from 2018 onwards including the level of granularity of the classes on which the recalculations will be performed**

(6) **<u>for non-deliverable forwards (NDF) and spread betting contracts only:</u> express your preference for either "Alternative A" or "Alternative B". If you disagree with both ESMA's proposal provides your alternative proposal for the LIS threshold floor.**

ESMA has proposed varying the large in scale threshold between liquid and illiquid instruments, such that the large in scale transaction size would be set as the greater of: (i) the threshold determined so that at least 90% of trades in liquid instruments and 70% of trades in illiquid instruments fall below the threshold; and (ii) a specified "threshold floor." Although ICI Global generally agrees that transactions in illiquid instruments should benefit from greater protection, we are unsure of what the benefits would be to applying different thresholds given that the same post-trade transparency deferral period of 48 hours would apply to transactions in illiquid instruments regardless of whether or not they were classed as large in scale.

In addition, ICI Global is concerned by ESMA's proposed 90%/70% "coverage ratio" approach. Such an approach to defining large in scale thresholds would necessarily result in a certain percentage of transactions being subject to full transparency requirements (at least where they fall within a sub-class of instruments classified as "liquid") regardless of whether this level is appropriate based on empirical analysis. A large in scale threshold based on analysis by a group of experts (which was proposed in ESMA's original Discussion Paper on the issue of transparency) would be preferable.

However, if ESMA does go forward with the proposed approach of incorporating coverage ratios into the large in scale threshold, we urge ESMA to adopt an initial phase-in period during which the threshold is set lower (*e.g.,* 50%). A phased implementation would help to avoid suddenly moving a significant amount of transactions into full transparency. Such a sudden movement could cause

difficulties for market participants seeking to adjust their trading and hedging practices to comply with the new transparency regime.

Finally, for all sub-classes of FX futures, ESMA proposes to apply large in scale thresholds equal to €100,000 to all such instruments regardless of their terms (*e.g.,* currency pair). ICI Global is concerned that this artificial floor may operate to prevent the large in scale threshold from operating as it is intended as indicated by ESMA's statement that, without the €100,00 floor, the large in scale thresholds for FX futures would have been "significantly smaller" in size. ESMA should bear in mind that trade sizes in the FX market, for example, may be relatively small given the role of the FX market in supporting payment transactions. Thus, rather than imposing a pre-determined floor across all trades, ESMA should apply its general methodology for determining the floor, which may be lower than €100,000.

In relation to recalculation of thresholds, ICI Global would prefer an annual recalculation to a more static regime with no recalculation. In our view, it is essential that the transparency regime keeps pace with changing market conditions, and classes of instruments should not be subject to full transparency requirements on the basis of outdated information.

ICI Global agrees with setting the post-trade transparency deferral period at 48 hours for FX derivatives.

Finally, ICI Global acknowledges that setting the SSTI thresholds as a percentage of the large in scale thresholds will provide for simple implementation by the trading venues and market participants. Because ESMA does not provide a rationale for setting the SSTI threshold at 50% of the large in scale threshold across all instruments, it is difficult, however, to assess whether ESMA has proposed an appropriate level.

Q3. Which is your preferred option for the definition of a liquid market of single name CDS? Please provide an answer detailed per underlying issuer type identified (sovereign and corporate), addressing the following points:

(7) Would you use different qualitative criteria to define the sub-classes?

(8) Would you use different parameters or the same parameters (i.e. average number of trades per day and average notional amount traded per day) but different thresholds in order to define a sub-class as liquid?

(9) Would you define classes declared as liquid in ESMA's proposal as illiquid (or vice versa)? Please provide reasons for your answer.

ICI Global considers that "Option A" (under which sub-classes of single name CDS would be assessed separately for liquidity purposes) is preferable to "Option B" (under which a single name CDS would be considered liquid only if its reference entity or obligation is included in a liquid CDS index as set out in Table 60 of Annex II, Section 7 of draft RTS 9). Different instruments should be considered independently for the purpose of assessing liquidity given that their liquidity profile and the manner in which they trade may vary regardless of whether they have certain common features.

If ESMA does choose, however, to go forward with Option B, we note that ordinarily new CDS indices would be issued periodically (*e.g.,* every six months), and each new CDS index could include a different combination of credit entities or "names." If the liquidity of single name CDS contracts is linked to the liquidity of CDS indices, we stress that it will be vital for the liquidity profile of single name contracts to change (*i.e.,* to "illiquid") if the entity or obligation that they reference is removed from any new CDS index series.