Securities and Markets Stakeholder Group

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ADVICE TO ESMA

Transparency for the trading of non-equity instruments

I. Executive summary

The advice is based on Consultation and Discussion papers published by ESMA and finds these in line with the requirements of European legislation at Level 1. Recognising that this is new ground for regulation, we point out areas where special care must be exercised in specifying Regulatory Technical Standards (RTS).It is pointed out that mistakes in specifying thresholds may prove costly and regulatory flexibility must be enhanced, at the level of the legislative process itself. It is also pointed out that where markets have already specified transparency requirements, ESMA's RTS must ensure that the level of transparency is improved. A final general point is that transparency and liquidity must reinforce each other in the long-run and not damage each other in the short-run. Several more technical points are adduced including differences in liquidity over the life-cycle of non-equity instruments, differences between bonds and bond-like instruments from derivative contracts that imply different treatments, and the need for more stringent rules for post- as compared to pre-trade transparency.

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II. Opinion on Transparency for trading of non-equity instruments

1. The SMSG agrees with ESMA that this is a very important area, as it breaks new ground in European regulation and broadens very considerably the scope of application of transparency requirements. So far, experience with transparency requirements has been concentrated on the equity side of the markets and the experience with non-equity instruments is limited to rules and requirements which have been applied by specific organized markets and trading venues.

1. We have considered the contents of both the Consultation and the Discussion Papers and have focused on central issues presented and analyzed in the Discussion Paper. In our deliberations we have taken fully into account the content of the Level 1 text and the scope which this imposes on ESMA's work with respect to the specification of Regulatory Technical Standards (RTS).

2. The members of the SMSG are in broad agreement that ESMA's approach is generally in line with the level 1 requirements of MIFID II/MIFIR. However, the scope of the non-equities instruments is very broad. Since the non-equities cover transferable securities of various types including derivatives contracts, we would like to highlight to ESMA that besides classification into asset classes, the nature of some transferable securities, especially derivatives contracts, requires a different approach in general.

3. In this context, the SMSG also appreciates the fact that ESMA has considered and offered up for consultation a variety of options so as to give market participants an opportunity to provide specific input and proposals for the elaboration of RTS. It is noted however that proposals are mainly based on examples of bonds. A one-to-one application of bond market concepts to other asset classes, notably derivatives contracts, is not obvious or advisable.

4. The members of the SMSG are also cognizant that detail matters a great deal since the parameters which will be set by technical standards and which will determine the overall level of market transparency will not be easily changeable. Technical responses to the consultation paper by market participants will probably guide ESMA proposals about the choice among the various options for specifying asset classes, liquidity metrics, large scale parameters, time frequencies for the calculation of whether thresholds are reached and time frequencies of periodic reviews. The members of the SMSG have no technical data that allow them to go into such detail, but urge that all these parameters should be vetted in two ways: on one hand they should be checked for unintended consequences on an individual basis, for example how will transparency requirements respond to sudden changes in market conditions; on the other hand what will be the overall impact of the synchronous application of all the RTS together and whether they work well as a total system rather than having some undermining or mitigating the effect of others.

5. From the Consultation and Discussion Papers it is clear that ESMA staff are aware of the major issues that have arisen in the internal discussions among members of the SMSG, namely (a) the differentiation between instruments and asset classes; (b) the framework for setting thresholds; (c) the changing conditions of liquidity over the life of an instrument; (d) the differential requirements and consequences of pre-trade vs. post-trade transparency; (e) the problem of inflexibility of thresholds once they are set in approved RTS.

6. There are three matters which touch on general principle and procedure for completing ESMA's regulatory work in the area of transparency requirements for non-equity instruments. The SMSG has agreed to emphasize these general points to ESMA and the European Commission:

I. *The need to endow regulatory parameters with flexibility in face of changing market structures, investor composition and general conditions*. MIFID II/MIFIR introduce a multitude of concepts that need to be expressed as definitive parameters through the specification of technical standards. Required parameters such as definitions of asset classes, thresholds for judging the level of liquidity, thresholds of large scale and size are ESMA's responsibility. These however, once specified, cannot be changed by simple regulatory decision but must go through the whole cycle of decision–making by European institutions. Although the legislative proposals are intuitive, we need to emphasize that liquidity often is measured by market participants with more sophisticated methods that go beyond a simple and static picture of liquid markets. Hence, level 1 requirements may be intuitive but rigid and might contradict practitioner's approaches, at least some times. We strongly propose that additional powers for rapid review and adjustment of such parameters must be given to ESMA. Regulatory flexibility is required in order to avoid unintended consequences in an environment of frequently changing structures and conditions in order to ensure smooth and normal operation of markets. With regard to point (b) above, a framework could be envisaged where the expertise in specific markets is incorporated in a cooperative mode between ESMA and market participants.

II. Transparency requirements for certain categories of non-equity instruments are already applied in some market venues. Although this coverage and the attendant experience is not comprehensive, the thresholds and asset class definitions which will be produced by ESMA *must not lead to reduction of actual levels of transparency*, where relevant rules are already applied. On the contrary, technical standards must be set in every case at levels which improve transparency for all venues and all market segments, as compared to the existing situation. This is after all the broader intent of MIFID II /MIFIR.

III. The application of transparency requirements, as mandated by MIFID II /MIFIR, is heavily dependent on assessments of the level of liquidity. There is no doubt that in the short-term sudden or burdensome transparency requirements may damage liquidity and lead to a deterioration of market function. Thus, assessments of liquidity must be made in ways that capture changes in liquidity over the life of a given instrument (see proposal under I). *On the other hand it has also been argued that in the long-run, when market structures are changeable, rising levels of transparency may encourage the entry of investors into the markets, increase the flow of savings to tradable financial instruments and generally enhance levels of liquidity*. Thus the relationship of transparency and liquidity is probably two-sided and a balance needs to be maintained between these two effects. In practical terms it is necessary to specify standards so as to ensure that the majority of trades come under transparency rules over long enough periods (semi-annually, annually, or longer). This can be a practical guide for the selection of 'scenarios' that ESMA has worked up. More generally, the regulatory system must work in a way that – in normal times – transparency and liquidity will be mutually reinforcing.

Besides the above general points of principle or methodology, there are specific items that the SMSG wishes to bring to the attention of ESMA.

(1) In the case of instruments such as bonds, but more generally instruments with fixed maturities, liquidity conditions change systematically over the life of the instrument; for example liquidity may attain higher levels of transactions as expiration approaches. This implies that the way in which quantitative criteria of "liquid markets" are measured and applied must be able to pick up such systematic changes and NOT smooth over them from too much averaging. In addition for bonds especially, factors such as issue size and the presence of a market maker may also be considered in the framework for identifying liquid instruments and appropriate thresholds.

(2) In terms of product definitions, and more generally the specification of asset classes, we remark several specific issues. It is important to clearly exclude securitized derivatives from the derivatives product spectrum. Listed futures and options are standardized instruments, in which liquidity is focused at pre-defined standard expiry points. For one underlying, there are, for example, call and put options, which investors can combine to express a wide range of trading and hedging strategies. Also, numerous market makers and multitude of liquidity providers provide quotation services and ensure liquidity. Securitized derivatives are often only quoted by the issuer, feature far lower levels of quoted, tradable and traded liquidity, and trading interest is spread out across thousands of products for one single underlying, as tailored payoff structures are created by virtue of listing a single product per strategy. It is not uncommon to see specific securitized derivatives products listed by multiple issuers, leading to further inherent differences.

(3) The length of time for the calculation of liquidity metrics is a very sensitive matter. With regard to instruments whose liquidity is highly seasonal or dependent on a life-cycle (bonds, derivatives) it is preferable to have shorter time spans for recalculation. The shorter time span enables the metrics to better capture changing liquidity conditions. This could be an item calculated on a monthly

basis. We would consider a quarterly basis as the upper limit of the time interval for calculation of liquidity metrics.

(4) On the other hand the length of time for recalculation of thresholds for large scale / size across classes or products *does not have to be short. Longer averaging is more desirable in this area.* The reasons for this are that (a) the size thresholds kick in *after* liquidity thresholds have been applied. So major seasonal effects and life-cycle sensitivities will be captured by recalculation over shorter-periods of the liquidity thresholds. The scale/size thresholds will be subsequently applied only to transactions where the liquidity thresholds have already been met. Hence the notion of large size should be as representative as possible. Representativeness implies longer periods of calculation, for example an annual frequency would appear preferable. We would consider a quarterly basis as the lower limit of the time interval for calculation of scale/size metrics.

(5) The point in (4) above seems to suggest a more general rule which provides that for transparency requirements post-trade sizes should be no smaller than pre-trade sizes; i.e. exemptions from transparency requirements due to the scale/size factor should be fewer with respect to post-trade than pre-trade transparency.

(6) We pointed out in a general remark above that the recalibration of thresholds should be a process that enables more regulatory flexibility so that parametric values can be easily changed. Regulatory flexibility could be twofold: i) flexibility in the review cycles of thresholds or ii) a cooperative framework, as mentioned above, where thresholds could be set in a way incorporating the market's perspective. For certain asset classes, the calibration of threshold levels themselves could be reviewed as frequently as possible, preferably on a quarterly basis, even if the review implies 'no change'. At times when market volumes, product composition, transaction sizes and investor population change, the ability to recalibrate threshold levels quickly could be required. These would be asset classes that could pursue i). In the context of required flexibility, ESMA could also provide that, if implemented thresholds manifestly and systematically affect the liquidity and activity in an instrument, (as documented by a trading venue of listing of that instrument) it can decide on an ad-hoc basis to revise the relevant parameters.

(7) In contrast, asset classes and markets that already provide high levels of transparency today and might be severely damaged by wrongly calibrated levels could benefit from cooperative frameworks as proposed under ii). For example, regulated markets already provide such high levels of transparency for exchange traded derivatives which are carefully set and not changed frequently, in order to increase certainty in those highly standardized products. Frequent disturbance and changes might be detrimental to such highly standardized markets. Therefore, a careful ex ante approach can be envisaged.

(8) Lastly, review of thresholds may also be required in a more 'macro' sense, if the proportion of trading that comes under transparency requirements appears to take sudden turns, positive or, more importantly, negative. This is the also a sense in which European legislation must enable higher regulatory flexibility.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA’s website.

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Jesper Lau Hansen

Chair
Securities and Markets Stakeholder Group