





## **Reply form for the Discussion Paper on the trading obligation for derivatives under MiFIR**

## Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the ESMA Discussion Paper on the trading obligation for derivatives under MiFIR, published on the ESMA website.

### **Instructions**

Please note that, in order to facilitate the analysis of the large number of responses expected, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, ESMA will only be able to consider responses which follow the instructions described below:

- use this form and send your responses in Word format (pdf documents will not be considered except for annexes);
- do not remove the tags of type <ESMA\_QUESTION\_MIFID\_TO\_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
- if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

Responses are most helpful:

- if they respond to the question stated;
- contain a clear rationale, including on any related costs and benefits; and
- describe any alternatives that ESMA should consider.

### **Naming protocol**

In order to facilitate the handling of stakeholders responses please save your document using the following format:

ESMA\_MiFID\_TO\_NAMEOFCOMPANY\_NAMEOFDOCUMENT.

e.g. if the respondent were ESMA, the name of the reply form would be:

ESMA\_MiFID\_TO\_ESMA\_REPLYFORM or

ESMA\_MiFID\_TO\_ESMA\_ANNEX1

### **Deadline**

Responses must reach us by **21 November 2016**.

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input/Consultations’.



### ***Publication of responses***

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA's Board of Appeal and the European Ombudsman.

### ***Data protection***

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the headings 'Legal notice' and 'Data protection'.



## Introduction

***Please make your introductory comments below, if any:***

< ESMA\_COMMENT\_MIFID\_TO\_0 >

Citadel LLC<sup>1</sup> appreciates the opportunity to provide comments to the European Securities and Markets Authority (“ESMA”) on its Discussion Paper on the trading obligation for derivatives under MiFIR.

As a central component of the OTC derivatives reforms agreed to by the G20 in 2009,<sup>2</sup> the trading obligation for derivatives is critical to achieving the goals of promoting market stability and integrity and improving conditions for investors through increased transparency, more competition, and better pricing. Transitioning trading in standardised, liquid OTC derivatives onto regulated venues enhances market stability and integrity by ensuring this activity is subject to appropriate monitoring and surveillance, and straight-through-processing requirements. In addition, market experience with the implementation of the trading obligation in the U.S. has demonstrated the benefits to investors that result from open and competitive execution, including better liquidity and lower transaction costs. Specifically, the Bank of England found that market participants transacting USD interest rate swaps are already saving as much as \$20 million - \$40 million *per day*, of which \$7 million - \$13 million is being saved by market end-users alone *per day*, due to lower transaction costs resulting from the implementation of the trading obligation in the U.S.<sup>3</sup>

An affirmative trading obligation and implementation timeline is necessary to facilitate the industry’s transition to trading on regulated trading venues. It is therefore critical that the scope of the trading obligation be appropriately calibrated to include all OTC derivatives that are sufficiently liquid. In this regard, we believe that the initial ESMA proposal does not capture many sufficiently liquid OTC derivatives.

We offer several suggestions below that are designed to improve both the methodology and data applied by ESMA for purposes of defining the scope of the trading obligation for derivatives under MiFIR.

### I. Improving the Methodology

#### 1. The Liquidity Test for the Trading Obligation Should Not Be Significantly Stricter than the Liquidity Test under RTS 2

ESMA’s initial proposal is to apply a “de facto stricter liquidity test” for determining the scope of the trading obligation.<sup>4</sup> In our view, this approach is not supported by MiFIR for the following two reasons.

First, as a legal matter, the liquidity test for the trading obligation set forth in Article 32(3) is materially similar to the liquidity test for transparency set forth in the definition of a “liquid market” in Article 2(1)(17)(a). There is no indication that MiFIR contemplates a stricter liquidity test being applied for the trading obligation.

Second, applying a stricter liquidity test for purposes of the trading obligation ultimately results in that same stricter test being retroactively applied for purposes of the pre-trade transparency requirements given the available waiver under Article 9(1)(c) of MiFIR. This waiver applies to OTC derivatives that are subject to the clearing obligation but are not subject to the trading obligation. Therefore, even though a cleared OTC derivative is initially determined to be liquid under the test used in RTS 2, it can

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<sup>1</sup> Citadel is a global financial firm built around world-class talent, sound risk management, and innovative market-leading technology. For more than a quarter of a century, Citadel’s hedge funds and capital markets platforms have delivered meaningful and measurable results to top-tier investors and clients around the world. Citadel operates in all major asset classes and financial markets, with offices in the world’s leading financial centers, including Chicago, New York, San Francisco, Boston, London, Hong Kong, and Shanghai.

<sup>2</sup> See “G20 Leaders Statement: The Pittsburgh Summit,” Sept. 25, 2009, available at: <http://www.g20.utoronto.ca/2009/2009communique0925.html> (“All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest”).

<sup>3</sup> See Staff Working Paper No. 580 “Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act”, Bank of England (January 2016), available at: <http://www.bankofengland.co.uk/research/Documents/workingpapers/2016/swp580.pdf>.

<sup>4</sup> See Discussion Paper at Paragraph 105.

still benefit from a waiver from pre-trade transparency under Article 9(1)(c) if it fails to satisfy any stricter liquidity test that is applied for the trading obligation. This means that, in practice, any stricter liquidity test applied for the trading obligation also becomes the de facto liquidity test for RTS 2, overriding ESMA's work in developing a suitable liquidity test for transparency purposes.

For both of the reasons above, we believe that the liquidity test for the trading obligation should be materially aligned with the liquidity test for transparency. Under ESMA's initial proposal, the liquidity test for the trading obligation is stricter due to the application of the same 10 trades-per-day threshold used in RTS 2 to the much smaller data set that is being analysed for purposes of implementing the trading obligation. Under RTS 2, the 10 trades-per-day threshold is applied at the subclass level, which, for a given currency of fixed-to-floating interest rate swaps, includes (a) all swaps in a given benchmark tenor and (b) all broken-dated swaps with maturities extending until the next benchmark tenor. However, when assessing liquidity for purposes of the trading obligation, ESMA proposes to eliminate all non-benchmark swaps from the data set, thereby removing approximately 55% of the total number of transactions.<sup>5</sup> Applying the same 10 trades-per-day threshold to a data set that has been reduced by over 50% results in a significantly stricter liquidity test being applied.

In order to calibrate the liquidity test for the trading obligation so that it is materially aligned with the liquidity test for transparency, ESMA must reduce the trades-per-day threshold by the same percentage that the data set used in RTS 2 has been reduced. Given that the overall data set has been reduced by more than 50% when compared to the data set used in RTS 2, the trades-per-day threshold should be set at no more than 5 trades-per-day.

Appropriately calibrating the trades-per-day threshold used to determine the scope of the trading obligation will ensure that sufficiently liquid OTC derivatives are not inadvertently excluded. For example, additional benchmark tenors in both USD (6, 12, 15, and 20 years) and GBP (2, 3, 4, 7, 15, and 20 years) interest rate swaps are sufficiently liquid for the trading obligation, but are not included in the initial proposed scope. In addition, appropriately calibrating the trades-per-day threshold will minimise problematic divergence between the trading and transparency regimes, which could result in cleared OTC derivatives that have already been assessed as liquid under RTS 2 for transparency purposes nonetheless being eligible for a waiver from pre-trade transparency due to being excluded from the trading obligation.

## **2. The Liquidity Test for the Trading Obligation Should Leverage All of the Criteria in RTS 4**

We urge ESMA to use any trades-per-day threshold as part of an overall liquidity assessment that takes into account the other criteria in RTS 4 (*Criteria for determining whether derivatives subject to the clearing obligation should be subject to the trading obligation*). These criteria include the amount of trading volume that already occurs on trading venues, the average size of trades, the number and type of active market participants, and the number of liquidity providers regularly offering quotes.

Under the current ESMA approach, it appears that the trades-per-day test is determinative, with an instrument included in the trading obligation if it passes this threshold and excluded from the trading obligation if it falls short. We instead recommend that the trades-per-day threshold be a factor in the overall liquidity assessment, but not solely determinative, and that a failure to satisfy the trades-per-day threshold alone should not automatically result in an instrument being excluded from the trading obligation.

In our view, RTS 4 contemplates a more holistic liquidity assessment where ESMA gathers data on a variety of liquidity measures, such as the number and type of active market participants, and the number of liquidity providers regularly offering quotes. We encourage ESMA to gather data that can help evaluate these liquidity criteria directly from trading venues and CCPs in order to supplement the data available from EU trade repositories. In addition, when evaluating these various criteria, we do not believe that ESMA should attempt to establish and rigidly apply minimum thresholds. Minimum

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<sup>5</sup> Discussion Paper at Paragraph 126, Table 6.

thresholds are not required under RTS 4 and risk being miscalibrated at levels that fail to take into account the significant variations that exist across different types of derivatives. Furthermore, establishing a minimum threshold for one specific criteria inevitably elevates that criteria above the others in RTS 4 if the assessment cannot continue unless the threshold is met. Instead, ESMA should collect the data contemplated in RTS 4 and perform a holistic liquidity assessment that takes into account all of the various criteria.

### 3. The MiFIR Framework is Sufficiently Flexible to Allow Large Trades to be Subject to the Trading Obligation

Article 32(3) of MiFIR permits ESMA to grant an exemption from the trading obligation for large trades, but does not require ESMA to do so. Under the MiFIR framework, large trades will already be eligible for both a pre-trade transparency waiver and a post-trade transparency deferral. In addition, unlike the U.S. regime, trades subject to the MiFIR trading obligation will not be required to be executed via specific trading protocols, such as RFQ-to-3 or on an Order Book. As a result, trading venues can offer trading protocols that allow for private negotiation of large trades, removing any concerns about information leakage. When combined with the available waivers and deferrals from transparency requirements, we do not believe that an additional exemption from the trading obligation is necessary for large trades.

Requiring the execution of large trades on regulated trading venues, as long as they can be entered into through private negotiation protocols designed to avoid information leakage, will benefit market stability and integrity. For example, these trades would remain subject to the pre-trade check and straight-through-processing requirements in RTS 26 that are applicable to transactions concluded on a trading venue. This will help to ensure that market participants have available clearing capacity before executing large trades, thereby mitigating the possibility of a subsequent rejection from clearing, which is a particularly undesirable risk for large trades. Ensuring that the pre-trade check requirements apply to large trades would also be consistent with the U.S. regime, where pre-execution credit checks are required for block trades that are intended to be cleared.<sup>6</sup> In fact, under the U.S. regime, market participants successfully petitioned the CFTC to allow block trades to be executed **on SEFs**, via the use of a RFQ-to-1 protocol.<sup>7</sup> We urge ESMA to ensure that the pre-trade check and straight-through-processing requirements in Articles 2 and 3 of RTS 26 apply to large trades in derivatives that are subject to the trading obligation.

If ESMA were to nonetheless provide an exemption from the trading obligation for large trades, these trades should still be required to be executed **subject to the rules** of a regulated trading venue and ultimately reported into a venue in accordance with those rules. This will distinguish large trades in instruments subject to the trading obligation from large trades in other instruments and will provide consistency with how “block” trades are handled in other asset classes.

In conjunction with clarifying the application of the trading obligation to large trades, ESMA should clearly affirm that Article 28(1) of MiFIR requires that transactions in derivatives subject to the trading obligation must be concluded on a regulated trading venue. This means that unless an exemption applies, transactions in derivatives subject to the trading obligation cannot be pre-arranged or concluded outside of a regulated trading venue. Permitting trades subject to the trading obligation to be concluded outside of a regulated trading venue (even if subsequently reported into a venue) would significantly undermine the MiFIR framework, including the open and transparent execution process that characterizes transactions executed on a regulated venue. In addition, this could result in unintended outcomes, such as the pre-trade check and straight-through-processing requirements in Articles 2 and 3 of RTS 26 failing to apply. We urge ESMA to provide this clarification in connection with finalizing the trading obligation.

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<sup>6</sup> See CFTC No-Action Letter 16-74 (Oct. 7, 2016) at FN 7, available at: <http://www.cftc.gov/idx/groups/public/@lrllettergeneral/documents/letter/16-74.pdf>.

<sup>7</sup> See CFTC No-Action Letter 16-74 (Oct. 7, 2016), available at: <http://www.cftc.gov/idx/groups/public/@lrllettergeneral/documents/letter/16-74.pdf>

## II. Improving the Data Analysis

### 1. ESMA Should Not Exclude Trading Activity that Occurs on MTFs

ESMA has eliminated all swaps that have been executed on a regulated trading venue, such as an MTF, from the data set being used to assess the liquidity of instruments for the trading obligation.<sup>8</sup> A number of MTFs have been established to trade OTC derivatives, including BGC Brokers LP, Bloomberg Trading Facility Limited, GFI CreditMatch, GFI RatesMatch, ICAP Global Derivatives Limited, ICAP Europe MTF, MarketAxess Europe Limited, TPCreditDeal, TPSwapDeal, Trad-X, and Tradeweb.<sup>9</sup>

It is our understanding that significant volumes of OTC derivatives already trade on these platforms, and therefore ESMA must ensure this volume is included when assessing the overall liquidity of an instrument. Trading venues can assist ESMA by supplementing the data available in EU trade repositories.

### 2. ESMA Must Improve the Methodology for Eliminating Duplicate Records

We are concerned that ESMA is eliminating far too many records from the data set as a result of being unable to link the various transaction reports associated with a single cleared OTC derivative. In attempting to remove duplicate trade reports, ESMA has proposed to exclude all transactions from the data set where one of the counterparties is a CCP or a clearing member. This results in the elimination of nearly 70% of the transactions in the data set, which we believe is far too high.<sup>10</sup>

We are aware that market participants will often rely on the transaction reporting by the CCP in the first instance for cleared trades and will not separately report the initial bilateral trade that was submitted to clearing. This reporting approach leverages guidance provided by ESMA in the context of cleared exchange-traded derivatives, and reflects the successful clearing of the trade on the day of execution.<sup>11</sup> In this scenario, every single report associated with a cleared derivative would be eliminated under all of the options proposed by ESMA since the CCP is a counterparty on every transaction report.

As a result, we urge ESMA to consider a different approach to eliminate duplicate records from the data set. A more accurate methodology for eliminating duplicate trades would be to identify the number of cleared transactions in the data set and divide by two (2) to reflect the fact that one bilateral transaction becomes two after it has been cleared. We encourage ESMA to work with national competent authorities and CCPs to understand how cleared OTC derivatives are being reported in practice and obtain data directly from the CCPs regarding the number of trades cleared during the relevant timeframe in order to check the accuracy of the methodology.

### 3. ESMA Should Analyse the Liquidity of Certain Swaps that Appear to be Outside of Benchmark Dates

More than 50% of the transactions in the ESMA data set appear to be non-benchmark transactions. Under Article 32 of MiFIR, ESMA should analyse all of the classes of derivatives subject to the clearing obligation in order to assess whether they are sufficiently liquid for the trading obligation. In doing so, ESMA would find that many swaps that appear to be non-benchmark transactions are sufficiently liquid for the trading obligation.

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<sup>8</sup> See Discussion Paper at Paragraph 116.

<sup>9</sup> See [https://registers.esma.europa.eu/publication/searchRegister?core=esma\\_registers\\_mifid\\_mtf](https://registers.esma.europa.eu/publication/searchRegister?core=esma_registers_mifid_mtf).

<sup>10</sup> See Discussion Paper at Table 5.

<sup>11</sup> See TR Question 6, Questions and Answers: Implementation of the Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR) (July 26, 2016), available at: <https://www.esma.europa.eu/press-news/esma-news/esma-updates-its-emir-qa-2>.

For example, transactions in IMM and MAC interest rate swaps are forward-starting and therefore would likely appear as non-benchmark swaps in the ESMA data set. IMM interest rate swaps are standardised instruments that start on quarterly International Money Market (“IMM”) dates, which are the 3rd Wednesday of March, June, September and December.<sup>12</sup> MAC interest rate swaps also start on quarterly IMM dates, and use one of a few pre-set fixed Market Agreed Coupons (“MAC”) in order to further increase standardisation.<sup>13</sup> Many benchmark tenors in these forward-starting swaps are sufficiently liquid for the trading obligation. According to an analysis of U.S. SDR data, IMM and MAC swaps together constitute approximately 15% of the USD interest rate swap market in terms of trade count, and may account for even more of the EUR and GBP interest rate swap market.<sup>14</sup> Notably, IMM and MAC swaps are already subject to the U.S. trading obligation.

In addition, swaps that appear as non-benchmark in the ESMA data set are commonly included as part of an asset swap package with a cleared future (otherwise known as an “invoice spread”). These invoice spread packages are already listed and executed on MTFs, with the most common involving Gilt futures or the Schatz, Bobl, Bund, or Buxl futures that reference German Bunds.<sup>15</sup> An analysis of U.S. swap data repository data reveals that in relevant USD instruments, invoice spread volumes can reach \$20 billion per day and account for up to 3% of total volumes in the related bond future.<sup>16</sup> Given that these packages more frequently trade with a EUR or GBP interest rate swap, we would expect these figures to be significantly higher in the EU market. As a result, these EUR and GBP forward-starting swaps that are executed alongside a cleared future are also sufficiently liquid for the trading obligation.

### **III. Standardised and Liquid Packages Should Not Be Granted an Exemption from the Trading Obligation**

Data has shown that over 50% of all USD interest rate swaps are actually transacted as part of a package,<sup>17</sup> and we anticipate similar statistics for EUR and GBP interest rate swaps. It is therefore critical that standardised and liquid packages are not exempted from the trading obligation.

Under Article 28(1) of MiFIR, once a derivative is determined to be subject to the trading obligation, all transactions in such derivative must be concluded on a regulated trading venue unless an exemption applies. This is the case even if a market participant chooses to execute other instruments in conjunction with the derivative that is subject to the trading obligation.

As a result, we do not believe it is necessary for ESMA to separately specify that the trading obligation applies to specific types of packages that contain an instrument that is independently subject to the trading obligation. In practice, as long as the derivative subject to the trading obligation must be executed on a regulated venue, market participants will then have the choice whether to execute other instruments simultaneously on the venue alongside such derivative or execute such other instruments separately off-venue.

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<sup>12</sup> See “The IMM Roll for Swaps- What is it and What are the volumes?” Clarus Financial Technology (March 31, 2015), available at: <https://www.clarusft.com/the-imm-roll-for-swaps-what-is-it-and-what-are-the-volumes/>.

<sup>13</sup> See “SIFMA Asset Management Group Helps Develop New Market Agreed Coupon for Interest Rate Swaps” (April 23, 2013), available at: <http://www.sifma.org/newsroom/2013/sifma-asset-management-group-helps-develop-new-market-agreed-coupon-for-interest-rate-swaps/>.

<sup>14</sup> See “30% of the Euro swap market is standardized?” Clarus Financial Technology (Aug. 23, 2016), available at: <https://www.clarusft.com/30-of-the-euro-swap-market-is-standardized/> (The initial analysis by Clarus found that IMM and MAC swaps constitute approximately 30% of the EUR interest rate swap market and as much as 43% of the GBP interest rate swap market).

<sup>15</sup> See, e.g., “Trad-X strengthens interest rate swaps market presence with Eurex Clearing partnership” (Feb. 22, 2016), available at: <http://voxia.ch/en/trad-x-strengthens-interest-rate-swaps-market-presence-with-eurex-clearing-partnership/> (highlighting the trading of invoice spreads).

<sup>16</sup> See “Mechanics and Definitions of Bond Futures,” Clarus Financial Technology (July 19, 2016), available at: <https://www.clarusft.com/mechanics-and-definitions-of-bond-futures/>.

<sup>17</sup> See “Spreadovers: US Treasury Spreads in the Swaps Data,” Clarus Financial Technology (March 23, 2105), available at: <https://www.clarusft.com/spreadovers-us-treasury-spreads-in-the-swaps-data/>.

The question then becomes whether certain package transactions should benefit from an exemption to this general rule, thereby allowing an instrument that is otherwise subject to the trading obligation to be executed away from a regulated venue when it is traded as part of a package. This is consistent with the approach taken for implementing the U.S. trading obligation, where the CFTC has provided exemptions for specific types of packages. Given the overall trading activity in standardised and liquid packages, any such exemptions must be narrowly tailored. In addition, it should be noted that, as a practical matter, it should be easier to trade packages on regulated trading venues under the MiFIR framework given the broader range of permitted trading protocols (as compared to the CFTC's requirement to use RFQ-to-3 or Order Book trading protocols).

We do not believe an exemption should be granted for packages where at least one component is subject to the trading obligation and the other components are subject to the clearing obligation. These packages include (a) interest rate curves, (b) interest rate butterflies, (c) IMM or MAC rolls (assuming these interest rate swaps are included in the trading obligation), (d) CCP basis swaps, and (e) index CDS rolls. For example, interest rate curves and butterflies alone typically constitute approximately 1/3 of the total risk transfer in USD interest rate swaps and one analysis found that up to 45% of vanilla, spot starting USD interest rate swaps were traded as part of a curve or butterfly.<sup>18</sup> These types of packages are also extremely common for EUR and GBP interest rate swaps.

In addition, an exemption from the trading obligation should not be granted for "spread over" packages containing a USD interest rate swap that is subject to the trading obligation and a U.S. Treasury. These packages appear to be the single largest category of package transactions involving a USD interest rate swap in terms of overall risk transfer and constitute up to 20% of overall trade count.<sup>19</sup>

Finally, an exemption from the trading obligation should not be granted for invoice spread packages containing a EUR or GBP interest rate swap that is subject to the trading obligation and a cleared future. Invoice spread packages are already listed and executed on MTFs, with the most common involving Gilt futures or the Schatz, Bobl, Bund, or Buxl futures that reference German Bunds.<sup>20</sup> An analysis of U.S. swap data repository data reveals that in relevant USD instruments, invoice spread volumes can reach \$20 billion per day and account for up to 3% of total volumes in the related bond future.<sup>21</sup> Given that these packages more frequently trade with a EUR or GBP interest rate swap, we would expect these figures to be significantly higher in the EU market and we encourage ESMA to gather data from trading venues and futures exchanges such as Eurex and ICE in order to assess the liquidity of these packages.

#### **IV. ESMA Should Analyse the Liquidity of CDX IG and CDX HY Pursuant to Article 32(4) of MiFIR**

CDX IG and CDX HY indices are also sufficiently liquid for the trading obligation. As highlighted by ESMA in the Consultation Paper on the Clearing Obligation under EMIR (no. 2), the CDX IG index is the second-largest in terms of total notional amount traded after the iTraxx Europe index.<sup>22</sup> Under Article 32(4) of MiFIR, ESMA has the power to identify classes of derivatives that should be subject to the trading obligation but for which no CCP has yet received authorisation under EMIR. According to

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<sup>18</sup> See "September 2016 Swaps Review," Clarus Financial Technology (Oct. 12, 2016) at Table 2, available at: <https://www.clarusft.com/september-2016-swaps-review/>; and "USD Swaps: Spreads and Butterflies Part II," Clarus Financial Technology (Sept. 30, 2014), available at: <https://www.clarusft.com/usd-swaps-spreads-and-butterflies-part-ii/>.

<sup>19</sup> See "September 2016 Swaps Review," Clarus Financial Technology (Oct. 12, 2016) at Table 2, available at: <https://www.clarusft.com/september-2016-swaps-review/>; and "Spreadovers: US Treasury Spreads in the Swaps Data," Clarus Financial Technology (March 23, 2105), available at: <https://www.clarusft.com/spreadovers-us-treasury-spreads-in-the-swaps-data/>.

<sup>20</sup> See, e.g., "Trad-X strengthens interest rate swaps market presence with Eurex Clearing partnership" (Feb. 22, 2016), available at: <http://voxia.ch/en/trad-x-strengthens-interest-rate-swaps-market-presence-with-eurex-clearing-partnership/> (highlighting the trading of invoice spreads).

<sup>21</sup> See "Mechanics and Definitions of Bond Futures," Clarus Financial Technology (July 19, 2016), available at: <https://www.clarusft.com/mechanics-and-definitions-of-bond-futures/>.

<sup>22</sup> See Consultation Paper on the Clearing Obligation under EMIR (no. 2) at page 19, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-800.pdf>.



the ESMA Public Register for the Clearing Obligation under EMIR,<sup>23</sup> it does not appear as though a CCP has received authorisation for CDX indices. Therefore, given the trading activity in these indices, the available clearing solutions on recognised third-country CCPs, and the fact that these indices are subject to the trading obligation in the U.S., we believe that it is appropriate for ESMA to conduct a liquidity assessment of both CDX IG and CDX HY in accordance with the criteria outlined in RTS 4 pursuant to its power under Article 32(4) of MiFIR. ]

< ESMA\_COMMENT\_MIFID\_TO\_0 >

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<sup>23</sup> See Public Register for the Clearing Obligation under EMIR, available at: [https://www.esma.europa.eu/sites/default/files/library/public\\_register\\_for\\_the\\_clearing\\_obligation\\_under\\_emir.pdf](https://www.esma.europa.eu/sites/default/files/library/public_register_for_the_clearing_obligation_under_emir.pdf).

**Q1. Do you agree that the level of granularity for the purpose of the trading obligation should apply at the same level as the one used for calibrating the transparency regime of non-equity instruments? If not, which level of granularity for the TO would you recommend and why? Would that differ by asset class and type of instrument?**

<ESMA\_QUESTION\_MIFID\_TO\_1>

We agree with the approach taken by ESMA in the Discussion Paper, which is to use the classes of derivatives identified for purposes of implementing the clearing obligation as the starting point for assessing the application of the trading obligation. This is the approach required by MiFIR Article 32(2), which provides that each class of derivatives declared subject to the clearing obligation must be assessed to determine whether such class, or a subset of such class, (a) is admitted to trading or traded on a least one trading venue and (b) is sufficiently liquid for the trading obligation. The trading obligation may ultimately be applied to subsets of these classes based on the analysis of the relevant criteria, but beginning the assessment with the classes of derivatives already identified for the clearing obligation provides the appropriate level of granularity.

<ESMA\_QUESTION\_MIFID\_TO\_1>

**Q2. Do you agree that all derivatives currently subject to or considered for the CO are admitted to trading or traded on at least one trading venue? If not, please explain which classes of derivatives are not available for trading on at least one trading venue.**

<ESMA\_QUESTION\_MIFID\_TO\_2>

We agree that the vast majority of derivatives that are currently subject to the clearing obligation are already listed for trading on a regulated venue, including the fixed-to-floating interest rate swaps and index CDS that are the main focus of this Discussion Paper. Furthermore, any more bespoke derivative that may not currently be listed for trading on a regulated venue can be facilitated by a voice broker and therefore will likely be listed on an OTF once these venues are registered. We recommend that ESMA continue to engage with trading venues directly regarding the instruments listed for trading.

<ESMA\_QUESTION\_MIFID\_TO\_2>

**Q3. How should ESMA determine the total number of market participants trading in a class of derivatives? Do you consider it appropriate to carry out this assessment with TR data or would you recommend other data sources?**

<ESMA\_QUESTION\_MIFID\_TO\_3>

ESMA should utilize all available sources of relevant data when performing its liquidity assessment of specific classes of derivatives, including when determining the number and type of active market participants. These available data sources include EU trade repositories, which we agree should be able to help ESMA determine the number of EU market participants transacting in specific types of derivatives.

However, in order to accurately assess the liquidity of cleared derivatives, ESMA must take into account the global nature of these markets where liquidity pools are not defined by geographical boundaries. ESMA recognized the importance of analysing liquidity at a global level when implementing the clearing obligation,<sup>24</sup> and we urge a similar approach for the trading obligation. Available data sources that can provide ESMA with a more holistic view of trading activity and the number of active market participants in a specific class of derivatives include (a) the main CCPs for interest rate swaps and credit default swaps, and (b) swap data repositories in the U.S.

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<sup>24</sup> See Paragraph 53 of the Discussion Paper for ESMA's description of the global data obtained when assessing the clearing obligation.



In addition, trading venues in both the EU and the U.S. can provide ESMA with data regarding the number of market participants that have been on-boarded to trade the relevant classes of derivatives on these venues. Data from EU trading venues will provide ESMA with an initial sense of how trading activity has started to voluntarily migrate to regulated trading venues in advance of the implementation of MiFID II.

We urge ESMA to work with national competent authorities and global policymakers and regulators as appropriate in order to obtain access to these additional data sources for purposes of accurately assessing the liquidity of specific classes of derivatives. |

<ESMA\_QUESTION\_MIFID\_TO\_3>

**Q4. In your view, what should be the minimum total number of market participants to consider the following classes of derivatives as sufficiently liquid for the purpose of the trading obligation? i) OTC interest rate derivatives denominated in EUR, USD, GBP and JPY; ii) OTC interest rate derivatives denominated in NOK, PLN and SEK; iii) Credit default swaps (CDS) indices? Should you consider that this assessment should be done on a more granular level, please provide your views on the relevant subsets of derivatives specified in 1.-3.**

<ESMA\_QUESTION\_MIFID\_TO\_4>

We do not believe that ESMA should attempt to establish and rigidly apply minimum thresholds for any of the liquidity assessments made pursuant to RTS 4. Minimum thresholds are not required under RTS 4 and risk being miscalibrated levels that fail to take into account the significant variations that exist across different types of derivatives. For example, the index CDS market is much smaller than the EUR interest rate swap market, but that does not suggest that the index CDS market is not sufficiently liquid for the trading obligation. Furthermore, establishing a minimum threshold for one specific criteria inevitably elevates that criteria above the others in RTS 4 if the assessment cannot continue unless the threshold is met.

In our view, RTS 4 contemplates a more holistic liquidity assessment where ESMA gathers and analyses data on a variety of liquidity measures, such as the number and type of active market participants. We encourage ESMA to gather data that can help evaluate these liquidity criteria directly from trading venues and CCPs in order to supplement the data available from EU trade repositories. By gathering all of the data envisaged in RTS 4 and analysing it together, ESMA will be in a better position to compare and contrast different types of derivatives within a given asset class, and appropriately calibrate the trading obligation so that sufficiently liquid derivatives are not inadvertently excluded. |

<ESMA\_QUESTION\_MIFID\_TO\_4>

**Q5. Do you agree with this approach? Do you consider alternative ways to identify the number of trading venues admitting to trading or trading a class of derivatives as more appropriate?**

<ESMA\_QUESTION\_MIFID\_TO\_5>

We do not agree that the liquidity of an instrument is correlated to the number of trading venues on which it can be traded. Trading venues compete in order to gain market share, and some have been extremely successful in consolidating trading activity in specific instruments. This success may be attributed to a number of factors, including the trading protocols offered, fee structure, support from liquidity providers, and overall functionality. As a result, highly liquid derivatives may be predominantly traded on a single trading venue. In fact, in many highly liquid exchange-traded interest rate derivatives markets, all of the activity in a given instrument occurs on a single exchange.

Examining trading activity on SEFs in the U.S. illustrates this point. For example, Bloomberg SEF consistently accounts for approximately 75% of the total trading activity in highly liquid index CDS, with its market



share remaining remarkably constant since the beginning of the trading obligation in February 2014.<sup>25</sup> In addition, just two venues (Bloomberg and Tradeweb) account for nearly all of the dealer-to-client activity in all of the OTC derivatives traded on SEFs in the U.S.<sup>26</sup> A decision by market participants to use only a limited number of trading venues has no bearing on the overall liquidity of the instruments traded on these venues.

<ESMA\_QUESTION\_MIFID\_TO\_5>

**Q6. On how many trading venues should a derivative or a class of derivatives be traded in order to be considered subject to the TO?**

<ESMA\_QUESTION\_MIFID\_TO\_6>

As stated in our response to Question 4, we do not believe that ESMA should attempt to establish and rigidly apply minimum thresholds for any of the liquidity assessments made pursuant to RTS 4. Minimum thresholds are not required under RTS 4 and risk being miscalibrated levels that fail to take into account the significant variations that exist across different types of derivatives. For example, the index CDS market is much smaller than the EUR interest rate swap market, but that does not suggest that the index CDS market is not sufficiently liquid for the trading obligation. Furthermore, establishing a minimum threshold for one specific criteria inevitably elevates that criteria above the others in RTS 4 if the assessment cannot continue unless the threshold is met.

Specifically regarding the number of trading venues, we note that MiFIR Article 32 requires that the relevant class of derivatives must be admitted to trading or traded **on at least one** trading venue. Establishing a higher minimum threshold would override this provision of MiFIR, as it would no longer be sufficient for the class of derivatives to be traded on a single trading venue. In light of the above and our response to Question 5, which highlights the fact that the trading activity in highly liquid derivatives may be concentrated on a single trading venue, we urge ESMA not to establish an additional threshold. The liquidity of an instrument is not correlated to the number of trading venues on which it can be traded.

In our view, RTS 4 contemplates a more holistic liquidity assessment where ESMA gathers and analyses data on a variety of liquidity measures, such as the number of trading venues on which an instrument can be traded. By gathering all of the data envisaged in RTS 4 and analysing it together, ESMA will be in a better position to compare and contrast different types of derivatives within a given asset class, and appropriately calibrate the trading obligation so that sufficiently liquid derivatives are not inadvertently excluded.

<ESMA\_QUESTION\_MIFID\_TO\_6>

**Q7. What would be in your view the most efficient approach to assess the total number of market makers for a class of derivatives? Where necessary, please distinguish between: i) The phase prior to the application of MiFID II (i.e. before January 2018); ii) The phase after the application of MiFID II (i.e. after January 2018).**

<ESMA\_QUESTION\_MIFID\_TO\_7>

We are not aware of a trading venue for OTC derivatives that currently has a market making scheme in place or that requires investment firms to enter into a market making agreement. It may be the case, however, that certain trading venues have revenue share agreements with certain of their members that incentivize quoting with certain levels of consistency. That said, we are not aware of any affirmative obligations that are in place for market makers to provide firm quotes, and understand that the vast majority of quoting activity continues to be on an indicative basis only. The most efficient approach for ESMA would be to obtain this information directly from the trading venues.

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<sup>25</sup> See FIA SEF Tracker, available at: <https://fia.org/node/1834/>.

<sup>26</sup> See September 2016 Swaps Review, Clarus Financial Technology, available at: <https://www.clarusft.com/september-2016-swaps-review/>.



ESMA should also be aware that it remains unclear how many market making schemes and market making agreements will be implemented for OTC derivatives under the MiFID II requirements. RTS 8 (*Requirements on market making agreements and schemes*) does not require trading venues to implement a market making scheme for OTC derivatives. Furthermore, a significant percentage of trading activity on venues occurs via either request-for-quote or voice. Therefore, many trading venues for OTC derivatives may not have a market making scheme or need to provide market making agreements under RTS 8. |

<ESMA\_QUESTION\_MIFID\_TO\_7>

**Q8. How many market makers and other market participants under a binding written agreement or an obligation to provide liquidity should be in place for a derivative or a class of derivatives to be considered subject to the TO?**

<ESMA\_QUESTION\_MIFID\_TO\_8>

As stated in our response to Question 4, we do not believe that ESMA should attempt to establish and rigidly apply minimum thresholds for any of the liquidity assessments made pursuant to RTS 4. Minimum thresholds are not required under RTS 4 and risk being miscalibrated levels that fail to take into account the significant variations that exist across different types of derivatives. For example, the index CDS market is much smaller than the EUR interest rate swap market, but that does not suggest that the index CDS market is not sufficiently liquid for the trading obligation. Furthermore, establishing a minimum threshold for one specific criteria inevitably elevates that criteria above the others in RTS 4 if the assessment cannot continue unless the threshold is met.

Specifically with respect to the number of market makers, we note our response to Question 7 explaining why many trading venues for OTC derivatives may not have a market making scheme or need to provide market making agreements under RTS 8 given the widespread use of request-for-quote and voice trading platforms for trading OTC derivatives. This suggests that a lower weighting should be applied to this specific criteria in terms of the overall liquidity assessment. In addition, ESMA should also collect data from trading venues on the number of liquidity providers that are regularly offering quotes, even if they are not required to formally enter into a market making agreement. These prices, which may occur, for example, via the “request-for-stream” protocol on the main request-for-quote trading venues, can be indicative prices (instead of firm), but nonetheless indicate the overall liquidity available for a specific instrument and are used by clients to determine with whom to transact on the venue. Collecting this additional data will assist ESMA in determining the number and type of active market participants, as intended in RTS 4.

Along with the other liquidity criteria in RTS 4, ESMA should gather all of the relevant data and make its assessment on a holistic basis. By gathering all of the data envisaged in RTS 4 and analysing it together, ESMA will be in a better position to compare and contrast different types of derivatives within a given asset class, and appropriately calibrate the trading obligation so that sufficiently liquid derivatives are not inadvertently excluded. |

<ESMA\_QUESTION\_MIFID\_TO\_8>

**Q9. Do you agree with the proposed approach or do you consider an alternative approach as more appropriate?**

<ESMA\_QUESTION\_MIFID\_TO\_9>

The requirement in Article 4(2) of RTS 4 for ESMA to compare the ratio of market participants to the average size of trades and the average frequency of trades is intended to be part of the overall liquidity assessment of a class of derivatives. However, as with the other liquidity criteria, it must take into account the variations that exist across different types of OTC derivatives.

For example, interest rate derivatives and credit derivatives are used for very different purposes, and interest rate derivatives tend to be much more frequently traded by a larger number of active market partici-



pants. As an asset class, interest rate derivatives represent approximately 80% of the global OTC derivatives market by notional amount outstanding and contracts denominated in EUR and USD are the most frequently traded given the importance of the underlying currencies in the global financial system.<sup>27</sup>

In turn, credit derivatives are commonly used to hedge credit exposure and to express investment views on companies that may not issue bonds often or may have bonds that are difficult to source. Fewer market participants are active in these products than in interest rate derivatives, and transactions tend to occur less frequently, resulting in an outstanding notional figure that is only a fraction of the total for interest rate derivatives.<sup>28</sup> That said, credit derivatives generally exhibit an even higher degree of standardization than interest rate derivatives, and at present, index credit derivatives have experienced greater use of order book trading.

Given these significant differences across various classes of OTC derivatives, data on the number of market participants, the average size of trades, and the average frequency of trades cannot be compared in isolation. If data on the number of market participants and the average frequency of trades in the EUR or USD interest rate swaps market was always used as the benchmark for assessing liquidity, it would likely prove difficult for other classes of OTC derivatives to ever satisfy the liquidity assessment, given the overall size of the EUR and USD interest rate swap markets. However, other criteria included in RTS 4 can help provide a more holistic assessment of actual liquidity, such as whether the instruments are already traded on regulated venues and the number of market participants actively providing liquidity in the product through regularly offering quotes to clients.

Just because a class of derivatives is smaller in size than, for example, the EUR interest rate swap market does not mean it cannot be sufficiently liquid for the trading obligation. We urge ESMA to gather all of the relevant data under RTS 4 and make its assessment on a holistic basis, without giving undue weight to a limited number of criteria.

<ESMA\_QUESTION\_MIFID\_TO\_9>

**Q10. Do you agree that the criterion of average size of spreads, in particular in case of absence of information on spreads, should receive a lower weighting than the other liquidity criteria? If not, please specify your reasons**

<ESMA\_QUESTION\_MIFID\_TO\_10>

Yes, we agree that the criteria relating to the average size of spreads should receive a lower weighting given the difficulty ESMA is experiencing in collecting this information. In addition, we note that while average spreads can provide useful data to evaluate trends over time, they should not be considered in isolation and may be impacted by overall market structure. For example, wider than expected spreads could indicate lower levels of liquidity in a particular instrument, but they could also be due to a small group of liquidity providers benefiting from significant pricing power in a particular asset class. As OTC derivatives transition to central clearing and trading on regulated venues, we would expect average spreads to decrease given the additional transparency and competition that results. This has already been demonstrated to have occurred following the implementation of the U.S. clearing and trading reforms, with the Bank of England finding that market participants transacting USD interest rate swaps are saving as much as \$20 million - \$40 million *per day*, of which \$7 million - \$13 million is being saved by market end-users alone *per day*.<sup>29</sup>

<ESMA\_QUESTION\_MIFID\_TO\_10>

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<sup>27</sup> See Statistical release: OTC derivatives statistics at end-December 2015, Bank for International Settlements (May 2016), available at: [http://www.bis.org/publ/otc\\_hy1605.pdf](http://www.bis.org/publ/otc_hy1605.pdf).

<sup>28</sup> *Id.*

<sup>29</sup> See Staff Working Paper No. 580 "Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act", Bank of England (January 2016), available at: <http://www.bankofengland.co.uk/research/Documents/workingpapers/2016/swp580.pdf>.



**Q11. Which sources do you recommend for obtaining information on the average size of spreads by asset class?**

<ESMA\_QUESTION\_MIFID\_TO\_11>

We recommend that ESMA obtain information regarding the average size of the spreads from both trading venues and the main liquidity providers in the relevant asset class. These are the market participants with the best information regarding the prices that are quoted for a particular instrument. |

<ESMA\_QUESTION\_MIFID\_TO\_11>

**Q12. What do you consider as an appropriate proxy in case of lack of information on actual spreads?**

<ESMA\_QUESTION\_MIFID\_TO\_12>

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<ESMA\_QUESTION\_MIFID\_TO\_12>

**Q13. Do you agree with the suggested approach? If not, what approach would you recommend?**

<ESMA\_QUESTION\_MIFID\_TO\_13>

For purposes of assessing the anticipated impact that the trading obligation may have on liquidity and the commercial activities of end-users, we urge ESMA to take into account market experience with the trading obligation in other jurisdictions. For example, the U.S. trading obligation has been in effect for almost three years, and has been shown to improve liquidity and reduce transaction costs for investors, including end-users. Specifically, Bank of England research found that the implementation of the U.S. trading obligation led to a significant improvement in liquidity and a material reduction in execution costs, with market participants transacting USD interest rate swaps saving as much as \$20 million - \$40 million *per day*, of which \$7 million - \$13 million was being saved by market **end-users** alone *per day*.<sup>30</sup>

Based on this market experience, the implementation of the MiFIR trading obligation can also reasonably be expected to improve liquidity for all market participants, including end-users, due to the increased transparency and competition present on regulated trading venues. In fact, trading on trading venues increases choice and access to a broader range of trading counterparties as compared to prior bilateral trading relationships that required the negotiation of complex documentation. Furthermore, buy-side customers are typically already connected to the main trading venues that facilitate trading in cleared IRS and CDS, such as Bloomberg and Tradeweb. |

<ESMA\_QUESTION\_MIFID\_TO\_13>

**Q14. Do you agree that trades above the post-trade large in scale threshold should not be subject to the TO? If not, what approach would you suggest? Should transactions above the post-trade LIS threshold meet further conditions in order to be exempted from the TO?**

<ESMA\_QUESTION\_MIFID\_TO\_14>

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<sup>30</sup> See Staff Working Paper No. 580 "Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act", Bank of England (January 2016), available at: <http://www.bankofengland.co.uk/research/Documents/workingpapers/2016/swp580.pdf>.

Article 32(3) of MiFIR permits ESMA to grant an exemption from the trading obligation for large trades, but does not require ESMA to do so. We do not believe that an exemption from the trading obligation is necessary for large trades under the MiFIR framework. First, these trades will already be eligible for both a pre-trade transparency waiver and a post-trade transparency deferral. Second, unlike the U.S. regime, trades subject to the MiFIR trading obligation will not be required to be executed via specific trading protocols, such as RFQ-to-3 or on an Order Book. As a result, trading venues can offer trading protocols that allow for private negotiation of large trades, removing any concerns about information leakage which motivated the need for a block trade exemption under the U.S. regime. When combined with the available waivers and deferrals from transparency requirements, we do not believe that an additional exemption from the trading obligation is necessary for large trades under MiFIR.

Requiring the execution of large trades on regulated trading venues, as long as they can be entered into through private negotiation protocols designed to avoid information leakage, will benefit market stability and integrity. For example, these trades would remain subject to the pre-trade check and straight-through-processing requirements in RTS 26 that are applicable to transactions concluded on a trading venue. This will help to ensure that market participants have available clearing capacity before executing large trades, thereby mitigating the possibility of a subsequent rejection from clearing, which is a particularly undesirable risk when executing a large trade. Ensuring that the pre-trade check requirements apply to large trades would also be consistent with the U.S. regime, where pre-execution credit checks are required for block trades that are intended to be cleared.<sup>31</sup> In fact, under the U.S. regime, market participants successfully petitioned the CFTC to allow block trades to be executed **on SEFs**, via the use of a RFQ-to-1 protocol.<sup>32</sup> A similar trading protocol for large trades is possible under the MiFIR framework and we urge ESMA to ensure that the pre-trade check and straight-through-processing requirements in Articles 2 and 3 of RTS 26 apply to large trades in derivatives that are subject to the trading obligation.

If ESMA were to nonetheless provide an exemption from the trading obligation for large trades, we agree that the post-trade large-in-scale (“LIS”) threshold is the appropriate reference point. This approach maximises harmonisation with how the U.S. regime calibrates the block trade exemption from the RFQ-to-3 or Order Book trading requirements. Although the post-trade LIS threshold includes both a trade count and volume component, we expect the volume component to drive the overall calculation, thereby assisting the comparison with the U.S. regime.<sup>33</sup> In addition, even when using the post-trade LIS threshold, up to 30% of the volume in a specific instrument may be eligible for the exemption, which is a significant portion of the market. We would certainly not support this exemption being broadened to include a greater percentage of trades.

In addition, if ESMA provides an exemption from the trading obligation for large trades, these trades should still be required to be executed **subject to the rules** of a regulated trading venue and ultimately reported into a venue in accordance with those rules. This will distinguish large trades in instruments subject to the trading obligation from large trades in other instruments and will provide consistency with how “block” trades are handled in other asset classes.

In conjunction with clarifying the application of the trading obligation to large trades, ESMA should clearly affirm that Article 28(1) of MiFIR requires that transactions in derivatives subject to the trading obligation must be concluded on a regulated trading venue. This means that unless an exemption applies, transactions in derivatives subject to the trading obligation cannot be pre-arranged or concluded outside of a regulated trading venue. Permitting trades subject to the trading obligation to be concluded outside of a regulated trading venue (even if subsequently reported into a venue) would significantly undermine the MiFIR framework, including the open and transparent execution process that characterizes transactions executed on a regulated venue. In addition, this could result in unintended outcomes, such as the pre-trade

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<sup>31</sup> See CFTC No-Action Letter 16-74 (Oct. 7, 2016) at FN 7, available at: <http://www.cftc.gov/idc/groups/public/@llettergeneral/documents/letter/16-74.pdf>.

<sup>32</sup> See CFTC No-Action Letter 16-74 (Oct. 7, 2016), available at: <http://www.cftc.gov/idc/groups/public/@llettergeneral/documents/letter/16-74.pdf>

<sup>33</sup> See “Is It Time To MAT The Entire Curve? (Part 1)” Clarus Financial Technology (Aug. 27, 2014), available at: <https://www.clarusft.com/is-it-time-to-mat-the-entire-curve-part-1/> (finding that 5-7% of trade count executed on SEFs accounts for the volume of block trades under the U.S. regime).

check and straight-through-processing requirements in Articles 2 and 3 of RTS 26 failing to apply. We urge ESMA to provide this clarification in connection with finalizing the trading obligation.]  
<ESMA\_QUESTION\_MIFID\_TO\_14>

**Q15. How highly should ESMA prioritise the alignment of the TO with transparency? What would be the main consequences for the market if some instruments are covered by transparency and not by the TO or vice versa? If the two are not fully aligned, would a broader scope for the TO or for transparency be preferable, and why? In case of a broader or narrower scope for the TO (compared with transparency), how should the two liquidity thresholds relate to each other?**

<ESMA\_QUESTION\_MIFID\_TO\_15>

In the Discussion Paper, ESMA's initial proposal is to apply a "de facto stricter liquidity test" for determining the scope of the trading obligation.<sup>34</sup> In our view, this approach is not supported by MiFIR for the following two reasons.

First, as a legal matter, the liquidity test for the trading obligation set forth in Article 32(3) is materially similar to the liquidity test for transparency set forth in the definition of a "liquid market" in Article 2(1)(17)(a). There is no indication that MiFIR contemplates a stricter liquidity test being applied for the trading obligation.

Second, applying a stricter liquidity test for purposes of the trading obligation ultimately results in that same stricter test being retroactively applied for purposes of the pre-trade transparency requirements given the available waiver under Article 9(1)(c) of MiFIR. This waiver applies to OTC derivatives that are subject to the clearing obligation but are not subject to the trading obligation. Therefore, even though a cleared OTC derivative is initially determined to be liquid under the test used in RTS 2, it can still benefit from a waiver from pre-trade transparency under Article 9(1)(c) if it fails to satisfy any stricter liquidity test that is applied for the trading obligation. This means that, in practice, any stricter liquidity test applied for the trading obligation also becomes the de facto liquidity test for RTS 2, overriding ESMA's work in developing a suitable liquidity test for transparency. This will result in situations where OTC derivatives that have been assessed as sufficiently liquid for both (a) the EMIR clearing obligation and (b) non-equity transparency requirements under RTS 2 will nonetheless be eligible for a waiver from pre-trade transparency.

For both of the reasons above, we believe that the liquidity test for the trading obligation should be materially aligned with the liquidity test for transparency. Under ESMA's initial proposal, the liquidity test for the trading obligation is stricter due to the application of the same 10 trades-per-day threshold used in RTS 2 to the much smaller data set that is being analysed for purposes of implementing the trading obligation. Under RTS 2, the 10 trades-per-day threshold is applied at the subclass level, which, for a given currency of fixed-to-floating interest rate swaps, includes (a) all swaps in a given benchmark tenor and (b) all broken-dated swaps with maturities extending until the next benchmark tenor. However, when assessing liquidity for purposes of the trading obligation, ESMA proposes to eliminate all non-benchmark tenor swaps from the data set, thereby removing approximately 55% of the total number of transactions.<sup>35</sup> Applying the same 10 trades-per-day threshold to a data set that has been reduced by over 50% results in a significantly stricter liquidity test being applied.

In order to calibrate the liquidity test for the trading obligation so that it is materially aligned with the liquidity test for transparency, ESMA must reduce the trades-per-day threshold by the same percentage that the data set used in RTS 2 has been reduced. Given that the overall data set has been reduced by more than 50% when compared to the data set used in RTS 2, the trades-per-day threshold should be set at no more than **5 trades-per-day**.

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<sup>34</sup> See Discussion Paper at Paragraph 105.

<sup>35</sup> Discussion Paper at Paragraph 126, Table 6.

Appropriately calibrating the trades-per-day threshold used to determine the scope of the trading obligation will ensure that sufficiently liquid OTC derivatives are not inadvertently excluded. For example, additional benchmark tenors in both USD (6, 12, 15, and 20 years) and GBP (2, 3, 4, 7, 15, and 20 years) interest rate swaps are sufficiently liquid for the trading obligation, but are not included in the initial proposed scope. In many cases, these omitted cleared OTC derivatives are already subject to a trading obligation in other jurisdictions, further illustrating their liquidity and suitability for trading on regulated trading venues.

The practical effect of more accurately conforming the liquidity test used for the trading and transparency regimes will be to reduce the number of instances where an instrument is assessed as liquid under RTS 2 but illiquid for purposes of trading obligation (and therefore also eligible for a waiver from pre-trade transparency). Minimising this type of divergence will not make the trading obligation broader than the transparency regime (as all of the instruments are liquid under RTS 2); instead it will serve to strengthen both regimes by ensuring that liquid instruments are not excluded from both requirements.

More accurately conforming the liquidity test used for the trading and transparency regimes should not be expected to result in a significant number of instances where an instrument is assessed as illiquid under RTS 2 but liquid for purposes of the trading obligation. Notably, we anticipate that the vast majority of subclasses containing fixed-to-floating interest rate swaps and index CDS that are subject to the EMIR clearing obligation will be determined to be liquid under RTS 2. To the extent that this mismatch does arise, it should highlight the need for further analysis by ESMA before applying the trading obligation. The additional criteria in RTS 4 provide ESMA with the necessary flexibility to perform a holistic liquidity assessment based on all of the gathered data in order to arrive at the correct result. This also highlights the importance of performing a holistic assessment of liquidity as contemplated in RTS 4. Trades-per-day should be one component of this overall assessment, but not the only one, and therefore a failure to satisfy the trades-per-day threshold alone should not automatically result in such instrument being excluded from the trading obligation. Instead, ESMA should also be analysing the amount of trading volume that already occurs on trading venues, the average size of trades, the number and type of active market participants, and the number of liquidity providers regularly offering quotes.

We note that certain derivatives may be determined to be illiquid under RTS 2 as a result of the application of additional qualitative criteria, rather than failing to satisfy objective liquidity measures. For example, under RTS 2, the first off-the-run version of an index credit default swap is only deemed to be liquid for the first 30 working days of its off-the-run status, irrespective of actual trading activity. We believe that the first off-the-run index is sufficiently liquid to be subject the trading obligation throughout its duration, notwithstanding the qualitative criteria under RTS 2. This is based on an objective analysis of the criteria in RTS 4, including the number and type of active market participants, the number of liquidity regularly offering quotes to clients, and the amount of trading that already occurs on regulated venues. Furthermore, the first off-the-run series is already covered by the U.S. trading obligation and trading activity in these instruments has successfully transitioned to regulated trading venues.

Finally, while we recommend that ESMA focus on the first option of modifying the trades-per-day threshold for purposes of defining the initial scope of the trading obligation, we support ESMA retaining the flexibility to modify its approach in future consultations regarding expansions to this initial scope. Specifically, it is possible that all interest rate swaps in a specific currency (including non-benchmark tenors) will become subject to the trading obligation in other jurisdictions and, if that were to occur, it would be useful for ESMA to have the flexibility to analyse liquidity at a sub-class level, as is the case for transparency under RTS 2.

<ESMA\_QUESTION\_MIFID\_TO\_15>

**Q16. Do you agree with the proposed methodology to eliminate duplicated trades or would you recommend another approach? Do you agree with selecting Option 2?**

<ESMA\_QUESTION\_MIFID\_TO\_16>

We are concerned that ESMA is eliminating too many records from the data set as a result of being unable to link the various transaction reports associated with a single cleared OTC derivative. In attempting to

remove duplicate trade reports, ESMA has proposed to exclude all transactions from the data set where one of the counterparties is a CCP or a clearing member. This results in the elimination of nearly 70% of the transactions in the data set, which we believe is far too high.<sup>36</sup>

In developing its methodology for eliminating duplicate records, ESMA appears to suggest that the execution of a cleared OTC derivative should always be accompanied by a transaction report for the originally executed trade, designating such trade as “Not-cleared”. We do not believe this accurately reflects current market practice.

We are aware that market participants will often rely on the transaction reporting by the CCP in the first instance for cleared trades and will not separately report the initial bilateral trade that was submitted to clearing. This reporting approach leverages guidance provided by ESMA in the context of cleared exchange-traded derivatives, and reflects the successful clearing of the trade on the day of execution.<sup>37</sup> In this scenario, all of the options proposed by ESMA would result in far too many transaction reports being removed from the data set. As an example, assume self-clearing members Party A and Party B execute a trade and submit it to CCP X for clearing. Under the reporting approach described above, the only transaction reports submitted would be for trades between (a) Party A and CCP X and (b) Party B and CCP X. Every single report associated with this cleared derivative would therefore be eliminated under *all* of the options being considered by ESMA since the CCP is a counterparty in each of the transaction reports.

In addition, it is important to note that cleared OTC derivatives can be executed on anonymous order books and many MTFs already offer this functionality. In this case, the trading counterparties would not know the identity of the other counterparty, and would instead immediately face the CCP, eliminating the possibility of any trade reporting prior to clearing. Furthermore, the straight-through-processing requirements in Article 5 of RTS 26 provide that any intended-to-be-cleared trade executed electronically on a regulated trading venue will be considered void if not successfully cleared, suggesting that separate transaction reports for any original bilateral trade will not exist in these situations either.

As a practical matter, absent the ability to link any initial transaction report to subsequent reports indicating that the trade has been successfully cleared, reporting intended-to-be-cleared transactions as “Not-cleared” would appear to make it difficult to distinguish such trades from those that actually remain un-cleared. This would hinder the ability of regulators to monitor compliance with relevant regulatory requirements, such as the EMIR mandatory clearing obligation and the straight-through-processing requirements under RTS 26 that establish a deadline for how quickly the original trade must be submitted to clearing.

As a result of the above, we urge ESMA to consider a different approach to eliminate duplicate records from the data set. A more accurate methodology for eliminating duplicate trades would be to identify the number of cleared transactions in the data set and divide by two (2) to reflect the fact that one bilateral transaction becomes two after it has been cleared. We believe this simpler approach would be far more accurate, particularly given that the EMIR clearing obligation still only applies to Category 1 entities, which are all self-clearing members. We encourage ESMA to work with national competent authorities and CCPs to understand how cleared OTC derivatives are being reported in practice and obtain data directly from the CCPs regarding the number of trades cleared during the relevant timeframe in order to check the accuracy of the methodology.

Given the amount of self-clearing activity, it is critically important that these cleared trades are not incorrectly removed from the data set. More generally, we urge ESMA to work to ensure, as a matter of priority, that transaction reports associated with a single cleared OTC derivative can be accurately identified and linked. This is crucial to ensuring that policy decisions are based on accurate data regarding the market’s transition to central clearing.

<ESMA\_QUESTION\_MIFID\_TO\_16>

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<sup>36</sup> See Discussion Paper at Table 5.

<sup>37</sup> See TR Question 6, Questions and Answers: Implementation of the Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR) (July 26, 2016), available at: <https://www.esma.europa.eu/press-news/esma-news/esma-updates-its-emir-qa-2>.



**Q17. Do you agree with the approach taken with regard to calculating tenors?**

<ESMA\_QUESTION\_MIFID\_TO\_17>

In order to more precisely calculate tenors, we recommend that ESMA also take into account the effective date of a contract in addition to the execution date and the maturity date. This should allow for the identification of forward-starting contracts, as otherwise a 5-year forward starting 5-year swap will appear as the same as a spot-starting 10-year swap.

Given the identified data deficiencies, we agree with ESMA's approach to group transactions by benchmark dates +/- 5 days. This should allow spot-starting benchmark swaps (which typically have an effective date of Trade Date + 2 Business Days) to be identified, taking into account data quality issues and ESMA's methodology of dividing the total number of days between the maturity date and execution date of a contract by 365.25 in order to take into account leap years, which will often result in a figure that is not a round number.

<ESMA\_QUESTION\_MIFID\_TO\_17>

**Q18. Do you agree with the reasons mentioned above or is there another explanation for the significant number of trades outside of benchmark dates?**

<ESMA\_QUESTION\_MIFID\_TO\_18>

We agree that there are a variety of reasons why more than 50% of the transactions in the ESMA data set appear to be non-benchmark transactions, including as a result of novations, unwinds, and swaps being packaged with new bond issuances. However, many swaps that appear as non-benchmark in the data set represent trading activity in derivatives that are sufficiently liquid for the trading obligation and ESMA should analyse this portion of the data set further as required by Article 32 of MiFIR.

For example, transactions in IMM and MAC interest rate swaps are forward-starting and therefore would likely appear as non-benchmark swaps in the ESMA data set. IMM interest rate swaps are standardised instruments that start on quarterly International Money Market ("IMM") dates, which are the 3rd Wednesday of March, June, September and December.<sup>38</sup> MAC interest rate swaps also start on quarterly IMM dates, and use one of a few pre-set fixed Market Agreed Coupons ("MAC") in order to further increase standardisation.<sup>39</sup> Many benchmark tenors in these forward-starting swaps are sufficiently liquid for the trading obligation. According to an analysis of U.S. SDR data, IMM and MAC swaps together constitute approximately 15% of the USD interest rate swap market in terms of trade count, and may account for even more of the EUR and GBP interest rate swap market.<sup>40</sup> Notably, IMM and MAC interest rate swaps are already subject to the U.S. trading obligation.<sup>41</sup> It is therefore critical that ESMA perform a liquidity assessment of IMM and MAC swaps.

In addition, swaps that appear as non-benchmark in the ESMA data set are commonly included as part of an asset swap package with a cleared future (otherwise known as an "invoice spread"). These invoice spread packages are already listed and executed on MTFs, with the most common involving Gilt futures or

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<sup>38</sup> See "The IMM Roll for Swaps- What is it and What are the volumes?" Clarus Financial Technology (March 31, 2015), available at: <https://www.clarusft.com/the-imm-roll-for-swaps-what-is-it-and-what-are-the-volumes/>.

<sup>39</sup> See "SIFMA Asset Management Group Helps Develop New Market Agreed Coupon for Interest Rate Swaps" (April 23, 2013), available at: <http://www.sifma.org/newsroom/2013/sifma-asset-management-group-helps-develop-new-market-agreed-coupon-for-interest-rate-swaps/>.

<sup>40</sup> See "30% of the Euro swap market is standardized?" Clarus Financial Technology (Aug. 23, 2016), available at: <https://www.clarusft.com/30-of-the-euro-swap-market-is-standardized/> (The initial analysis by Clarus found that IMM and MAC swaps constitute approximately 30% of the EUR interest rate swap market and as much as 43% of the GBP interest rate swap market).

<sup>41</sup> See Swaps Made Available to Trade, available at: <http://www.cftc.gov/idx/groups/public/@otherif/documents/file/swapsmadeavailablechart.pdf>.



the Schatz, Bobl, Bund, or Buxl futures that reference German Bunds.<sup>42</sup> From an operational workflow perspective, a single price is listed for the package on an MTF, representing the price for executing both the interest rate derivative and the future. Then, following execution, the future is reported into the relevant exchange pursuant to its rules.

An analysis of U.S. swap data repository data reveals that in relevant USD instruments, invoice spread volumes can reach \$20 billion per day and account for up to 3% of total volumes in the related bond future.<sup>43</sup> Given that these packages more frequently trade with a EUR or GBP interest rate swap, we would expect these figures to be significantly higher in the EU market.

We urge ESMA to identify these packages in the data set<sup>44</sup> and apply the trading obligation to the forward-starting EUR and GBP swaps that are executed alongside a cleared future. We believe that market data regarding overall trading activity will show that invoice spread packages, and the forward-starting swaps included in these packages, are sufficiently liquid for the trading obligation pursuant to the criteria set forth in RTS 4. The liquidity of the overall package is also assisted by the fact that the future is cleared as well, meaning that all instruments included in the package are cleared derivatives. We encourage ESMA to gather data from trading venues and futures exchanges such as Eurex and ICE in order to help assess the liquidity of these packages.

Given that more than 50% of the ESMA data set appears as non-benchmark tenors, we urge ESMA to perform additional analysis of this trade population. Under Article 32 of MiFIR, ESMA should analyse all of the classes of derivatives subject to the clearing obligation in order to assess whether they are sufficiently liquid for the trading obligation. Since many swaps that appear as non-benchmark in the ESMA data set are actually either (a) benchmark transactions in forward-starting IMM and MAC interest rate swaps or (b) part of a highly liquid invoice spread package with a cleared future, we urge ESMA to assess whether such swaps are appropriate for the trading obligation. This will ensure liquid cleared OTC derivatives are not inadvertently excluded from the trading obligation, which would also result in these liquid cleared OTC derivatives being eligible for a waiver from pre-trade transparency requirements under Article 9(1)(c) of MiFIR.

<ESMA\_QUESTION\_MIFID\_TO\_18>

**Q19. Does this result reflect your assessment of liquidity in fixed-float IRS? If not, please explain on which subclasses you disagree and why.**

<ESMA\_QUESTION\_MIFID\_TO\_19>

No, based on our experience transacting in the OTC derivatives market, the initial liquidity assessment of fixed-to-floating IRS fails to include a significant number of liquid instruments.

First, additional benchmark tenors in USD and GBP are sufficiently liquid for the trading obligation. These include the 6, 12, 15, and 20 year tenors for USD and the 2, 3, 4, 7, 15, and 20 year tenors for GBP.

Second, many benchmark tenors in forward-starting IMM and MAC instruments are also sufficiently liquid for the trading obligation, in each case for the next two upcoming IMM dates. We list those tenors and currencies below:

- USD IMM- 2, 3, 4, 5, 6, 7, 10, 15, 20, 30

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<sup>42</sup> See, e.g., "Trad-X strengthens interest rate swaps market presence with Eurex Clearing partnership" (Feb. 22, 2016), available at: <http://voxia.ch/en/trad-x-strengthens-interest-rate-swaps-market-presence-with-eurex-clearing-partnership/> (highlighting the trading of invoice spreads).

<sup>43</sup> See "Mechanics and Definitions of Bond Futures," Clarus Financial Technology (July 19, 2016), available at: <https://www.clarusft.com/mechanics-and-definitions-of-bond-futures/>.

<sup>44</sup> See "A New Flavor of Invoice Spreads?" Clarus Financial Technology (June 12, 2015), available at: <https://www.clarusft.com/a-new-flavor-of-invoice-spreads/> (explaining how to find invoice spreads).

- EUR IMM- 2, 3, 5, 6, 7, 8, 9, 10, 15, 20, 30
- GBP IMM- 2, 5, 10, 15, 30
- USD MAC- 1, 2, 3, 4, 5, 7, 10, 15, 20, and 30
- EUR MAC- 2, 5, 7, 10, 15, 20, 30
- GBP MAC- 2, 5, 7, 10, 15, 20, 30

According to an analysis of U.S. SDR data, IMM and MAC swaps together constitute approximately 15% of the USD interest rate swap market in terms of trade count, and may account for even more of the EUR and GBP interest rate swap market.<sup>45</sup>

Third, forward-starting EUR and GBP interest rate swaps traded as part of an invoice spread package with a cleared future are highly liquid given the frequency with which this particular type of package is traded in the EU. These invoice spread packages are already listed and executed on MTFs, with the most common involving Gilt futures or the Schatz, Bobl, Bund, or Buxl futures that reference German Bunds.<sup>46</sup> From an operational workflow perspective, a single price is quoted for the package on an MTF, representing the price for executing both the interest rate derivative and the future. Then, following execution, the future is reported into the relevant exchange pursuant to its rules. An analysis of U.S. swap data repository data reveals that in relevant USD instruments, invoice spread volumes can reach \$20 billion per day and account for up to 3% of total volumes in the related bond future.<sup>47</sup> Given that these packages more frequently trade with a EUR or GBP interest rate swap, we would expect these figures to be significantly higher in the EU market.

All of these fixed-to-floating interest rate swaps should be considered sufficiently liquid based on a holistic assessment of the criteria included in RTS 4. We believe that the instruments above were excluded from the initial proposed scope of the trading obligation due to (a) ESMA applying a “de facto stricter liquidity test” for determining the scope of the trading obligation compared to transparency requirements (as discussed in our response to Question 15), and (b) ESMA having not yet analysed the 50% of the data set that appears to be non-benchmark transactions (as discussed in our response to Question 18).

In addition, in order to accurately assess the liquidity of specific instruments, ESMA must ensure that it is capturing all of the trading activity in the market. As highlighted in our response to Question 16, we are concerned that ESMA is eliminating too many records from the data set as a result of being unable to link the various transaction reports associated with a single cleared OTC derivative. In addition, ESMA has eliminated all swaps that have been executed on a regulated trading venue, such as an MTF, from the data set.<sup>48</sup> A number of MTFs have been established to trade OTC derivatives, including BGC Brokers LP, Bloomberg Trading Facility Limited, GFI CreditMatch, GFI RatesMatch, ICAP Global Derivatives Limited, ICAP Europe MTF, MarketAxess Europe Limited, TPCreditDeal, TPSwapDeal, Trad-X, and Tradeweb.<sup>49</sup> It is our understanding that significant volumes in OTC derivatives occur on these platforms, and therefore ESMA must ensure this volume is included when assessing the overall liquidity of an instrument.

We encourage ESMA to gather data that can help evaluate the liquidity criteria in RTS 4 directly from trading venues and CCPs in order to supplement the data available from EU trade repositories. In addition, the scope of the U.S. trading obligation is also an important reference point, and is much broader than the

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<sup>45</sup> See “30% of the Euro swap market is standardized?” Clarus Financial Technology (Aug. 23, 2016), available at: <https://www.clarusft.com/30-of-the-euro-swap-market-is-standardized/> (The initial analysis by Clarus found that IMM and MAC swaps constitute approximately 30% of the EUR interest rate swap market and as much as 43% of the GBP interest rate swap market).

<sup>46</sup> See, e.g., “Trad-X strengthens interest rate swaps market presence with Eurex Clearing partnership” (Feb. 22, 2016), available at: <http://voxia.ch/en/trad-x-strengthens-interest-rate-swaps-market-presence-with-eurex-clearing-partnership/> (highlighting the trading of invoice spreads).

<sup>47</sup> See “Mechanics and Definitions of Bond Futures,” Clarus Financial Technology (July 19, 2016), available at: <https://www.clarusft.com/mechanics-and-definitions-of-bond-futures/>.

<sup>48</sup> See Discussion Paper at Paragraph 116.

<sup>49</sup> See [https://registers.esma.europa.eu/publication/searchRegister?core=esma\\_registers\\_mifid\\_mtf](https://registers.esma.europa.eu/publication/searchRegister?core=esma_registers_mifid_mtf).



initial ESMA proposal.<sup>50</sup> Interestingly, many of the same criteria that appear in RTS 4 were considered in connection with defining the appropriate scope of the U.S. trading obligation and should provide additional data for ESMA given the global liquidity pool that exists for these instruments. Specifically, in the context of determining the scope of the U.S. trading obligation more than three years ago, a number of significant global operators of OTC derivatives trading venues, including both Bloomberg and Tradeweb, voluntarily provided an analysis of the liquidity in EUR, GBP, and USD fixed-to-floating IRS (among other instruments). Their analysis included an evaluation of similar criteria to those in RTS 4, including (i) whether there are ready and willing buyers and sellers, (ii) the frequency and size of transactions, (iii) trading volumes, (iv) the number and types of market participants, and (v) bid/ask spreads, and (vi) the usual number of resting firm or indicative bids and offers, and concluded that a broader scope of instruments should be subject to the trading obligation when compared against the initial ESMA proposal.<sup>51</sup> In our experience, global liquidity in these interest rate products has only increased since that time. |

<ESMA\_QUESTION\_MIFID\_TO\_19>

**Q20. What thresholds would you propose as the liquidity criteria? What minimum number of counterparties would you consider appropriate for introducing the TO?**

<ESMA\_QUESTION\_MIFID\_TO\_20>

In our view, RTS 4 contemplates a holistic liquidity assessment where ESMA gathers data on a variety of liquidity measures, and we do not believe that ESMA should attempt to establish and rigidly apply minimum thresholds. Minimum thresholds are not required under RTS 4 and risk being miscalibrated levels that fail to take into account the significant variations that exist across different types of derivatives. For example, the index CDS market is much smaller than the EUR interest rate swap market, but that does not suggest that the index CDS market is not sufficiently liquid for the trading obligation. Furthermore, establishing a minimum threshold for one specific criteria inevitably elevates that criteria above the others in RTS 4 if the assessment cannot continue unless the threshold is met.

We urge ESMA to instead gather the relevant data in order to assess all of the liquidity criteria in RTS 4 on a holistic basis. By gathering all of the data envisaged in RTS 4 and analysing it together, ESMA will be in a better position to compare and contrast different types of derivatives within a given asset class, and appropriately calibrate the trading obligation so that sufficiently liquid derivatives are not inadvertently excluded.

If ESMA nonetheless decides to set specific thresholds, we do not believe that a minimum threshold requiring transactions to take place on at least 80% of trading days should be imposed. For example, certain types of instruments such as IMMs and MACs will trade much more frequently on specific roll dates.<sup>52</sup> Notably, this type of threshold was not imposed when assessing the liquidity of cleared OTC derivatives under RTS 2, and was only imposed for bonds and structured finance products.

In addition, any trades-per-day threshold established by ESMA must not result in a stricter liquidity test being applied for the trading obligation than the similar liquidity test that is being used for transparency purposes under RTS 2. ESMA's initial proposal is to apply a "de facto stricter liquidity test" for determining the scope of the trading obligation.<sup>53</sup> In our view, this approach is not supported by MiFIR for the following two reasons.

First, as a legal matter, the liquidity test for the trading obligation set forth in Article 32(3) is materially similar to the liquidity test for transparency set forth in the definition of a "liquid market" in Article 2(1)(17)(a).

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<sup>50</sup> See Swaps Made Available to Trade, available at: <http://www.cftc.gov/idx/groups/public/@otherif/documents/file/swapsmadeavailablechart.pdf>.

<sup>51</sup> See, e.g., TrueEx MAT filing (Oct. 21, 2013), available at: <http://www.cftc.gov/stellent/groups/public/@otherif/documents/ifdocs/trueexsub201314mat.pdf>; and Javelin MAT filing (Oct. 18, 2013), available at: <http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/rul010814javsef001.pdf>.

<sup>52</sup> See "The IMM Roll for Swaps- What is it and What are the volumes?" Clarus Financial Technology (March 31, 2015), available at: <https://www.clarusft.com/the-imm-roll-for-swaps-what-is-it-and-what-are-the-volumes/>.

<sup>53</sup> See Discussion Paper at Paragraph 105.

There is no indication that MiFIR contemplates a stricter liquidity test being applied for the trading obligation.

Second, applying a stricter liquidity test for purposes of the trading obligation ultimately results in that same stricter test being retroactively applied for purposes of the pre-trade transparency requirements given the available waiver under Article 9(1)(c) of MiFIR. This waiver applies to OTC derivatives that are subject to the clearing obligation but are not subject to the trading obligation. Therefore, even though a cleared OTC derivative is initially determined to be liquid under the test used in RTS 2, it can still benefit from a waiver from pre-trade transparency under Article 9(1)(c) if it fails to satisfy any stricter liquidity test that is applied for the trading obligation. This means that, in practice, any stricter liquidity test applied for the trading obligation also becomes the de facto liquidity test for RTS 2, overriding ESMA's work in developing a suitable liquidity test for transparency. This will result in situations where OTC derivatives that have been assessed as sufficiently liquid for both (a) the EMIR clearing obligation and (b) non-equity transparency requirements under RTS 2 will nonetheless be eligible for a waiver from pre-trade transparency.

For both of the reasons above, we believe that the liquidity test for the trading obligation should be materially aligned with the liquidity test for transparency. Under ESMA's initial proposal, the liquidity test for the trading obligation is stricter due to the application of the same 10 trades-per-day threshold used in RTS 2 to the much smaller data set that is being analysed for purposes of implementing the trading obligation. Under RTS 2, the 10 trades-per-day threshold is applied at the subclass level, which, for a given currency of fixed-to-floating interest rate swaps, includes (a) all swaps in a given benchmark tenor and (b) all broken-dated swaps with maturities extending until the next benchmark tenor. However, when assessing liquidity for purposes of the trading obligation, ESMA proposes to eliminate all non-benchmark swaps from the data set, thereby removing approximately 55% of the total number of transactions.<sup>54</sup> Applying the same 10 trades-per-day threshold to a data set that has been reduced by over 50% results in a significantly stricter liquidity test being applied.

In order to calibrate the liquidity test for the trading obligation so that it is materially aligned with the liquidity test for transparency, ESMA must reduce the trades-per-day threshold by the same percentage that the data set used in RTS 2 has been reduced. Given that the overall data set has been reduced by more than 50% when compared to the data set used in RTS 2, the trades-per-day threshold should be set at no more than **5 trades-per-day**.

We also urge ESMA to use any trades-per-day threshold as part of the overall liquidity assessment that takes into account the other criteria in RTS 4. These criteria include the amount of trading volume that already occurs on trading venues, the average size of trades, the number and type of active market participants, and the number of liquidity providers regularly offering quotes. Under the current ESMA approach, it appears that the trades-per-day test is determinative, with an instrument included in the trading obligation if it passes this threshold and excluded from the trading obligation if it falls short. We instead recommend that the trades-per-day threshold be a factor in the overall liquidity assessment, but not determinative, and that a failure to satisfy the trades-per-day threshold alone should not automatically result in an instrument being excluded from the trading obligation.

We also encourage ESMA to utilize all available sources of market data when evaluating the liquidity criteria. For example, trading activity already occurring on regulated trading venues, such as MTFs, should be considered per Article 2(2) of RTS 4, instead of being entirely excluded.<sup>55</sup> Trading venues can also indicate the number of liquidity providers regularly offering quotes to clients, which is one of the most important indicators of whether there is sufficient liquidity in an instrument and the ease with which a client can transact. In addition, data from the CCPs for interest rate swaps and credit default swaps can provide a sense of the global liquidity pool that exists for cleared instruments and can assist ESMA in ensuring that too many records were not inadvertently eliminated from the data set as a result of not being able to link the various transaction reports associated with a single cleared OTC derivative. We recommend that ESMA work with national competent authorities and global policymakers and regulators as appropriate in

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<sup>54</sup> Discussion Paper at Paragraph 126, Table 6.

<sup>55</sup> See Discussion Paper at Paragraph 116.



order to obtain access to these additional data sources for purposes of accurately assessing the liquidity of specific classes of derivatives. |

<ESMA\_QUESTION\_MIFID\_TO\_20>

**Q21. What further specifications (e.g. payment frequency, reset frequency, day count convention, trade start type) would you consider necessary for specifying the trading obligation for fixed-float IRS? How would you determine these additional specifications?**

<ESMA\_QUESTION\_MIFID\_TO\_21>

We agree that additional granularity should be provided regarding the instruments subject to the MiFIR trading obligation. Specifications such as payment frequency, reset frequency and day count convention will be useful to distinguish standard transactions from more bespoke variations. However, ESMA should be mindful that providing too many additional specifications may provide a mechanism to evade the trading obligation, particularly if certain additional specifications can be altered without materially affecting the price of the transaction.

In order to determine the appropriate specifications for the instruments subject to the trading obligation, ESMA should consult the trading venues and the specifications listed by the CFTC for purposes of the U.S. trading obligation.<sup>56</sup> Ideally, EU trade repository data should also be able to assist, but it appears ESMA is encountering serious shortcomings in this data that should be rectified as a matter of priority.<sup>57</sup> |

<ESMA\_QUESTION\_MIFID\_TO\_21>

**Q22. Does this result reflect your assessment of liquidity in OIS? If not, please explain on which subclasses you disagree and why.**

<ESMA\_QUESTION\_MIFID\_TO\_22>

|TYPE YOUR TEXT HERE |

<ESMA\_QUESTION\_MIFID\_TO\_22>

**Q23. What thresholds would you propose for the liquidity criteria? What minimum number of counterparties would you consider appropriate for introducing the TO?**

<ESMA\_QUESTION\_MIFID\_TO\_23>

|TYPE YOUR TEXT HERE |

<ESMA\_QUESTION\_MIFID\_TO\_23>

**Q24. What further specifications (e.g. payment frequency, reset frequency, day count convention, trade start type) would you consider necessary for specifying the trading obligation for OIS? How would you determine these additional specifications?**

<ESMA\_QUESTION\_MIFID\_TO\_24>

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<ESMA\_QUESTION\_MIFID\_TO\_24>

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<sup>56</sup> See Swaps Made Available to Trade, available at: <http://www.cftc.gov/idc/groups/public/@otherif/documents/file/swapsmadeavailablechart.pdf>.

<sup>57</sup> See Discussion Paper at Paragraph 133.

**Q25. Do you agree that due to the specificities of the FRA-market, FRAs should not be considered for the TO? Do you agree that the majority of FRAs transactions serve post-trade risk reduction purposes rather than actual trades.**

<ESMA\_QUESTION\_MIFID\_TO\_25>  
|TYPE YOUR TEXT HERE |  
<ESMA\_QUESTION\_MIFID\_TO\_25>

**Q26. In case you consider FRAs should be considered for the TO, which FRA sub-classes are in your view sufficiently liquid and based on which criteria? How should a TO for FRAs best be expressed? Should it be based on the first (effective date) or the second period (reference date)? Apart from the tenor, which elements do you consider necessary for specifying the TO for FRAs and why?**

<ESMA\_QUESTION\_MIFID\_TO\_26>  
|TYPE YOUR TEXT HERE |  
<ESMA\_QUESTION\_MIFID\_TO\_26>

**Q27. Would you consider the two index CDS as sufficiently liquid for being covered by the TO?**

<ESMA\_QUESTION\_MIFID\_TO\_27>

Yes, we agree that both the iTraxx Europe and iTraxx Crossover indices are sufficiently liquid for the trading obligation. These instruments should be considered sufficiently liquid based on a holistic assessment of the criteria included in RTS 4, including the average frequency of trades, the amount of trading volume that already occurs on trading venues, the average size of trades, the number and type of active market participants, and the number of dealers regularly offering quotes. The scope of the U.S. trading obligation is also an important reference point that indicates the deep global liquidity pool for these instruments.

In addition, we would note that the CDX IG and CDX HY indices are also sufficiently liquid for the trading obligation. As highlighted by ESMA in the Consultation Paper on the Clearing Obligation under EMIR (no. 2), the CDX IG index is the second-largest in terms of total notional amount traded after the iTraxx Europe index.<sup>58</sup> Under Article 32(4) of MiFIR, ESMA has the power to identify classes of derivatives that should be subject to the trading obligation but for which no CCP has yet received authorisation under EMIR. According to the ESMA Public Register for the Clearing Obligation under EMIR,<sup>59</sup> it does not appear as though a CCP has received authorisation for CDX indices.

Therefore, given the trading activity in these indices, the available clearing solutions on recognised third-country CCPs, and the fact that these indices are subject to the trading obligation in the U.S., we believe that it is appropriate for ESMA to conduct a liquidity assessment of both CDX IG and CDX HY in accordance with the criteria outlined in RTS 4 pursuant to its power under Article 32(4) of MiFIR. |

<ESMA\_QUESTION\_MIFID\_TO\_27>

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<sup>58</sup> See Consultation Paper on the Clearing Obligation under EMIR (no. 2) at page 19, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-800.pdf>.

<sup>59</sup> See Public Register for the Clearing Obligation under EMIR, available at: [https://www.esma.europa.eu/sites/default/files/library/public\\_register\\_for\\_the\\_clearing\\_obligation\\_under\\_emir.pdf](https://www.esma.europa.eu/sites/default/files/library/public_register_for_the_clearing_obligation_under_emir.pdf).



**Q28. Do you agree that the TO for CDS should cover the on-the-run series as well as the first thirty working days of the most recent off-the-run-series? If not, please explain why and propose an alternative approach.**

<ESMA\_QUESTION\_MIFID\_TO\_28>

The trading obligation should cover both the on-the-run series and most recent off-the-run series. A significant amount of trading in both of these series does occur in the days following the creation of the new index as market participants “roll” their position by offsetting a transaction in the older series and entering into a new transaction in the current series. However, for the entire length of time that a series is the most recent off-the-run, and not just for the first 30 working days, there is sufficient liquidity for it to be subject to the trading obligation.

We recognize that an additional qualitative liquidity criterion was added to RTS 2 that results in the most recent off-the-run series only being deemed to be liquid for transparency purposes for the first 30 working days. However, RTS 4 instructs ESMA to focus on quantitative criteria for assessing the liquidity of an instrument for purposes of the trading obligation. We believe that a holistic assessment of the criteria in RTS 4, as applied to the most recent off-the-run series as a whole, will result in the determination that the trading obligation should also be applied to the most recent off-the-run series. This conclusion is also consistent with the scope of the U.S. trading obligation. |

<ESMA\_QUESTION\_MIFID\_TO\_28>

**Q29. Apart from the tenor, which elements do you consider indispensable for specifying the TO for CDSs and why?**

<ESMA\_QUESTION\_MIFID\_TO\_29>

Given the standardization of credit default swap transactions, we do not believe that additional specifications are necessary in order to identify the instruments subject to the trading obligation. |

<ESMA\_QUESTION\_MIFID\_TO\_29>

**Q30. Do you agree with the proposed application dates? If not, please provide an alternative and explain your reasoning.**

<ESMA\_QUESTION\_MIFID\_TO\_30>

Yes, we agree with the proposed application dates. Mandatory trading should not apply to a category of counterparties prior to such category of counterparties being subject to mandatory clearing with respect to the relevant class of derivatives. This will provide a natural phase-in for Category 4 counterparties, and potentially also Category 3 counterparties given the proposed delay to the clearing obligation, giving them time after January 1, 2018 in order to take the necessary steps in order to comply with the trading obligation.

However, it is important that trading obligation apply to categories of counterparties already subject to mandatory clearing as soon as possible following the implementation date of MiFID II. Thus, at a minimum, Category 1 and Category 2 market participants should be subject to the trading obligation on the same date. This will ensure that trading activity in liquid derivatives transitions to regulated platforms, achieving the MiFID II objectives of enhancing market resiliency, transparency, and competition for the benefit of all market participants. |

<ESMA\_QUESTION\_MIFID\_TO\_30>

**Q31. Do you consider necessary to provide for an additional phase-in for the TO for operational purposes and to avoid bottlenecks? If yes, please provide a proposal on**

**the appropriate length of such a phase-in for the different categories of counterparties and explain your reasoning.**

<ESMA\_QUESTION\_MIFID\_TO\_31>

No, we do not believe that an additional phase-in is necessary to implement the trading obligation. Most market participants have already established connectivity to the major trading venues for cleared derivatives. In addition, we anticipate that any new venues, such as OTFs, will begin submitting applications for registration during the course of 2017, allowing market participants sufficient time to establish connectivity in advance of the MiFID II implementation date. Furthermore, the trading venues that we expect will initially serve the dealer-to-customer market are MTFs that are already registered. The phase-in already provided to Category 4 counterparties, and potentially also Category 3 counterparties given the proposed delay to the clearing obligation, will provide these market participants with additional time to take the necessary steps in order to comply with the trading obligation.

It is important to note that no additional phase-in by counterparty type was provided when implementing the U.S. trading obligation, and such a staggered transition may only serve to bifurcate liquidity between on-venue and off-venue transactions.

<ESMA\_QUESTION\_MIFID\_TO\_31>

**Q32. Which types of package transactions are carried out comprising components of classes of derivatives that are assessed for the purpose of the TO, i.e. IRD and/or CDS? Please describe the package and its components as well as your view on the liquidity of those packages.**

<ESMA\_QUESTION\_MIFID\_TO\_32>

There are many different types of package transactions that include an interest rate derivative or credit derivative subject to the EMIR clearing obligation. Data has shown that over 50% of all USD interest rate swaps entered into are actually transacted as part of a package,<sup>60</sup> and we anticipate similar statistics for EUR and GBP interest rate swaps. It is therefore critical that standardised and liquid packages are not exempted from the trading obligation.

Examples of liquid and standardised packages in both of these asset classes include the following:

**Liquid and Standardised Packages with an Interest Rate Derivative subject to the Clearing Obligation**

- **Interest Rate Curve**- 2 interest rate swaps of different maturities
- **Interest Rate Butterfly**- 3 interest rate swaps of different maturities
- **Invoice Spread**- interest rate swap and a future on a sovereign bond
- **IMM or MAC Rolls**- trading out of an existing IMM or MAC swap and replacing it with the next longest maturity
- **CCP Basis Swap**- two or more interest rate swaps that are cleared at different CCPs (e.g. LCH and Eurex)
- **Spread Over Treasury**- interest rate swap and a U.S. Treasury security

**Liquid and Standardised Packages with a Credit Derivative subject to the Clearing Obligation**

- **Index CDS Rolls**- trading out of an existing index CDS and replacing it with the latest index version

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<sup>60</sup> See "Spreads: US Treasury Spreads in the Swaps Data," Clarus Financial Technology (March 23, 2105), available at: <https://www.clarusft.com/spreads-us-treasury-spreads-in-the-swaps-data/>

All of these types of packages already trade on regulated venues, indicating their standardisation.<sup>61</sup> In addition, all of these packages should be considered sufficiently liquid based on a holistic assessment of the criteria included in RTS 4, such as the amount of trading volume that already occurs on trading venues, the average size of trades, the number and type of active market participants, and the number of liquidity providers regularly offering quotes.

**Interest rate curves and butterflies** typically constitute approximately 1/3 of the total risk transfer in USD interest rate swaps and one analysis found that up to 45% of vanilla, spot starting USD interest rate swaps were traded as part of a curve or butterfly.<sup>62</sup> These packages are also extremely common for EUR and GBP interest rate swaps.

**Invoice spreads** are also highly liquid, with the most common involving Gilt futures or the Schatz, Bobl, Bund, or Buxl futures that reference German Bunds. An analysis of U.S. swap data repository data reveals that in relevant USD instruments, invoice spread volumes can reach \$20 billion per day and account for up to 3% of total volumes in the related bond future.<sup>63</sup> Given that these packages more frequently trade with a EUR or GBP interest rate swap, we would expect these figures to be significantly higher in the EU market.

**IMM and MAC rolls** represent a significant amount of overall trading activity in IMM and MAC swaps and are concentrated in the days leading into the roll.<sup>64</sup> Given the trading activity in these packages, IMMs and MACs are at their most liquid point around the roll.

**CCP basis swaps** typically involve a risk transfer between cleared portfolios of interest rate derivatives at LCH and CME given their market share of the cleared interest rate swap market. An analysis of CME-LCH basis packages shows average trading volumes of approximately \$8 billion per week just on SEF in the U.S.<sup>65</sup> In addition, as cleared volumes increase at other CCPs, we would expect that these types of packages may be executed for other combinations of CCPs as well.

**Spread over Treasury** packages appear to be the single largest type of package involving a USD interest rate swap in terms of overall risk transfer and constitute up to 20% of overall trade count.<sup>66</sup>

**Index CDS rolls**, similar to IMM and MAC rolls, represent a significant amount of trading activity of index CDS in the days around the index roll.

In addition to the packages described above, there are more bespoke types of packages that include an interest rate derivative or credit derivative subject to the EMIR clearing obligation. Often, these more bespoke packages will also include an uncleared derivative or a corporate bond. |

<ESMA\_QUESTION\_MIFID\_TO\_32>

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<sup>61</sup> See, e.g., "Trad-X strengthens interest rate swaps market presence with Eurex Clearing partnership" (Feb. 22, 2016), available at: <http://voxia.ch/en/trad-x-strengthens-interest-rate-swaps-market-presence-with-eurex-clearing-partnership/> (highlighting the trading of curves, butterflies, invoice spreads, and CCP basis swaps).

<sup>62</sup> See "September 2016 Swaps Review," Clarus Financial Technology (Oct. 12, 2016) at Table 2, available at: <https://www.clarusft.com/september-2016-swaps-review/>; and "USD Swaps: Spreads and Butterflies Part II," Clarus Financial Technology (Sept. 30, 2014), available at: <https://www.clarusft.com/usd-swaps-spreads-and-butterflies-part-ii/>.

<sup>63</sup> See "Mechanics and Definitions of Bond Futures," Clarus Financial Technology (July 19, 2016), available at: <https://www.clarusft.com/mechanics-and-definitions-of-bond-futures/>.

<sup>64</sup> See "The IMM Roll for Swaps – What is it and what are the volumes?" Clarus Financial Technology (March 31, 2015), available at: <https://www.clarusft.com/the-imm-roll-for-swaps-what-is-it-and-what-are-the-volumes/>; and "MAC Trading McUpdate," Clarus Financial Technology (Jan. 30, 2015), available at: <https://www.clarusft.com/mac-trading-mcupdate/>.

<sup>65</sup> See "CME-LCH Basis Swaps Volumes Update," Clarus Financial Technology (July 15, 2015), available at: <https://www.clarusft.com/cme-lch-basis-swaps-volumes-update/>.

<sup>66</sup> See "September 2016 Swaps Review," Clarus Financial Technology (Oct. 12, 2016) at Table 2, available at: <https://www.clarusft.com/september-2016-swaps-review/>; and "Spreads: US Treasury Spreads in the Swaps Data," Clarus Financial Technology (March 23, 2015), available at: <https://www.clarusft.com/spreads-us-treasury-spreads-in-the-swaps-data/>.

**Q33. Are there packages that only comprise components of classes of derivatives that are assessed for the purpose of the TO? Do you consider those package transactions to be standardised and sufficiently liquid?**

<ESMA\_QUESTION\_MIFID\_TO\_33>

Several of the packages described in our response to Question 32 only contain instruments that are subject to the EMIR clearing obligation, including:

- Interest Rate Curves
- Interest Rate Butterflies
- IMM or MAC Rolls
- CCP Basis Swaps
- Index CDS Rolls

All of these types of packages already trade on regulated venues, indicating their standardisation.<sup>67</sup> In addition, as highlighted in our response to Question 32, these packages should be considered sufficiently liquid based on a holistic assessment of the criteria included in RTS 4, including include the amount of trading volume that already occurs on trading venues, the average size of trades, the number and type of active market participants, and the number of liquidity providers regularly offering quotes. |

<ESMA\_QUESTION\_MIFID\_TO\_33>

**Q34. Do you agree that package transactions that are comprised only of components subject to the TO should also be covered by the TO or should the TO only apply to categories of package transactions that are considered liquid? If not, please explain.**

<ESMA\_QUESTION\_MIFID\_TO\_34>

We agree that package transactions containing only instruments that are independently subject to the trading obligation should not be provided with an exemption from the trading obligation.

**The MiFIR Trading Obligation and Packages**

Under Article 28(1) of MiFIR, once a derivative is determined to be subject to the trading obligation, all transactions in such derivative must be concluded on a regulated trading venue unless an exemption applies. This is the case even if a market participant chooses to execute other instruments in conjunction with the derivative that is subject to the trading obligation.

As a result, we do not believe it is necessary for ESMA to separately specify that the trading obligation applies to specific types of packages that contain an instrument that is independently subject to the trading obligation. In practice, as long as the derivative subject to the trading obligation must be executed on a regulated venue, market participants will then have the choice whether to execute other instruments simultaneously on the venue alongside such derivative or execute such other instruments separately off-venue. Notably, this choice will not exist for packages that only contain instruments that are subject to the trading obligation, as Article 28(1) of MiFIR requires each component to be concluded on a regulated trading venue.

The question then becomes whether certain packages should benefit from an exemption to this general rule, thereby allowing an instrument that is otherwise subject to the trading obligation to be executed away from a regulated venue. We do not believe that any packages that only contain components that are all independently subject to the trading obligation should benefit from an exemption.

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<sup>67</sup> See, e.g., "Trad-X strengthens interest rate swaps market presence with Eurex Clearing partnership" (Feb. 22, 2016), available at: <http://voxia.ch/en/trad-x-strengthens-interest-rate-swaps-market-presence-with-eurex-clearing-partnership/> (highlighting the trading of curves, butterflies, and CCP basis swaps).

## **The Standardisation and Liquidity of Packages Containing Only Components that are Subject to the Trading Obligation**

These types of packages represent a subset of the packages described in our response to Question 33, and include certain (a) interest rate curves, (b) interest rate butterflies, (c) IMM or MAC rolls (assuming IMM and MACs are included in the trading obligation), (d) CCP basis swaps, and (e) index CDS rolls. All of these types of packages already trade on regulated venues, indicating their standardisation.<sup>68</sup> In addition, all of these packages should be considered sufficiently liquid based on a holistic assessment of the criteria included in RTS 4, including include the amount of trading volume that already occurs on trading venues, the average size of trades, the number and type of active market participants, and the number of liquidity providers regularly offering quotes.

**Interest rate curves and butterflies** typically constitute approximately 1/3 of the total risk transfer in USD interest rate swaps and one analysis found that up to 45% of vanilla, spot starting USD interest rate swaps were traded as part of a curve or butterfly.<sup>69</sup> These packages are also extremely common for EUR and GBP interest rate swaps.

**IMM and MAC rolls** represent a significant amount of overall trading activity in IMM and MAC swaps and are concentrated in the days leading into the roll.<sup>70</sup> Given the trading activity in these packages, IMM and MACs are at their most liquid point around the roll.

**CCP basis swaps** typically involve a risk transfer between cleared portfolios of interest rate derivatives at LCH and CME given their market share of the cleared interest rate swap market. An analysis of CME-LCH basis packages shows average trading volumes of approximately \$8 billion per week just on SEF in the U.S.<sup>71</sup> In addition, as cleared volumes increase at other CCPs, we would expect that these types of packages may be executed for other combinations of CCPs as well.

**Index CDS rolls**, similar to IMM and MAC rolls, represent a significant amount of trading activity of index CDS in the days around the index roll.

Market experience with the U.S. trading obligation demonstrates that these types of packages are suitable for trading on regulated venues. In the U.S., packages where all components are independently subject to the trading obligation fall under the “MAT/MAT” category.<sup>72</sup> This category of packages was given a short 3 month phase-in due to the fact that the CFTC’s approach to packages was not finalized until days before the trading obligation was due to go into effect.<sup>73</sup> Once the market was provided with notice that these types of packages would be subject to the trading obligation, trading activity smoothly transitioned within the 3 month phase-in period. This transition should be even more straightforward under the MiFIR framework, given the broader range of permitted trading protocols (as compared to the CFTC’s RFQ-to-3 or Order Book trading protocols). This demonstrates that no additional phase-in should be required for these packages as long as the market is provided with sufficient notice regarding the scope of the MiFIR trading obligation.

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<sup>68</sup> See, e.g., “Trad-X strengthens interest rate swaps market presence with Eurex Clearing partnership” (Feb. 22, 2016), available at: <http://voxia.ch/en/trad-x-strengthens-interest-rate-swaps-market-presence-with-eurex-clearing-partnership/> (highlighting the trading of curves, butterflies, invoice spreads, and CCP basis swaps).

<sup>69</sup> See “September 2016 Swaps Review,” Clarus Financial Technology (Oct. 12, 2016) at Table 2, available at: <https://www.clarusft.com/september-2016-swaps-review/>; and “USD Swaps: Spreads and Butterflies Part II,” Clarus Financial Technology (Sept. 30, 2014), available at: <https://www.clarusft.com/usd-swaps-spreads-and-butterflies-part-ii/>.

<sup>70</sup> See “The IMM Roll for Swaps – What is it and what are the volumes?” Clarus Financial Technology (March 31, 2015), available at: <https://www.clarusft.com/the-imm-roll-for-swaps-what-is-it-and-what-are-the-volumes/>; and “MAC Trading McUpdate,” Clarus Financial Technology (Jan. 30, 2015), available at: <https://www.clarusft.com/mac-trading-mcupdate/>.

<sup>71</sup> See “CME-LCH Basis Swaps Volumes Update,” Clarus Financial Technology (July 15, 2015), available at: <https://www.clarusft.com/cme-lch-basis-swaps-volumes-update/>.

<sup>72</sup> See Appendix A of CFTC No-Action Letter 16-76 (Nov. 1, 2016), available at: <http://www.cftc.gov/idc/groups/public/@lrllettergen-eral/documents/letter/16-76.pdf>.

<sup>73</sup> See CFTC No-Action Letter 14-12 (Feb. 10, 2014), available at: <http://www.cftc.gov/idc/groups/public/@newsroom/documents/letter/14-12.pdf>.

## **The Interaction between Pre-Trade Transparency and the Trading Obligation**

We expect that many of the types of packages that contain a derivative subject to the trading obligation (and listed in our response to Question 32) will be determined to have a liquid market as a whole for purposes of pre-trade transparency.<sup>74</sup> However, while we encourage ESMA to leverage this analysis, we do not believe that the liquidity assessment for pre-trade transparency should necessarily determine the scope of the trading obligation.

In the “Quick Fix” amendments to the Level 1 MiFIR text, a tailored regime for packages was included for pre-trade transparency requirements. However, no such amendments were made to the framework for implementing the trading obligation, despite requests from market participants. As a result, unlike for pre-trade transparency, we do not believe it is necessary for ESMA to separately specify that the trading obligation applies to specific types of packages. Instead, under Article 28(1) of MiFIR, once a derivative is determined to be subject to the trading obligation, all transactions in such derivative must be concluded on a regulated trading venue unless an exemption applies. This is the case even if a market participant chooses to execute other instruments in conjunction with the derivative that is subject to the trading obligation. Given that market participants may choose to execute a variety of different types of instruments on a regulated trading venue alongside a derivative that is subject to the trading obligation (and the fact that trading venues have built functionality specifically designed to support the trading of such packages), a broader range of packages may trade on regulated venues compared to the types of packages that are assessed to be liquid for pre-trade transparency purposes.

Given the differences between the pre-trade transparency regime and the trading obligation, we believe that it is appropriate for a broader range of packages to trade on regulated trading venues. For example, the trading obligation allows for more flexible implementation than pre-trade transparency by enabling trading venues to develop methods of execution that are specifically designed to facilitate packages being traded on the facility, including via RFQ-to-1 protocols. This flexible implementation assists in achieving the goals of the trading obligation by maximising the amount of trading activity that is executed on regulated trading venues. Transitioning trading in cleared OTC derivatives onto regulated venues enhances market stability and integrity and improves conditions for investors through increased competition and better pricing. Market stability and integrity is enhanced by ensuring this activity is subject to appropriate monitoring and surveillance, along with the pre-trade check and straight-through-processing requirements in RTS 26 that are applicable to transactions concluded on a trading venue. In addition, market experience with the implementation of the trading obligation in the U.S. has demonstrated the benefits to investors that result from open and competitive execution, including better liquidity and lower transaction costs.<sup>75</sup>

Acknowledging that a broader range of packages may trade on regulated venues compared to the types of packages that are assessed to be liquid for pre-trade transparency purposes is also consistent with how vanilla standalone transactions are dealt with under MiFIR. For example, many transactions that are subject to the trading obligation will not be subject to pre-trade transparency, given the available waivers under Article 9 of MiFIR (including the SSTI waiver that will initially apply to approximately 70% of transactions in a given derivative).

Data has shown that over 50% of all USD interest rate swaps entered into are actually transacted as part of a package,<sup>76</sup> and we anticipate similar statistics for EUR and GBP interest rate swaps. Given this overall trading activity in packages, any exemptions granted by ESMA to the general requirement in Article

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<sup>74</sup> See ESMA Consultation Paper: Draft RTS on package orders for which there is a liquid market, Nov. 10, 2016, available at: <https://www.esma.europa.eu/press-news/consultations/consultation-draft-rts-package-orders-which-there-liquid-market>.

<sup>75</sup> See Staff Working Paper No. 580 “Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act”, Bank of England (January 2016), available at: <http://www.bankofengland.co.uk/research/Documents/workingpapers/2016/swp580.pdf>.

<sup>76</sup> See “Spreadovers: US Treasury Spreads in the Swaps Data,” Clarus Financial Technology (March 23, 2105), available at: <https://www.clarusft.com/spreadovers-us-treasury-spreads-in-the-swaps-data/>.



28(1) of MiFIR must be narrowly tailored based on an assessment of the criteria in RTS 4, and will not necessarily overlap with the pre-trade transparency regime. |  
<ESMA\_QUESTION\_MIFID\_TO\_34>

**Q35. How should the TO apply for package transactions that include some components subject to the TO, whereas other components are not subject to the TO?**

<ESMA\_QUESTION\_MIFID\_TO\_35>

Under Article 28(1) of MiFIR, once a derivative is determined to be subject to the trading obligation, all transactions in such derivative must be concluded on a regulated trading venue unless an exemption applies. This is the case even if a market participant chooses to execute other instruments in conjunction with the derivative that is subject to the trading obligation.

As a result, we do not believe it is necessary for ESMA to separately specify that the trading obligation applies to specific types of packages that contain at least one instrument that is independently subject to the trading obligation. In practice, as long as the derivative subject to the trading obligation must be executed on a regulated venue, market participants will then have the choice whether to execute other instruments simultaneously on the venue alongside such derivative (which trading venues have built the functionality to support) or execute such other instruments separately off-venue. This instrument-level approach is consistent with how the clearing obligation has been implemented under EMIR. For example, if a market participant chooses to execute a derivative subject to the clearing obligation along with an uncleared derivative, the derivative subject to the clearing obligation must still be cleared even though it is being executed in conjunction with other instruments.

The question then becomes whether certain packages should benefit from an exemption to this general requirement in Article 28(1) of MiFIR, thereby allowing an instrument that is otherwise subject to the trading obligation to be executed away from a regulated venue. This is consistent with the approach taken for implementing the U.S. trading obligation, where the CFTC has provided exemptions for specific types of packages. Data has shown that over 50% of all USD interest rate swaps entered into are actually transacted as part of a package,<sup>77</sup> and we anticipate similar statistics for EUR and GBP interest rate swaps. Given the overall trading activity in standardised and liquid packages, any such exemptions must be narrowly tailored. In addition, it should be noted that, as a practical matter, it should be easier to trade packages on regulated trading venues under the MiFIR framework given the broader range of permitted trading protocols (as compared to the CFTC's requirement to use RFQ-to-3 or Order Book trading protocols).

We believe that, at a minimum, the following three categories of package transactions should not benefit from an exemption from the trading obligation given their standardisation and liquidity:

- **Packages with Only Cleared OTC Derivatives.** As described in our response to Question 33, packages including at least one component that is independently subject to the trading obligation and other components that are subject to the clearing obligation are standardised and sufficiently liquid for the trading obligation. Examples include (a) interest rate curves, (b) interest rate butterflies, (c) IMM or MAC rolls (assuming IMM and MACs are included in the trading obligation), (d) CCP basis swaps, and (e) index CDS rolls.

The number of packages that will fall into this category versus the category described in Question 34 (where all components of the package are independently subject to the trading obligation) will depend on the ultimate scope of the trading obligation. However, it is important to highlight that a number of different curves and butterflies are commonly traded in the market, making it important

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<sup>77</sup> See "Spreadovers: US Treasury Spreads in the Swaps Data," Clarus Financial Technology (March 23, 2105), available at: <https://www.clarusft.com/spreadovers-us-treasury-spreads-in-the-swaps-data/>.

to ensure that all of these different variations are included within the scope of the trading obligation.<sup>78</sup>

Together, interest rate curves and butterflies typically constitute approximately 1/3 of the total risk transfer in USD interest rate swaps and one analysis found that up to 45% of vanilla, spot starting USD interest rate swaps were traded as part of a curve or butterfly.<sup>79</sup> These packages are also extremely common for EUR and GBP interest rate swaps.

These types of packages are already subject to the U.S. trading obligation under the “MAT/Non-MAT (Cleared)” category<sup>80</sup> and trading activity smoothly transitioned onto regulated venues during a short 3.5 month phase-in that was provided because the CFTC’s approach to packages was not finalized until days before the trading obligation was due to go into effect.<sup>81</sup> This transition should be even more straightforward under the MiFIR framework, given the broader range of permitted trading protocols (as compared to the CFTC’s requirement to use RFQ-to-3 or Order Book trading protocols). This experience demonstrates that no additional phase-in should be required for these packages as long as the market is provided with sufficient notice regarding the scope of the MiFIR trading obligation.

- **Spread Over Treasuries.** Packages involving a USD interest rate swap that is subject to the trading obligation and a U.S. Treasury are also standardised and sufficiently liquid for the trading obligation. These are a primary hedging tool used by liquidity providers in USD interest rate swaps and are already subject to the U.S. trading obligation.<sup>82</sup> Trading activity smoothly transitioned onto regulated venues during a short 4 month phase-in that was provided because the CFTC’s approach to packages was not finalized until days before the trading obligation was due to go into effect.<sup>83</sup> This transition should be even more straightforward under the MiFIR framework, given the broader range of permitted trading protocols (as compared to the CFTC’s requirement to use RFQ-to-3 or Order Book trading protocols).

This experience demonstrates that no additional phase-in should be required for these packages as long as the market is provided with sufficient notice regarding the scope of the MiFIR trading obligation. Given that these packages appear to be the single largest type of package involving a USD interest rate swap in terms of overall risk transfer and constitute up to 20% of overall trade count, we urge ESMA to identify these packages in the data set<sup>84</sup> and ensure they are not granted an exemption from the trading obligation.<sup>85</sup>

- **Invoice Spreads.** Finally, an exemption from the trading obligation should not be granted for invoice spread packages containing a EUR or GBP interest rate swap that is subject to the trading obligation and a cleared future. As highlighted in our response to Question 18, a significant percentage of the non-benchmark swaps that appear in the ESMA data set are likely part of these

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<sup>78</sup> See “USD Swaps: Spreads and Butterflies Part II,” Clarus Financial Technology (Sept. 30, 2014), available at: <https://www.clarusft.com/usd-swaps-spreads-and-butterflies-part-ii/>.

<sup>79</sup> See “September 2016 Swaps Review,” Clarus Financial Technology (Oct. 12, 2016) at Table 2, available at: <https://www.clarusft.com/september-2016-swaps-review/>; and “USD Swaps: Spreads and Butterflies Part II,” Clarus Financial Technology (Sept. 30, 2014), available at: <https://www.clarusft.com/usd-swaps-spreads-and-butterflies-part-ii/>.

<sup>80</sup> See Appendix A of CFTC No-Action Letter 16-76 (Nov. 1, 2016), available at: <http://www.cftc.gov/idc/groups/public/@llettergen-eral/documents/letter/16-76.pdf>.

<sup>81</sup> See CFTC No-Action Letter 14-12 (Feb. 10, 2014), available at: <http://www.cftc.gov/idc/groups/public/@newsroom/documents/letter/14-12.pdf>.

<sup>82</sup> See Appendix A of CFTC No-Action Letter 16-76 (Nov. 1, 2016), available at: <http://www.cftc.gov/idc/groups/public/@llettergen-eral/documents/letter/16-76.pdf>.

<sup>83</sup> See CFTC No-Action Letter 14-12 (Feb. 10, 2014), available at: <http://www.cftc.gov/idc/groups/public/@newsroom/documents/letter/14-12.pdf>.

<sup>84</sup> “Mechanics and Definitions of Spreadovers (Swap Spreads),” Clarus Financial Technology (May 11, 2015), available at: <https://www.clarusft.com/mechanics-and-definitions-of-spreadovers-swap-spreads/>.

<sup>85</sup> See “September 2016 Swaps Review,” Clarus Financial Technology (Oct. 12, 2016) at Table 2, available at: <https://www.clarusft.com/september-2016-swaps-review/>; and “Spreadovers: US Treasury Spreads in the Swaps Data,” Clarus Financial Technology (March 23, 2105), available at: <https://www.clarusft.com/spreadovers-us-treasury-spreads-in-the-swaps-data/>.

packages. Whereas liquidity providers tend to hedge their client-facing trading activity in USD interest rate derivatives with spread over packages containing a U.S. Treasury, invoice spread packages are used as a primary hedging instrument for client-facing trading activity in EUR and GBP interest rate derivatives.

These invoice spread packages are already listed and executed on MTFs, with the most common involving Gilt futures or the Schatz, Bobl, Bund, or Buxl futures that reference German Bunds.<sup>86</sup> From an operational workflow perspective, a single price is quoted for the package on an MTF, representing the price for executing both the interest rate derivative and the future. Then, following execution, the future is reported into the relevant exchange pursuant to its rules.

An analysis of U.S. swap data repository data reveals that in relevant USD instruments, invoice spread volumes can reach \$20 billion per day and account for up to 3% of total volumes in the related bond future.<sup>87</sup> Given that these packages more frequently trade with a EUR or GBP interest rate swap, we would expect these figures to be significantly higher in the EU market.

Given the standardisation and liquidity in invoice spread packages, we urge ESMA to identify these packages in the data set<sup>88</sup> and gather data from trading venues and futures exchanges such as Eurex and ICE in order to assess the liquidity of these packages. We believe that market data regarding overall trading activity will show that the trading obligation should be applied to the forward-starting EUR and GBP swaps included in these packages pursuant to the liquidity criteria set forth in RTS 4. The liquidity of the overall package is also assisted by the fact that the future is cleared as well, meaning that all instruments included in the package will be cleared derivatives.

We note that invoice spread packages are not yet subject to the trading obligation in the U.S. However, this is not based on a liquidity assessment of these packages. Rather, the CME (where all of the relevant interest rate futures are listed in the U.S.) has implemented a rule that has prevented SEFs from listing invoice spread packages. Specifically, CME Rule 538 prevents the futures component of a package from being reported into the CME, as is required, if the swap component of the package is executed on a SEF.<sup>89</sup> This conflict between CME Rule 538 and the trading obligation for derivatives must be resolved by the CFTC prior to mandating the trading of invoice spread packages on SEFs. However, the failure to resolve this commercial conflict between CME and the SEFs should not impact the liquidity assessment for invoice spread packages under MiFIR.

<ESMA\_QUESTION\_MIFID\_TO\_35>

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<sup>86</sup> See, e.g., "Trad-X strengthens interest rate swaps market presence with Eurex Clearing partnership" (Feb. 22, 2016), available at: <http://voxia.ch/en/trad-x-strengthens-interest-rate-swaps-market-presence-with-eurex-clearing-partnership/> (highlighting the trading of invoice spreads).

<sup>87</sup> See "Mechanics and Definitions of Bond Futures," Clarus Financial Technology (July 19, 2016), available at: <https://www.clarusft.com/mechanics-and-definitions-of-bond-futures/>.

<sup>88</sup> See "A New Flavor of Invoice Spreads?" Clarus Financial Technology (June 12, 2015), available at: <https://www.clarusft.com/a-new-flavor-of-invoice-spreads/> (explaining how to find invoice spreads).

<sup>89</sup> See CME Market Regulation Advisory Notice, Exchange for Related Positions (Oct. 4, 2016) at page 7, available at: [http://www.cmegroup.com/notices/market-regulation/2016/09/RA1612-5.pdf?mkt\\_tok=evJplioi1RKbFlqTmhaVEUyWWpieSlInQi-OiJHbDV1WEIXb2l0c3BhQXRhdFwvZm9YZUt3NndiS2VsT28yXC9RNTBaMTc3UUU1U0FEc085bVZSNVRTbVBINKnNbUduY-VRyazBpaVvrU1lpT2NWZfVYODRBakJHMEFQUWxkTEtIz2V5MzV0THIRPSJ9](http://www.cmegroup.com/notices/market-regulation/2016/09/RA1612-5.pdf?mkt_tok=evJplioi1RKbFlqTmhaVEUyWWpieSlInQi-OiJHbDV1WEIXb2l0c3BhQXRhdFwvZm9YZUt3NndiS2VsT28yXC9RNTBaMTc3UUU1U0FEc085bVZSNVRTbVBINKnNbUduY-VRyazBpaVvrU1lpT2NWZfVYODRBakJHMEFQUWxkTEtIz2V5MzV0THIRPSJ9).