EUROPEAN COMMISSION
Directorate-General for Financial Stability, Financial Services and Capital Markets Union

Director General

Brussels,
FISMA C3/TL/alf(2016)2368644

Mr Steven Maijoor
Chairman
European Securities and Markets Authority - ESMA
103, rue de Grenelle
F-75345 Paris

Dear Mr. Maijoor,

On 28 September 2015, ESMA submitted to the Commission the draft regulatory technical standard (draft RTS 2) on transparency requirements in respect of bonds, structured finance products, emission allowances and derivatives pursuant to Article 9 and Article 11 of Regulation (EU) No 600/2014 (MiFIR).

The draft RTS submitted by ESMA lays down the criteria for when bonds, structured finance products, emission allowances and derivatives are considered to be liquid and sets out the parameters and methods for the calculation of those thresholds above which waivers or deferrals may be granted.

With this letter I would like to inform ESMA that the Commission intends to endorse the ESMA standard on transparency requirements in respect of bonds, structured finance products, emission allowances and derivatives once the amendments below are introduced.

Overall, the Commission is supportive of the general approach that ESMA has taken to this standard. However, in the areas set out below the Commission considers necessary to take a more cautious approach to the calibration of the regime in the initial years, gradually building towards ESMA's proposed calibrations once the data reporting system is effectively up and running and the effects of that regime can be properly assessed. Such an approach is also reflective of the concerns raised by the European Parliament's ECON Committee and some members of the Council.

Definition of a liquid market

According to Article 2(1)(17) MiFIR a market for a financial instrument or a class of financial instruments can only be considered a 'liquid market' when there are ready and willing buyers and sellers on a continuous basis'.

With respect to the determination of liquidity for all classes of bonds, the Commission is concerned that two daily trades in a given bond (ISIN) may not reflect the existence of ready and willing buyers and sellers on a continuous basis. In consequence, such a 'liquidity' standard might identify too many ISIN as liquid instruments.

Liquidity conditions, defined as the existence of ready and willing buyers and sellers on a continuous basis, can differ across asset classes. In this respect, the Commission notes that that some markets, such as equity or equity derivatives, are generally more liquid than fixed income markets, especially corporate bond markets.

Fixed income instruments are more susceptible to low levels of liquidity due to the diversity of instruments per issue/underlying asset and features of each instrument, the fact that investors often hold to maturity and transact in large sizes and the scarcity in the relevant markets when existing fixed income instruments reach maturity and are not replaced by new issuances – a situation that does not arise with perpetual instruments such as equities.

Differences in liquidity are determined by a variety of factors, such as financial performance of the issuers, its creditworthiness, macroeconomic factors, issuance frequency or the volume of outstanding traded instruments. Characteristics of the specific instruments, such as issue size, maturity, coupon rates, also play a role. For example, sovereign bonds tend to trade more frequently than corporate bonds as they are generally more homogenous and tend to be issued in larger volumes.

Market liquidity, especially in the area of non-equities, is currently the subject of significant debate[1] and analysis, the results of which are not conclusive. While primary issuance has been increasing in recent years against a backdrop of low interest rates, there is evidence that secondary market liquidity in some markets may be decreasing. For example, in the case of European corporate bonds, according to a recent survey[2], trading volumes have declined by up to 45% between 2010 and 2015. This survey also suggests that large bond trades are becoming more difficult to execute without affecting prices. Declining depth in non-equity markets has been evidenced by a decline in transaction sizes. The consequence is that smaller trading volumes are able to move market prices by larger amounts.

It is against this background that the Commission considers that two daily trades may not reflect the prevalence of ready and willing buyers and sellers on a continuous basis with respect to fixed income markets. This concern is particularly relevant given that ESMA's draft RTS, for all other non-equity asset classes, work on the assumption that 10 or 15 trades would be indicative of a liquid market[3].

There is no conclusive evidence that the daily trading threshold for bonds should be established at a threshold that is significantly lower than that applicable to other non-equity instruments. This is of concern, not least in light of the fact that interest rate derivatives, where ISDA estimates a 13% increase in trading volumes between December 2012 and June 2014, are deemed liquid only once a threshold of 10 daily trades is breached while corporate bonds, where volumes decreased over a comparable period, are deemed liquid as of two daily trades.

---

[1] See for example, the 2015 IMF Global Financial Stability Report (http://www.imf.org/external/pubs/ft/gfsr/2015/01/) and the January 2016 CGFS paper on fixed income market liquidity (http://www.bis.org/publ/cgfs55.pdf)

[2] PricewaterhouseCoopers LLP, Global Financial Markets Liquidity Study, August 2015

[3] For example, the RTS requires 15 daily trades for certain equity derivatives, such as swaps and portfolio swaps - despite that fact that equity derivatives are generally assumed to be typically more liquid than fixed income instruments.

The Commission is concerned that assuming the existence of a liquid market for bonds at a daily trading volume that is significantly lower than those proposed for other non-equity instruments is not sufficiently cautious in light of the available evidence.

Therefore, the Commission will only consider endorsing the draft RTS once the approach to defining a liquid market for bonds is further aligned with that which prevails for all other non-equity instruments - where a liquid market is only assumed once a financial instrument trades at least 10 or 15 times per day. This will require that the modified RTS takes the upper threshold that governs other non-equity instruments (15 trades) as a starting point and then gradually increases the bonds subject to the transparency rules. As daily trades are inversely related to bond coverage, the Commission advocates a gradual decrease of the daily trades that denote a liquid market. This gradual approach would then gradually increase the number of ISIN covered and ensure the requirements are phased in a more gradual way, helping to prevent a further decline of trade volumes.

The alignment between bonds and other non-equity instruments is therefore to be achieved by proceeding in four successive thresholds:

- Year 1: 15 daily trades (estimated coverage: 1100 bonds or "ISINs");
- Year 2: 10 daily trades (estimated coverage: 1500 ISINs);
- Year 3: 7 daily trades (estimated coverage: 1900 ISINs);
- Year 4: 2 daily trades (estimated coverage: 2600 ISINs).

The four year period reflects information provided by ESMA on daily trades and estimated ISIN coverage. The Commission aligns its proposal with ESMA's data, especially in light of the fact that ESMA has supplied quantitative estimates on ISIN coverage that corresponds to four different sets of daily trades. In these circumstances, the impacts of the chosen phase-in in terms of ISIN coverage can be anticipated with a degree of certainty.

Determining the waiver threshold

According to Article 9(1)(b) MiFIR competent authorities shall be able to waive the obligation for market operators and investment firms operating a trading venue to make public the information referred to in Article 8(1) MiFIR for actionable indications of interest in request-for-quote and voice trading systems that are above a size specific to the financial instrument (SSTI). Waivers under this provision can only be granted once the obligations in Article 8(1) MiFIR would expose liquidity providers to undue risk.

In light of the above observations on liquidity in non-equity markets, the Commission is concerned that the SSTI waivers as currently calibrated in the draft RTS are not conducive to ensuring liquidity providers do not take on undue risk. For example, corporate bonds can trade large monthly volumes but individual bonds trade relatively infrequently, which implies that market makers take on significant risk when they trading in secondary markets. Market making, where bonds are held on the liquidity provider's balance sheets, is therefore of crucial importance to maintain market liquidity. In these markets, market making is important due to the often large sizes but low frequency of trades.

The current calibration of the SSTI at the 60th percentile, in the Commission's view, does not sufficiently take into account that (1) there has been a reduction in market making activities and (2) inventories of financial instruments and balance sheet capacity to support market making have declined. Hence, there is no conclusive evidence as to why a waiver at the 60th percentile would not put market makers at undue risk.

The Commission does not believe that a marginal reduction of the trading percentile to, e.g., the 50th percentile of trades, will be sufficient to address the risk of miscalibration, given that all trade percentiles that are currently contained in the ESMA technical standard are not based on complete and actual trading data. According to ESMA, such data will only become available when the technical infrastructure that is necessary for the collection of transaction data (project "FIRDS") is put in place. ESMA has suggested that the electronic systems to collect actual trading data for approximately 15 million instruments from about 300 trading venues is not yet in place and operational. Until this infrastructure is set up and operational there is no reliable manner in which to establish the SSTI thresholds that apply to bonds and the other non-equity instruments. The 60^{th}, 50^{th} or even 40^{th} percentiles must therefore be seen at best as proxies for the real monetary values of the SSTI thresholds.

In light of the fact that the current percentiles are established in the absence of actual trading data collected via the above mentioned electronic infrastructure, the Commission has no concrete evidence on which to assess the likelihood that the assumptions which underpin the choice of the 60^{th} percentile are sufficiently robust to withstand an actual "market test". Therefore, in light of the evidence on liquidity in non-equity markets and smaller trading volumes, a more cautious approach would imply also selecting materially lower SSTI thresholds.

Given the evidence on declining trading volumes and turnover ratios (ratio of trading to the sizes of markets), the Commission takes the view that potential harm caused by the application of SSTI thresholds that, in actual monetary or "cash" values prove too high, outweighs the cost of introducing transparency in non-equity markets in a much more gradual manner. In these circumstances, the preferred approach is to provide for significantly lower percentiles at which SSTI waivers can be obtained and to adjust the SSTI waiver gradually in light of actual trading data becoming available. The risk that transparency levels are too low is mitigated by proposed cash floors within the RTS which would ensure a minimum level of transparency regardless of the percentile-based threshold.

All of the above considerations lead the Commission to conclude that the SSTI thresholds as proposed in the draft RTS for bonds and all other non-equity asset classes do not comply with Article 9(1)(b) MiFIR as they risk exposing liquidity providers in bond and other non-equity markets to undue risk.

In light of the above considerations, the Commission is of the view that the initial SSTI threshold should be reduced to the 30^{th} percentile. While it is acknowledged that this could reduce the monetary or "cash" value of the waiver, it is the Commission's considered view that any reduction in transparency is justified in light of the above mentioned risk that an adaptation to, e.g., the 50^{th} percentile would still hold the potential of putting liquidity providers at risk.

In order to address the above concerns, the Commission proposes a more cautious approach in two areas:

- In relation to the calculation of the SSTI thresholds that are applicable to bonds, the Commission suggests that the percentile calibrations currently contained in the relevant tables of the RTS, generally the 60^{th} percentile, are set at the 30^{th} percentile. Moving to the 30^{th} percentile would be accompanied by an annual increase to the 40^{th} (year 2), 50^{th} (year 3) and then 60^{th} (year 4) percentile.

- In relation to the SSTI thresholds that apply to derivatives and other non-equity asset classes, the Commission would also suggest that references to the 60^{th} percentile currently contained in the relevant tables of the draft RTS are set at the 30^{th} percentile. Moving to the 30^{th} percentile would be accompanied by an annual increase to the 40^{th} (year 2), 50^{th} (year 3) and then 60^{th} (year 4) percentile. To ensure that such an approach still results in an increase in the level of transparency compared with what is required today, all cash floors currently contained in the draft RTS stay in place during the phase-in period.

In both the case of the liquidity and SSTI thresholds, the RTS will initially include the above-mentioned values for year 1. ESMA shall, every year, submit to the Commission an assessment of the operation of the applicable thresholds, taking into account the evolution of trading volumes and other relevant factors, and – where appropriate - a new RTS adjusting the threshold to the next level. If ESMA does not submit a new RTS, ESMA shall explain the factors that underpin its assessment why a move to the next threshold is not warranted. If ESMA does not submit a draft RTS adjusting the threshold within the established time-limit, the Commission may request such a draft in accordance with Article 10 of Regulation (EU) No 1095/2010.

I therefore inform you that the Commission, acting in accordance with the procedure set out in the fifth and sixth subparagraphs of Article 10(1) of Regulation (EU) No 1095/2010, intends to endorse the draft regulatory technical standard submitted by ESMA on transparency requirements in respect of bonds, structured finance products, emission allowances and derivatives pursuant to Article 9 and Article 11 of Regulation (EU) No 600/2014 (MiFIR) once the above-mentioned concerns are adequately taken into account and the necessary modifications are made.

I am very grateful for the work that has been undertaken by ESMA and its members to deliver the MiFID II level II package of measures. This is a substantial package that has been delivered professionally and to a high standard. The standards that have been submitted, if endorsed by the co-legislators, will contribute to better functioning financial markets in the EU with a high level of investor protection.

Yours sincerely,

p.o.

Olivier Guersent