International
Capital
Market
Association

ESMA Consultation Paper
MiFID II/MiFIR: ESMA 2014/1570
International Capital Market Association
Response

Introduction:

- Who we are:

The International Capital market Association (ICMA) represents a broad range of capital market interests including global investment banks and smaller regional banks, as well as asset managers, exchanges, central banks, law firms and other professional advisers. It has 467 member firms located in 55 countries. ICMA's market conventions and standards have been the pillars of the international debt market for almost 50 years, providing the framework of rules governing market practice which facilitate the orderly functioning of the market. ICMA actively promotes the efficiency and cost effectiveness of the capital markets by bringing together market participants including regulatory authorities and governments.

- Our approach:

As mentioned above, ICMA covers issues relating to the 'orderly functioning of the market'. With this in mind, ICMA put together a technical working group made up of heads of fixed income dealing desks on the buy-side (Asset Managers) and heads of fixed income trading desks and Market Structure on the sell-side (Investment Banks/Brokers) to respond to the MiFID II Consultation Paper E.g. Bondcube Ltd, GAM, Goldman Sachs International, HSBC Bank plc, Nomura International plc, Nordea Investment Management, Société Générale S.A. and Tradition (UK) Ltd etc. This technical working group was tasked with answering the consultation questions that most affected the 'orderly functioning of the market', such as: transparency, as it relates to liquidity in the bond market. ICMA is exceptional because we are one of the very few international trade associations that has buy-side and sell-side members.

Since determining liquidity is the foundation of a functioning bond market, ICMA's working group had to innovate and come to agreement across the spectrum of the working group as to potential future market practices. Much debate and deliberation took place and in the end a consensus emerged as to proposed solutions for ESMA to consider.

The questions are answered in depth and hopefully provide a usable context to measure liquidity, where appropriate. Owing to the buy-side and sell-side membership in the working group, we believe this is an accurate picture as to the way forward for bond market trading regulation and practice.

- ICMA Welcomes the opportunity to respond to ESMA's MiFID II Consultation Paper:

  MiFID II extends much of the equity transparency requirements in MiFID I to fixed income instruments. Often, this is referred to as the 'equitisation' of the fixed income markets. This means potentially pre-trade transparency with firm executable prices advertised to the whole market and post- trade disclosure transparency of details such as price, volume and time of trade. However, fixed income is not equities. In fixed income markets, transparency does not equal liquidity. The importance of this concept is why ICMA is focusing on liquidity related questions in the Consultation Paper. Due to ICMA's make up of buy-side and sell-side membership, we believe our response will be particularly valuable to ESMA. It is widely expected that MiFID II will lead to an evolutionary change in bond trading. ICMA looks forward to working with industry participants to navigate this substantial change.

Questions:

Q57.

Do you agree with ESMA's proposal for the definition of a liquid market? Please provide an answer for SFPs and for each type of bonds identified (European Sovereign Bonds, Non-European Sovereign Bonds, Non-European Sovereign Bonds, Other European Public Bonds, Other European Public Bonds, Financial Convertible Bonds, Covered Bonds, Senior Corporate Bonds-Financial, Senior Corporate Bond Non-Financial, Subordinated Corporate Bonds Non-Financial) addressing the following points:

(i) Would you use different qualitative criteria to define the subclasses with respect to those selected (i.e. bond type, debt seniority, issuer sub-type and issuance size)?

(ii) Would you use different parameters (different from average number of trades per day, average nominal amount per day and number of days traded) or the same parameters (different from the average number of trades per day, average nominal amount per day and number of days traded) or the same parameters but different thresholds in order to define a bond or a SFP as liquid?

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

ICMA Response

57.1.2.3 – Summary:

ICMA welcomes ESMA's efforts to determine liquidity in the bond market. The bond market is a heterogeneous market not a homogeneous market. It is quite complex, made up of moving parts such as maturity dates, coupons, multiple currencies and cyclicality. Due to its complexity, ICMA considers the only true way to calibrate liquidity is daily (trading) behaviour. Any other methodology will generate a high proportion of false liquidity as evidenced in ESMA's data.

Therefore, ESMA's proposals need considerable refinement if they are to become 'fit for purpose' in serving the needs of all market participants in the international bond markets, including investors. ICMA also understands ESMA's ambition to devise a regime for classification which is reasonably simple to implement. ICMA hopes to prove our response to be both 'fit for purpose' and simplified.

The ICMA response is two pronged. First as our preferred response, we consider it is necessary (if the classification is to be sensitive enough) to include elements of the Instrument by Instrument Approach (IBIA) alongside COFIA (Class by Class) in a 'Hybrid' approach. We have deliberately designed the 'Hybrid' approach as far as possible to meet ESMA's 'simplicity and predictability of calculation' criterion as explained in detail below in Table 1. We consider that it is not possible to protect the interests of market users properly using COFIA alone. If, despite the arguments highlighted in Section 3, ESMA continues to be of the view that COFIA alone is necessary - in the interest of regulatory simplicity, it will be vital to at least reduce the 'Large in Scale' (LIS) and 'Size Specific to The Instrument' (SSTI) thresholds for determining market transparency obligations. This is explained in the second part of our answer and detailed in Table 2 below.

A major reason why ICMA has proposed a hybrid IBIA/COFIA model as our preferred method of determining liquidity is that on page 104 of the MiFID II ESMA Consultation Paper in Table 5, between 42% and 74% of the instruments listed by ESMA as liquid are in fact illiquid. Throughout ESMA's discussion of COFIA, ESMA has materially understated the importance and number of false positives (inaccurate classification of instruments and trades as liquid when in fact they are illiquid) that COFIA throws up. Such a high level of false positives (between 42% and 74%) would clearly be inappropriate, and will be highly damaging to the markets, including investors. We describe in Section 3 examples of the type of problem that ESMA's proposed COFIA approach would cause, and the types of impact that 'false positives' will have on the investor community, a major end-user of the bond markets. Furthermore, ICMA supports the analysis detailed in The Association for Financial Markets in Europe's Tables in their official response to the MiFID II Consultation Paper.

Q57 (i)

Would you use different qualitative criteria to define the sub-classes with respect to those selected (i.e. bond type, debt seniority, issuer sub-type and issuance size)?

ICMA response:
ICMA disagrees with the subclass criteria defined in the Consultation Paper. ICMA considers that ESMA's definition of a liquid market for bonds needs more granularity in order to define more homogeneous classes, therefore we recommend different criteria. These sub-classes are set out in our proposed Liquidity Determination tables below.

Q57 (ii)

Would you use different parameters (different from average number of trades per day, average nominal amount per day and number of days traded) or the same parameters but different thresholds in order to define a bond or a SFP as liquid?

ICMA response:

ICMA disagrees with parameters and thresholds as defined in the Consultation Paper. ICMA considers that ESMA's definition of a liquid market and its parameters and thresholds for bonds needs refinement. We therefore recommend different criteria. These new/modified parameters and thresholds are set out in our proposed Liquidity Determination tables below.

Q57(iii)

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

ICMA response:

ICMA disagrees with ESMA's view as to where it is appropriate to set the boundary between liquid and illiquid classes, and considers that ESMA's definition of a liquid market for bonds needs more refinement and calibration (including criteria, parameters and thresholds). As explained in the summary above, ESMA's proposals would result in far too high a level of false positives. We therefore set out below ICMA's proposed Liquidity Determination Tables 1. Table 2 below is our secondary or reserve approach to determining liquidity.

57.1.2.3 - ICMA Proposed Solutions:

Key: In the following tables, an instrument would need to satisfy the criteria in each column in order to be deemed liquid. In all other cases, an instrument should be deemed illiquid. Failure to meet any single criterion should result in an instrument being classified as illiquid.

(I) Liquidity Determination Table 1: Hybrid - Granular COFIA with IBIA Liquidity Gate*

Liquidity Gate*	Issuance Size (EUR)	Credit Rating	Currency	Time since issuance	Time to Maturity	Bond Characteristics ****
EU Sovereign Bonds						
< 4 Bps Daily Avg Spread (firm price)	>= 2bn outstanding	IG or IG equivalent	EUR	Up to 4 weeks	< 30 years	Standard
< 4 Bps Daily Avg Spread (firm price)	>=5bn outstanding	IG or IG equivalent	EUR	4 weeks to 3 years	< 30 years	Standard

Liquidity Gate*	Issuance Size (EUR)	Credit Rating	Currency	Time since issuance	Time to Maturity	Bond Characteristics ****
< 4 Bps Daily Avg Spread (firm price)	>=10bn outstanding	IG or IG equivalent	Non-EUR	4 weeks to 3 years	< 30 years	Standard
Non-EU Sovereign Bonds						
< 4 Bps Daily Avg Spread (firm price)	>=2bn outstanding	IG or IG equivalent	USD	Up to 4 weeks	< 30 years	Standard
< 4 Bps Daily Avg Spread (firm price)	>=2bn outstanding	IG or IG equivalent	JPY	Up to 4 weeks	< 30 years	Standard
< 4 Bps Daily Avg Spread (firm price)	>=5bn outstanding	IG or IG equivalent	USD	4 weeks to 3 years	< 30 years	Standard
Senior corporate bonds						
< 4 Bps Daily Avg Spread (firm price)	>=750mn outstanding	IG or IG equivalent	EUR	Up to 4 weeks	< 30 years	Standard
< 4 Bps Daily Avg Spread (firm price)	>=1.25bn outstanding	IG or IG equivalent	EUR	4 weeks to three years	< 30 years	Standard
Subordinated corporate bonds						
< 4 Bps Daily Avg Spread (firm price)	>=500mn outstanding	IG or IG equivalent	EUR	Up to 4 weeks	< 30 years	Standard

Liquidity Gate*	Issuance Size (EUR)	Credit Rating	Currency	Time since issuance	Time to Maturity	Bond Characteristics ****
< 4 Bps Daily Avg Spread (firm price)	>=1bn outstanding	IG or IG equivalent	EUR	4 weeks to 3 years	< 30 years	Standard
Covered bonds						
< 4 Bps Daily Avg Spread (firm price)	>=750mn outstanding	IG or IG equivalent	G7**	Up to 6 months	< 30 years	Standard
Convertible bonds (excluding contingent conversion bonds)						
< 4 Bps Daily Avg Spread (firm price)	>=750mn outstanding	IG or IG equivalent	G7**	Up to 6 months	< 30 years	Standard

***Liquidity Gate =** IBIA calculation using 'average spread'. An average spread 'gate' (movable barrier) is used, due to MiFIR Level 1 language.

****IG** = Investment Grade (Bonds that are judged by a **rating** agency (s) as likely enough to meet payment obligations. Banks are allowed to invest in them. E.g. A bond is considered **investment grade** or IG if its **credit rating** is BBB- or higher by Standard & Poor's or Baa3 or higher by Moody's.)

*** **G7 =** EUR, USD, JPY, GBP, CAD, AUD, CHF

**** Standard Bond Characteristics include (i) fixed coupon and (ii) constant notional.

Liquidity Determination Table 1: Hybrid - Granular COFIA with IBIA Liquidity Gate – Reasoning:

Table 1 - MiFIR Level 1 Definition of a 'Liquid Market':

For ICMA's preferred approach, 'Hybrid - Granular COFIA with IBIA Liquidity Gate'; Level 1 text of MIFIR, Article 2(17) explicitly foresees the ***use of average spreads*** to determine liquidity:

MiFIR Level 1 states:

Article 2 (17) (a) (i) (ii) (iii):

(17) 'liquid market' means:

(a) for the purposes of Articles 9, 11, and 18, a market for a financial instrument or a class of financial instruments, where there are ready and willing buyers and sellers on a continuous basis, and where the market is assessed in accordance with the following criteria, taking into consideration the specific market structures of the particular financial instrument or of the particular class of financial instruments:

(i) the average frequency and size of transactions over a range of market conditions, having regard to the nature and life cycle of products within the class of financial instrument;

(ii) the number and type of market participants, including the ratio of market participants to traded financial instruments in a particular product;

(iii) **the average size of spreads, where available**;

Liquidity Determination Table 1: Hybrid - Granular COFIA with IBIA Liquidity Gate – Reasoning:

Table 1 - MiFIR Level 1 - Obligation to offer trade data on a separate and reasonable commercial basis:

MiFIR clearly states below a requirement to collect pre- trade and post trade data, available on a reasonable commercial basis. ICMA considers there will be the necessary mechanism in place (to calibrate daily) and in time to be compliant with ESMA's obligations regarding liquidity determination, to meet Table 1's proposed methodology. Please refer to relevant MiFIR Level 1 wording below:

MiFIR Level 1 states:

Title II - Transparency for Trading Venues

Chapter 3 - Obligation to offer trade data on a separate and reasonable commercial basis

Article 12.1

Obligation to make pre-trade and post-trade data available separately

Market operators and investment firms operating a **trading venue shall make the information published** in accordance with Articles 3, 4 and 6 to 11 (MiFIR – Title II Transparency for Trading Venues) **available to the public by offering pre-trade and post-trade transparency data separately.**

Article 13.1

Obligation to make pre-trade and post-trade data available on a reasonable commercial basis

Market operators and investment firms operating a trading venue shall make the information published in accordance with Articles 3, 4 and 6 to 11 (MiFIR – Title II Transparency for Trading Venues) **available to the public on a reasonable commercial basis and ensure non-discriminatory access to the information.** Such information shall be made available free of charge 15 minutes after publication.

TITLE III - Transparency for systematic internalisers and investment firms trading OTC

Article 14

Obligation for systematic internalisers to make public firm quotes in respect of shares, depositary receipts, ETFs, certificates and other similar financial instruments

Article 18.8

Obligation for systematic internalisers to make public firm quotes in respect of bonds, structured finance products, emission allowances and derivatives

The quotes published pursuant to paragraph 1 and 5 (see below) and those at or below the size referred to in paragraph 6 (see below) **shall be made public in a manner which is easily accessible to other market participants on a reasonable commercial basis.**

Paragraph 18.1: Investment firms shall make public firm quotes in respect of bonds, structured finance products, emission allowances and derivatives traded on a trading venue for which they are systematic internalisers and for which there is a liquid market when the following conditions are fulfilled:
(a) they are prompted for a quote by a client of the systematic internaliser;
(b) they agree to provide a quote.

Paragraph 18.5: Systematic internalisers shall make the firm quotes published in accordance with paragraph 1 available to their other clients. Notwithstanding, they shall be allowed to decide, on the basis of their commercial policy and in an objective non-discriminatory way, the clients to whom they give access to their quotes. To that end, systematic internalisers shall have in place clear standards for governing access to their quotes. Systematic internalisers may refuse to enter into or discontinue business relationships with clients on the basis of commercial considerations such as the client credit status, the counterparty risk and the final settlement of the transaction.

Paragraph 18.6: Systematic internalisers shall undertake to enter into transactions under the published conditions with any other client to whom the quote is made available in accordance with paragraph 5 when the quoted size is at or below the size specific to the financial instrument determined in accordance with Article 9(5)(d).

Note: Table 1 (unlike Table 2) has no implication for RTS 9

(II) Liquidity Determination Table 2: <u>Granular COFIA w/tiered LIS and SSTI thresholds (calculation including trades below €100k)</u>

LIS: percentile of transactions in class	**SSTI: percentile of transactions in class***	**Issuance Size**	**Credit Rating**	**Currency**	**Time since issuance**	**Time to Maturity**	**Bond Characteristics**
EU Sovereign Bonds							
75%	35%	>= 2bn outstanding	IG or IG equivalent	EUR	Up to 4 weeks	< 30 years	Standard
75%	35%	>=5bn outstanding	IG or IG equivalent	EUR	4 weeks to 3 years	< 30 years	Standard
75%	35%	>=10bn outstanding	IG or IG equivalent	Non-EUR	4 weeks to 3 years	< 30 years	Standard
Non-EU Sovereigns							
75%	35%	>=2bn outstanding	IG or IG equivalent	USD	Up to 4 weeks	< 30 years	Standard

75%	35%	>=2bn outstanding	IG or IG equivalent	JPY	Up to 4 weeks	< 30 years	Standard
75%	35%	>=5bn outstanding	IG or IG equivalent	USD	4 weeks to 3 years	< 30 years	Standard
Senior Corporate Bonds							
50%	25%	>=750mn outstanding	IG or IG equivalent	EUR	Up to 4 weeks	< 30 years	Standard
50%	35%	>=1.25bn outstanding	IG or IG equivalent	EUR	4 weeks to three years	< 30 years	Standard
Subordinate Corporate Bonds							
50%	25%	>=500mn outstanding	IG or IG equivalent	EUR	Up to 4 weeks	< 30 years	Standard
50%	25%	>=1bn outstanding	IG or IG equivalent	EUR	4 weeks to 3 years	< 30 years	Standard
Covered Bonds							
50%	25%	>=750mn outstanding	IG or IG equivalent	G7*	Up to 6 months	< 30 years	Standard
Convertible Bonds (excluding contingent conversion bonds)							
75%	35%	>=750mn outstanding	IG or IG equivalent	G7*	Up to 6 months	< 30 years	Standard

***Percentile of transactions in a class:** The trade size corresponding to the trade below which lies the percentage specified in (the above Table 2) of all the transactions executed for the relevant class of bonds.

Liquidity Determination Table 2: Granular COFIA w/tiered LIS and SSTI thresholds (calculation including trades below €100k) - Reasoning:

Table 2 – ESMA Consultation Paper wording: 3.5 (35) (p. 100):

35. ESMA is aware of the risks that might arise from COFIA. Therefore, ESMA intends to design it with an **appropriate level of granularity and will strive to remedy the possible weaknesses.** In particular, if some relatively illiquid instrument happens to be wrongly classified as liquid, it is important that the potential adverse impact on liquidity is mitigated by means of the waivers and deferrals for transactions that are large-in-scale ('LIS') or above the size specific to the instrument ('SSTI').

Table 2 - Regulatory Technical Standard Amendment - RTS 9:

Proposed modified wording (in *italics*):

Article 11. 2 (a)

The large in scale (LIS) size referred to in paragraph 1(a) of this Article, shall be determined as the trade size corresponding to the trade below which lies ~~90%~~ *the percentage specified in (ICMA's Table 2)* of all the transactions executed for the relevant class of bonds; ~~*and*~~

~~*(b) the trade size corresponding to the trade below which lies 70% of the total volume of the transactions executed for this class of financial instruments; and*~~

~~*(c) The large in scale threshold floor as provided for in Table 47 of Section 11 of Annex III for the corresponding class.*~~

Article 11. 6

The size specific to the financial instrument referred to in paragraph 1(b), shall be calculated as ~~50%~~ *the trade size corresponding to the trade below which lies the percentage specified in (ICMA's Table 2) of all the transactions executed for the relevant class of bonds.*

57.1.2.3 - Unintended consequences of false positives:

It is important to understand the practical impacts for investors of inaccurate classification of instruments and trades as 'liquid' when they are in fact illiquid (false positives). The risks of withdrawal of liquidity provision (liquidity crunch) and severe market volatility could materially damage the ability to trade in secondary markets. In turn, loss of confidence in secondary markets might damage willingness to issue and invest in primary markets. As ESMA knows, Capital Markets Union is probably the most important plank of the European Commission's and European Union's policy development over the next five years. Our suggested 'Hybrid' approach is specifically designed to align ESMA's Technical Standards as closely as possible to the Capital Markets Union agenda.

Examples of Unintended Consequences of 'False Positives' in the Investor Community:

<u>'False Positive' Example 1</u>:
Routinely, Asset Managers/Investment Managers receive client instructions to liquidate their portfolios in adverse risk conditions. This is contractually agreed between the asset manager portfolio manager and the client (pension funds, insurance companies or large corporates). The result can be two-fold: first they may not be able to liquidate at all, particularly now in a shrunken balance sheet environment. Secondly, the price may be so disadvantageous that it corrupts the funds' performance.

<u>'False Positive' Examples 2</u>:
Public Funds are increasingly collateralised with OTC instruments such as bonds. E.g. Bond ETFs. Collateralisation is a daily and sometimes intraday process. If the collateral is advertised as liquid but is in fact, illiquid then this could put the underlying client at risk. This client could be a pension scheme or an insurance company or even a bank treasury (creating problems with balance sheets). Furthermore, the situation will create *forced* behaviour such as unavoidable buying and selling of bonds, resulting in more illiquidity in the market.

<u>'False Positive' Examples 3</u>:
Liquidity scores in Investment Managers:

Generally a senior portfolio manager at an Investment Manager must sign off on a liquidity score of a given fund. The individual security components have all been given a score, and an aggregate is produced for the client to review.

Hypothetically: A Fund has a liquidity score of 65% (using independent third-party service to ascertain the relative liquidity per individual ISIN). The client who has entrusted money, etc. will review and make informed decisions.

Investment Manager A has assigned a liquidity score of 65% to UCITS fund A. Additionally, Investment Manager B may have assigned a liquidity score of 55% to UCITS fund B. Fund A and Fund B hold the same amounts and same percentages of the specific securities (bonds in this example), but use different methodologies in calculating liquidity (hence different Liquidity scores). These methodologies are the tried and tested methodologies for the respective Investment Managers. Investment Managers discuss with their clients explaining to them; what they are holding and why and how the client can liquidate a certain 'liquid' portion, at the client's request. In which case, the 'liquid' securities can be immediately sold, as they are not considered particularly price sensitive.

Now, in MiFID II ESMA introduces a classification allowing classes of bonds, (not individual securities) to be either liquid or illiquid based on pure COFIA. ESMA's COFIA proposal identifies a large percentage of 'false positives', anywhere from 42% to 74%. Suddenly (under new MiFID II rules), the UCITS Funds above have new liquidity scores of perhaps 40% (for example). COFIA has changed the agreed Liquidity score and the data the client (together with the Investment Manager) made his 'informed' decision from.

So, what does this mean? The European client or end user (Pension Fund, State Treasury etc) as part of his fiduciary responsibilities may have made his decision to invest €100m based on a liquidity score of above 50%. This information and resulting decision is now incorrect. The Investment Manager immediately appears to be mis-managing the client's funds. The client who has agreed he can liquidate perhaps 20% of his portfolio quickly, in time of need may at that time have to pay a very high price to execute, if that portion is in fact illiquid according to ESMA's new rules. Therefore, the end user (EU Pension fund, EU Member State Treasury etc) is punished for the mis-calibrated ESMA simplified COFIA methodology.

All three examples highlight the dangers of 'false positives' and the threat to an EU functioning end user (EU Pension fund, EU Member State treasury, EU large corporate) based market. This is particularly relevant as Europe transitions closer towards a Capital Markets Union.

Q58.

Do you agree with the definitions of the bond classes provided in ESMA's proposal (please refer to Annex III of RTS 9)? Please provide reasons for your answer.

ICMA response:
ICMA disagrees moderately with ESMA's bond class definitions in Section 1 of RTS 9. Please note the modified definitions in RTS 9.

Regulatory Technical Standard Amendment - RTS 9:
Proposed modified wording (in *italics*):
Recital 11 should be amended, as follows:
"For the purposes of this Regulation, plain vanilla covered warrants, leverage certificates, exotic warrants, exchange-traded-commodities; exchange-traded notes, negotiable rights and structured

medium-term-notes (and other structured debt securities) should be considered securitised derivatives. This is not meant to be an exhaustive list of securitised derivatives."

Annex III:

(1) The definition of "bond" should be amended, as follows:
'Bond' means a transferable security that is constituted by an order, promise, engagement or acknowledgement to pay on demand, or at a determinable future time, a sum in money to, or to the order of, the holder of one or more units of the security. It includes depositary receipts representative of bonds falling within Article 4(1)(44)(b) of Directive 2014/65/EU which is not a structured finance product or a structured debt security.

(5) The definition of "convertible bond" should be amended, as follows:
'Convertible bond' means an instrument consisting of a bond or a securitised debt instrument with an embedded derivative, such as an option to buy the underlying equity acquire shares of an issuer or a member of the issuer's group.

Section 2:
The definition of "securitised derivatives" should be amended, as follows:
'Securitised derivative' means a structured debt security or a transferable security as defined in falling within Article 4(1)(44)(c) of Directive 2014/65/EU different from which is not a structured finance product.

New Definitions:

"Structured debt security" should be included, as follows:
"Structured debt security" means a transferable security falling within Article 4(1)(44)(b) of Directive 2014/65/EU with an embedded derivative which is not a convertible bond.

Q70.

Do you agree with ESMA's proposal with regard to the content of pre-trade transparency? Please provide reasons for your answer.

ICMA response:
ICMA disagrees with the content of pre-trade transparency as we would like to add to the 'content' for consideration for pre –trade transparency. ICMA recommends that ESMA augment non- equities asset classes - "bonds, structured finance products, emission allowances and derivatives" to include: combinations of these asset classes or combination within these asset classes. This combination of asset class instruments are 'package transactions' (a transaction comprising two or more components, each of which is a *bond, structured finance product, or derivative* where:

- The components are priced as a "package" with simultaneous execution of all such components;
- The execution of each component is contingent on the execution of the other components;
- Each component must be able to stand alone and must be able to bear economic risk; and
- either:
    i. the components are economically similar in nature such that the pricing of one component can affect the pricing of the other component; or

ii. the components must have a reasonable degree of correlation;

We would welcome clarification from ESMA that all components of a package have to be tradeable on a single venue in order that the package be considered "traded on a venue".

Note: the December 2014 MiFID II Consultation Paper does not address how these transactions might be treated under the new regulatory framework. ICMA recommends recognising specific tailored treatment and understanding for 'package transactions' as follows:

I. 'Package transactions' should be considered in its entirety when being assessed as subject to transparency.

II. 'Package transactions' should be considered as assisting end users to reduce transaction costs. E.g. a single transaction (less expensive to execute than multiple transactions)

III. 'Package transactions' should be considered to contribute to managing execution risk. E.g. a single execution (alleviates timing and other mechanical/process risks)

The MiFIR Level 1 text clearly identifies non equities as asset classes: "bonds, structured finance products, emission allowances and derivatives". However, both Level 1 and Level 2 fail to identify instruments that are combinations of these asset classes or combination within these asset classes. 'Package transactions' are such instruments and should be taken into consideration in pre -trade MiFIR Level 2 obligations. As ESMA has not identified these actively traded instruments in either MiFIR Level 1 or Level 2, ESMA has the scope and flexibility for the additional 'package transactions'. Below are also suggested modifications to RTS 9 to include 'package transactions'.

Unintended consequences:
If ESMA fails to provide for the appropriate trading of packages, investors will be required to trade the components independently, resulting in increased transaction costs and increased execution risks. There is considerable risk to market participants if such transactions are no longer available to market participants in the EU. This could be due to individual components being treated differently and inconsistently vs. each other: These challenges are likely to be particularly acute where one or more of the components of a package transaction include bonds subject to the trading obligation:

- Where some components of a package transaction are traded on a trading venue but others are not;
- Where some components of a package transaction are deemed liquid but others are not;
- Where some components of a package transaction are above the relevant LIS or SSTI thresholds but others are not;
- If the components of a package of transaction is below the relevant LIS or SSTI but together they behave similar to a single transaction above the LIS or SSTI; and
- Where the package transaction contains bonds or derivatives which trade on a different trading venue to other components

<u>Question 70 - Regulatory Technical Standard Amendment: RTS 9:</u>
Proposed modified wording (in *italics*):
Article 2. 1 (a) (b), 2. 2 (a) (b), 2. 3, 2. 4

For the purpose of Article 8 of Regulation (EU) No 600/2014, market operators and investment firms operating a trading venue shall, in accordance with the trading system they operate, make public information in respect of bonds, structured finance products, emission allowances and derivatives as specified in Annex I.

1. *Subject to point 3 below, if each component of a package transaction is liquid:*
   a. The package transaction should be considered liquid; and

   *b. If any one component is above the relevant threshold (LIS or SSTI) then the package transaction should be deemed to be above the threshold. **

2. *Subject to point 3 below, if the package transaction contains liquid and illiquid components:*
   a. The package transaction should be considered illiquid; and

   *b. If any one component is above the relevant threshold (LIS or SSTI) then the package transaction should be deemed to be above the threshold. **

3. *For the purposes of MiFIR Articles 8(1), 10(1), 18(1) and 18(2), all components of a package have to be tradable on a single venue in order that the package be considered "traded on a venue".*

4. *If the package transaction comprises ten or more component legs, the package transaction should be considered illiquid.*

**The International Swaps and Derivative Association's response contains alternative formations of these two clauses. ICMA is supportive of both of the alternatives presented by The International Swaps and Derivative Association.*

Q76.

Do you agree that securities financing transactions and other types of transactions subject to conditions other than the current market valuation of the financial instrument should be exempt from the reporting requirement under article 21? Do you think other types of transactions should be included? Please provide reasons for your answers.

ICMA response:
Yes. ICMA agrees (for the reasons ESMA provides) that securities financing transactions and primary market transactions should be exempt from the reporting requirement under Article 21.

Q77.

Do you agree with ESMA's proposal for bonds and SFPs? Please specify, for Q77 each type of bonds identified, 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

ICMA response:
ICMA observes that a deferral period of 48 hours in fixed income is shorter than the maximum deferral period available under MIFID 1 for equities. It seems to be restrictive for very large or illiquid trades in fixed income, though this restriction may be compensated by effective and consistent operation of the extended deferral regimes. In addition, It is important for consistency of implementation across Europe (and to eliminate arbitrage and uncertainty) that ESMA does all it can to encourage all jurisdictions apply the same 48 hour period, and not expressed as 'up to 48 hours'. In addition, to avoid trades done late on a Friday not benefitting from the necessary deferall, the deferral period should be set to 2 business days.

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

ICMA response:
ICMA considers that it is inappropriate to set SSTI at such a high percentage of LIS, particularly for pre trade transparency. Such a high threshold will discourage liquidity provision. Furthermore, under the Systematic Internaliser obligations, a threshold of 50% means that two SSTI level trades would be executed before the firm has taken on risk equivalent to the LIS threshold, which would cause SI's to limit the number of executions they will limit to very low levels that cannot have been the intention of MiFIR.

There is no rationale for choosing 50% (as opposed to another percentage) and its link to the LIS threshold means that the SSTI threshold is unlikely to result in 50% of trades in a sub-class actually falling below the SSTI threshold. Use of a 50% ratio does not appear to have factored in the elements required by MiFIR under article 5(d), specifically whether liquidity providers are able to hedge their risks, and the extent of retail participation (although we recognise the practical challenges of incorporating these factors).

Furthermore, as ESMA seems to view the waiver and deferral regimes as a way to reduce the detrimental impact of an illiquid instrument being incorrectly assessed as liquid, we urge ESMA to ensure that the LIS and SSTI thresholds are set at levels sufficiently low in order to compensate for inaccuracies in the liquidity calibration.

We propose instead that setting the SSTI at a level which covers a specified percentage of transactions (no higher than the median transaction size) would be more appropriate, though there may be potential for a higher level for post-trade transparency. The appeal of using a method based directly on the distribution of trade sizes is that ESMA can be sure that a predictable proportion of transactions in any liquid sub-class would be subject to pre-trade transparency, and would not experience deferred publication. We consider it would accord better with a normal market transaction at which liquidity providers could be reasonably expected to hedge their risks (as per MiFIR Article 9(5)(d). Furthermore, breaking the link to LIS would prevent the SSTI being skewed by individual, large transactions (which could result under ESMA's current proposal for LIS calibration).

The relevant percentages that ICMA recommends using are shown in Table 2 below. For those classes where the COFIA results in the highest false positive rates of bonds determined to be liquid that are in fact illiquid (e.g. corporate bonds and covered bonds), we recommend that the relevant percentile be 25%, whilst for those classes where the COFIA achieves less poor classification (e.g.

EU and non-EU sovereign bonds), we recommend that the relevant percentile be 35%. If ESMA is able to refine its COFIA such that it materially reduces false positive rates (as shown in column 8 of the table on page 104 of the Consultation Paper) below 20%, the relevant percentage used to set SSTI could be 50% (i.e. the median trade size for a given class).

(3) Volume measure used to set the large in scale threshold as specified in Annex II, Table 3 of draft RTS 9

ICMA response:
ICMA agrees with ESMA's proposals. But ESMA must use all trade sizes when calibrating LIS and SSTI, and should not consider excluding transactions below €100,000k.

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

ICMA response:
As noted under Q77(3) above, ICMA considers that for pre trade transparency a level of 10% of LIS would be more appropriate, though there may be potential for a higher level for post-trade transparency.

(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.

ICMA response:
As described in our response to Q57, ESMA can compensate for weaknesses of its liquidity determination by setting LIS and SSTI at low levels. We were encouraged by the statements made in Paragraph 35 on page 100 of the Consultation Paper in this regard, since this is an important method of compensation. However, we are disappointed that ESMA has not in fact embedded this compensation into its proposals. LIS and SSTI are proposed by ESMA to be calibrated using the same methodology (in terms of percentiles of volumes and transactions) regardless of how granularly classes are defined or regardless of how many illiquid instruments are classified as liquid in a given class. For example, ESMA's methodology is the same for the Bund Future (shown in Table 2 of Annex III of RTS9), which is a single instrument and for which the liquidity determination is accurate, as for covered bonds, a class for which table 5 on page 104 of the Consultation Paper identifies 74% of bonds labelled as liquid by ESMA are in fact illiquid (on ESMA's test, which is itself questionable as to whether it meets the description of a liquid market).

ICMA proposes that ESMA calibrate LIS and SSTI differently depending on how good a fit COFIA achieves for any given class.

As an illustration of what this looks like in practice, we have repeated below Table 2 from our response to Question 57. The first column proposes different percentiles for different asset classes, with lower percentiles (the median trade size) to be used for the classes for which the

COFIA delivers the least accurate results (although for no asset class, do we consider a threshold higher than the 75th percentile of transactions to be appropriate).

Liquidity Determination Table 2: Granular COFIA w/tiered LIS and SSTI thresholds (calculation including trades below €100k)

LIS: percentile of transactions in class	SSTI: percentile of transactions in class	Issuance Size	Credit Rating	Currency	Time since issuance	Time to Maturity	Bond Characteristics
EU Sovereign Bonds							
75%	35%	>= 2bn outstanding	IG or IG equivalent	EUR	Up to 4 weeks	< 30 years	Standard
75%	35%	>=5bn outstanding	IG or IG equivalent	EUR	4 weeks to 3 years	< 30 years	Standard
75%	35%	>=10bn outstanding	IG or IG equivalent	Non-EUR	4 weeks to 3 years	< 30 years	Standard
Non-EU Sovereigns							
75%	35%	>=2bn outstanding	IG or IG equivalent	USD	Up to 4 weeks	< 30 years	Standard
75%	35%	>=2bn outstanding	IG or IG equivalent	JPY	Up to 4 weeks	< 30 years	Standard
75%	35%	>=5bn outstanding	IG or IG equivalent	USD	4 weeks to 3 years	< 30 years	Standard
Senior Corporate Bonds							
50%	25%	>=750mn outstanding	IG or IG equivalent	EUR	Up to 4 weeks	< 30 years	Standard
50%	25%	>=1.25bn outstanding	IG or IG equivalent	EUR	4 weeks to three years	< 30 years	Standard
Subordinate Corporate Bonds							
50%	25%	>=500mn outstanding	IG or IG equivalent	EUR	Up to 4 weeks	< 30 years	Standard
50%	25%	>=1bn outstanding	IG or IG equivalent	EUR	4 weeks to 3 years	< 30 years	Standard
Covered Bonds							
50%	25%	>=750mn outstanding	IG or IG equivalent	G7*	Up to 6 months	< 30 years	Standard
Convertible Bonds (excluding contingent conversion bonds)							
75%	35%	>=750mn outstanding	IG or IG equivalent	G7*	Up to 6 months	< 30 years	Standard

(a) ICMA considers that thresholds should be recalculated annually using the above methodology.

(b) We agree with use of the 90th percentile of transaction sizes to calibrate the LIS since consideration of trade sizes is a methodology consistent with a natural reading of a "trade that is large in scale compared to normal market size". We don't consider that the threshold that covers 70% percent of volumes is an appropriate means of deriving a trade that is consistent with such a natural reading, appears to be an arbitrary method contrived in order to derive an extra-large number, and has the potential to be skewed by isolated extremely large transactions.

(c) There should be no LIS floor: there is no mandate in the Level 1 text to create such a floor, which would lead to a false LIS level.

(d) Rounding should be simple mathematical rounding to the nearest round figure. There should not be systematic rounding up of values, since this inappropriately skews outcomes. €100,000 trades or below should not be excluded from the assessment.

<u>Question 77 - Regulatory Technical Standard Amendment: RTS 9</u>
Proposed modified wording (in *italics*):
Article 8 (1)
The deferred publication of information in respect of transactions may be authorised by the competent authority in accordance with Article 11(1) of Regulation (EU) No 600/2014, for a period of ~~*no longer than*~~ 48 hours for bonds, structured finance products, derivatives and emission allowances, provided that one of the following criteria is satisfied:

Article 11.2 (a) (c)
The large in scale (LIS) size referred to in paragraph 1(a) of this Article, shall be determined as the greater of:
(a) the trade size corresponding to the trade below which lies ~~90%~~ *the percentage specified in (ICMA's Table 2)* of all the transactions executed for this class of financial instruments; ~~*and*~~
~~*(b) the trade size corresponding to the trade below which lies 70% of the total volume of the transactions executed for this class of financial instruments; and*~~
~~*(c) The large in scale threshold floor as provided for in Table 47 of Section 11 of Annex III for the corresponding class.*~~
(c) <u>until 30 April 2018,</u> the large in scale threshold floor as provided for in Table 47 of Section 11 of Annex III for the corresponding class.

Article 11.3 (b) (c)
The threshold determined in accordance to paragraph (2) shall be rounded ~~up~~ to the *nearest:*

(a) 100,000 if the threshold value is smaller than 1 million;
(b) 500,000 if the threshold value is equal to or greater than 1 million but smaller than 10 million;
(c) 5 million if the threshold value is equal to or greater than 10 million but smaller than 100 million;
(d) 25 million if the threshold value is equal to or greater than 100 million~~.~~

Article 11.5

The trade size, *nominal trades per day including trades below €100k)* and the total volume of the transactions referred to in paragraph 2(a) ~~*and (b)*~~ should be determined for the class in question as specified in Table 3 of Annex II of this Regulation.

Article 11.6

The size specific to the financial instrument referred to in paragraph 1(b), shall be calculated as ~~*50%* of the corresponding large in scale size as determined in accordance with paragraphs 2, 3, 4 and 5~~ *the trade size corresponding to the trade below which lies the percentage specified in (ICMA's Table 2) of all the transactions executed for the relevant class of bonds.*

Q83.

Do you agree with ESMA's proposal in relation to the supplementary deferral regime at the discretion of the NCA? Please provide reasons for your answer.

ICMA response:

ICMA agrees that the framework of the supplementary deferral regime is consistent with the Level 1 text. Given the international nature of capital markets, it will be important to encourage a consistent application of the supplementary deferral regime as possible, in order to minimise problems with cross-border transactions, and to promote a level playing field across Europe.

However, ICMA does not agree that 4 weeks' deferral is long enough to enable firms to protect certain trades. Quite often in order to hedge a large trade, it takes firms much longer than 4 weeks. For trades that are both large and illiquid, a longer deferral period is necessary, we consider 12 weeks to be an acceptable minimum deferral for such trades.

Q84.

Do you agree with ESMA's proposal with regard to the temporary suspension of transparency requirements? Please provide feedback on the following points:

(1) The measure used to calculate the volume as specified in Annex II, Table 3
(2) The methodology as to assess a drop in liquidity
(3) The percentages determined for liquid and illiquid instruments to assess the drop in liquidity. Please provide reasons for your answer.

ICMA response - 84, (1), (2), (3):

ICMA does not agree with ESMA's proposal. COFIA is unworkable for temporary suspensions: it would be necessary for the whole market in a class to collapse before a temporary suspension came into effect. ESMA's proposed 30 day look-back and opinion would come too late for the needs of market participants. The measure needs to be able to come into effect immediately. The approach based on 12 months' previous activity may not be an accurate indicator, as markets may move significantly over a 12 month period (this may not be a 'market event', justifying temporary suspension). In contrast, an increase in activity may be an indicator of a 'market event', justifying suspension.

Q215.

In your view, is there any other outcome or activity that should be excluded from the definition of transaction or execution? Please justify.

ICMA response:

ICMA disagrees with the exclusions from the definition of transaction or execution. There may be a difference in the implementation timing of MiFIR and the Securities Financing Transaction Regulation ("SFTR"), as well as potential exemptions from reporting under the SFTR which may not be carried through to the MiFIR reporting framework under the current draft of Article 3(3)(a) of RTS 32.

We do not consider that investment firms should be required to report SFTs under MiFIR for the period between MiFIR implementation and SFTR implementation, nor should they need to transaction report particular SFTs if such transactions are exempt from reporting under SFTR. We therefore suggest redrafting Article 3(3)(a) in order to avoid any such consequences – we would suggest that the Article is re-drafted simply to read "Securities financing transactions", and that an additional definition of "securities financing transaction" as is used in RTS 8 could be added to RTS 32 – namely "securities financing transactions means an instance of stock lending or stock borrowing or the lending or borrowing of other financial instruments, a repurchase or reverse repurchase transaction, or a buy-sell or sell-buy back transaction.