MiFID II

ESMA's draft technical standards

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Key Points

- The threshold for large in scale waivers has been reduced in order to maintain liquidity in instruments for small capitalised entities.
- The "Instrument by Instrument" approach to measuring bond market liquidity has been adopted.
- The requirement for trading venues to unbundle data will now be mandatory in all cases.
- Governance requirements for firms engaged in algorithmic and high-frequency trading have been detailed, including the option for the compliance function to operate the "kill switch".
- ESMA has revised the tests for assessing whether a non-financial firm trading in commodity derivatives should be within the scope of MiFID II.
- ESMA has stated that the publication of package transactions may be deferred, but it lacks the legal power to include provisions for pre-trade waivers, and that MiFIR should be amended in this respect.

Background

On 28 September 2015, the European Securities and Markets Authority ("**ESMA**") published its final major release of draft technical standards for MiFID II.

ESMA is required by the revised Market in Financial Instruments Directive (the "**MiFID II Directive**") and the Markets in Financial Instruments Regulation ("**MiFIR**"), to produce a series of draft technical standards to be considered for adoption by the European Commission.

These technical standards contain ESMA's proposals for detailed requirements in relation to MiFID II and have been much anticipated in the financial services industry.

The ESMA publication consists of a final report on the draft technical standards (the "**Final Report**"), together with the text of 28 draft technical standards.

This note deals with the ESMA's main proposals and covers the following topics:

- pre- and post-trade transparency;
- micro-structural issues;
- data publication and access;
- commodity derivatives; and
- market data reporting.

Pre- and Post-Trade Transparency

Thresholds for large in scale orders

MiFID II post-trade transparency rules require that transactions must be published to the markets immediately after the trade. However, orders that are large in scale ("**LIS**") may benefit from deferred publication. In the Final Report, ESMA noted that its previous proposals to lower the thresholds for LIS orders and to shorten publication delays in relation to shares and depositary receipts had been heavily criticised.[1] In particular, industry feedback suggested that this would adversely impact liquidity and pricing in stocks in small- and medium-sized enterprises.

ESMA has now reduced the LIS thresholds and increased the permissible publication delay for a new class of small caps.

Bond liquidity

Bonds will be subject to MiFID II transparency rules, requiring the pre-trade publication of bid and offer prices, and post-trade publication of transactions. However, waivers and deferrals are available for bonds in which there is no liquid market.

In its December 2014 consultation paper, ESMA considered two methods of calculating liquidity in non-equities, including bonds. The first was an Instrument by Instrument Approach ("**IBIA**") and the second was the Categories of Financial Instruments Approach ("**COFIA**"). In December 2014, ESMA stated its preference for the COFIA measurement of liquidity.

This provoked a mixed response from the industry. On the one hand, the buy-side and exchanges supported COFIA. On the other

[1] Final Report, chapter 2 (page 48).

hand, respondents from the sell-side tended to support IBIA. It was feared that more bonds would be classified as liquid under the COFIA approach, which would potentially harm price formation and reduce liquidity.

In the latest RTS, ESMA has adopted the IBIA approach in relation to calculating bond liquidity.[2]

Liquidity for derivatives and emissions allowances

Unlike its about-turn in relation to bonds, ESMA has continued to support the adoption of the COFIA approach to measuring liquidity in derivatives and emissions allowances.[3] ESMA has set out in revised and more granular detail the relevant classes of instrument, dividing them into asset classes, sub-asset classes and, in most cases, sub-classes.

Following current market practice, ESMA proposes a particular approach for equity derivatives. This is expected to result in the classification of most equity derivatives as liquid.

In addition, due to the current lack of reliable data, ESMA has proposed that all foreign exchange derivatives should initially be classified as illiquid. This position will be revisited once better data is available.

Double volume cap

As is currently the case under MiFID I, waivers will continue to be available from pre-trade transparency requirements. This will permit so-called "dark trading" to continue in the EU. However, under Article 5 of MiFIR, the use of these waivers will be limited by a "double volume cap". This means that over a rolling 12-month period, the volume of trading in any equity or equity-like instrument subject to these waivers will be capped as follows:

- The percentage of trading in a particular instrument on a trading venue must not exceed 4% of the total trading in that instrument across the EU.

- Overall EU trading in an instrument under these waivers must not exceed 8% of the total volume of trading in that instrument across the EU.

In the Final Report, ESMA published the methods by which it intends to collate the necessary information, calculate the actual volumes traded and publish the information. ESMA has clarified that it proposes to collect the relevant information from trading venues twice a month. It will however reserve the right to request information from consolidated tape providers if needed.

ESMA has maintained (with some revisions) its previous proposal to use "value" thresholds (measured by number of units traded multiplied by price) rather than "volume" thresholds (measured by number of instruments traded).

Package transactions

"Package transactions" are transactions with several linked and contingent components. According to ESMA, this would include certain bespoke transactions largely carried out OTC, trading strategies such as swap butterflies or swap spreads traded on the same trading venue, and exchange for physical ("**EFP**") transactions.

ESMA has clarified how package transactions will be treated for the purposes of the MiFID II transparency regime.[4] Where at least one component of the transaction is above the LIS or size specific to the instrument ("**SSTI**") thresholds, or is deemed illiquid, then the post-trade publication of the transaction may be deferred.

However, ESMA has stated that there will be no similar basis for a waiver from pre-trade transparency for package transactions, because ESMA lacks a legal basis on which to permit this. ESMA instead recommends an amendment to MiFIR to deal with this issue.

Micro-structural Issues

Algorithmic and high-frequency trading

MIFID II is intended to impose tighter controls on firms engaged in algorithmic and high-frequency trading. In the Final Report, ESMA has:

- maintained its previous proposal for segregation of trading functions, middle

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2 Final Report, chapter 2 (page 57-58); RTS 2.

3 Final Report, chapter 2 (page 58); RTS 2.

4 Final Report, chapter 2 (page 155); RTS 2.

office and back office, but clarified that this is in relation to a firm's governance of its algorithmic trading systems;

- allowed for the compliance function to operate the kill switch itself, i.e. to manually halt all algorithmic trading activity; and
- replaced specific training requirements with a more general focus on knowledge and competence.[5]

Tick sizes

ESMA has largely maintained its previous proposals in relation to the MiFID II requirement for tick sizes to be adopted for shares, depositary receipts, and certain exchange-traded funds.[6] ESMA proposes that the tick size should be based upon:

- the liquidity of the instrument; and
- the price of the order.

However, ESMA has revised its proposal in some respects, in particular in relation to the tick size for exchange-traded funds ("**ETFs**").

Data Publication and Access

Unbundling of data

Under MiFIR, trading venues will have to offer unbundled pre- and post-trade data on a reasonable commercial basis.[7] ESMA has maintained its previous proposal, which would require trading venues to disaggregate their data by:

- asset class (equity, equity-like, fixed income, emission allowances and various classes of derivative);
- the currency in which the instrument is traded;
- whether the data comes from scheduled daily auctions or is from continuous trading; and
- (in relation to shares and sovereign bonds), the country of issue.

ESMA has now made this disaggregation mandatory in all cases (previously it had offered trading venues the option not to disaggregate if there was "insufficient demand"). It has however dropped two criteria: membership of a major index, and industrial sector.

Commodity Derivatives

Ancillary activities exemption for trading in commodity derivatives

ESMA has finalised its technical standards on the two tests that determine whether a non-financial firm's trading in commodity derivatives is significant enough to bring the firm within the scope of the MiFID II regime.[8]

A firm must be below the threshold for both of the following tests in order to be exempt from MiFID II:

- The "market share test" assesses the firm's trading as a proportion of overall trading within the European Union. ESMA has now set the relevant thresholds which vary according to asset class (metals, oil, coal, gas, power, agriculture, other (including freight), emissions allowances).
- The "main business test" assesses the firms' speculative trading in commodity derivatives as a proportion of its overall trading in commodity derivatives. The threshold is set at 10 per cent.

ESMA also introduces a further backstop test so that that only larger market participants will be caught. This intended to ensure that a firm which has a high proportion of speculative activity may still be exempt if it has a low market share.

Position limits

MiFID II introduces limits on the size of the position that a trader in commodity derivatives can hold. ESMA has maintained its previous view that position limits in the spot month should be based on deliverable supply. However, in response to industry feedback, it has revised its previous proposal by stating that position limits in other months should be based on total open interest.[9]

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5 Final Report, chapter 3 (page 195).
6 Final report, chapter 3 (page 253); RTS 11.
7 Final Report, chapter 4 (page 273); RTS 14.
8 Final Report, chapter 6, RTS 20.
9 Final Report, chapter 6; RTS 21.

Position reporting

Requirements for the format of position reports were covered in ESMA's previous proposals, but have not been included in the Final Report. ESMA expects publish its draft technical standard on position reporting by the end of 2015.

Market Data Reporting

In the Final Report, ESMA has specified that:

- transaction reports and financial instrument reference data must be submitted in accordance with ISO 20022; and
- in response to industry feedback, the number of fields in the transaction report has been reduced to 65 (down from 81 in the previous proposal).[10]

Best Execution

In its previous proposals, ESMA stated that trading venues, systematic internalisers ("**SIs**"), market makers and other liquidity providers should be required to publish data on execution quality for all financial instruments subject to the trading obligation as set in MiFIR.

In the Final Report, ESMA has cut back on this proposal, stating that only trading venues and SIs should have to publish information on instruments subject to trading obligations.[11]

Firms must publish every year the top five execution venues for each class of financial instrument in which they have traded and the quality of the execution obtained. In response to industry feedback, ESMA has significantly reduced the number of classes of financial instrument.[12]

Next steps

ESMA submitted the Final Report and the technical standards to the Commission on 28 September 2015. The Commission has three months to consider whether to endorse the technical standards (i.e. until 28 December 2015).

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10 Final Report, chapter 7; RTS 22.
11 Final Report, chapter 9; RTS 27.
12 Final Report, chapter 9; RTS 28.

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