MiFID2/MiFIR – the new framework for derivatives

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CLIFFORD CHANCE

Objectives for derivatives markets

New market structure

Completing clearing mandate

Implementing G20 trading mandate

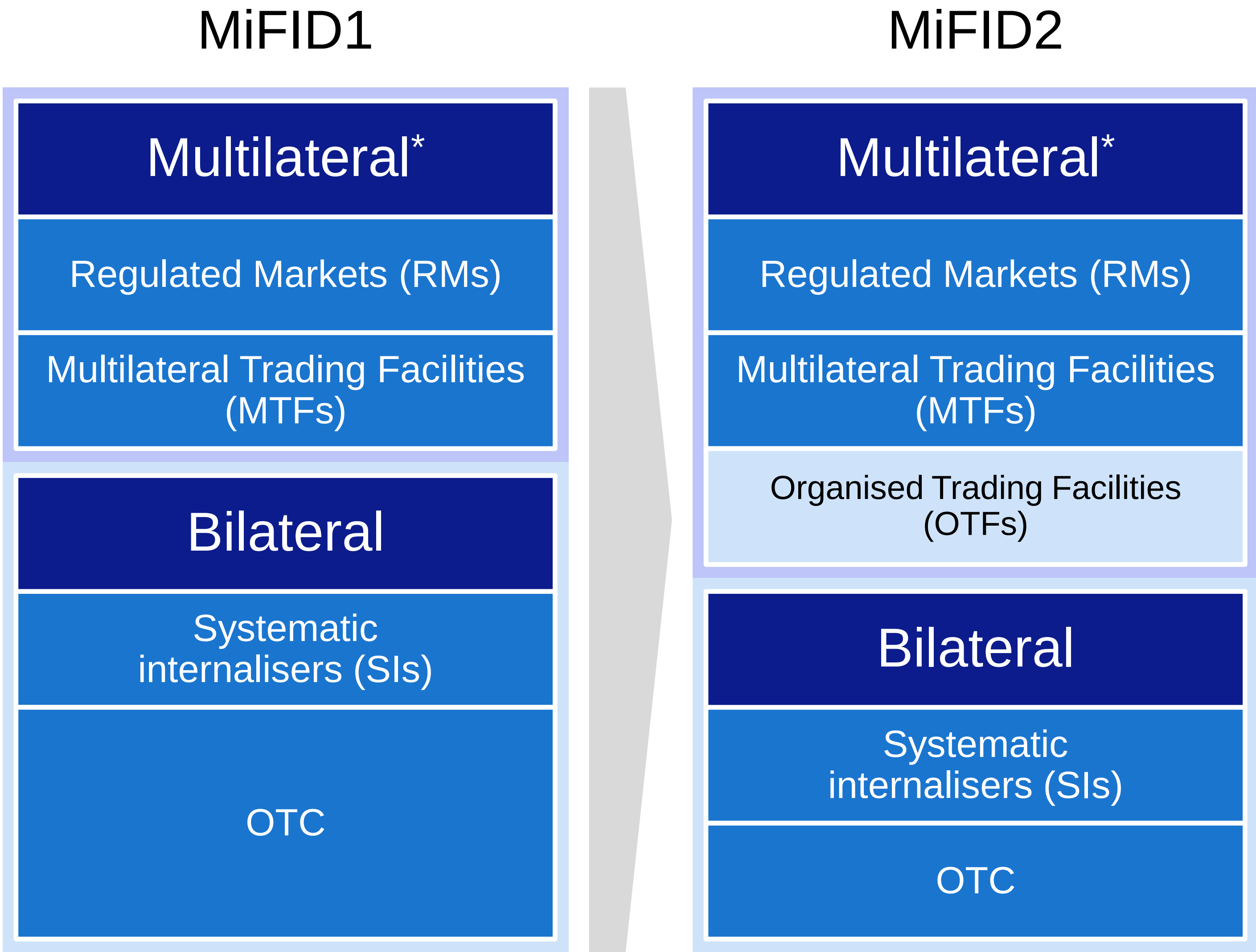
New pre- and post-trade transparency regime

Market structure

Market structure

Key changes:

- New trading venue – OTFs
- SIs wider in scope
- Trading pushed on venue or SI
- Align RM and MTFs



* "trading venues"

Key definitions

Multilateral	Bilateral

Multilateral

RMs and MTFs

- a multilateral system... which brings together … multiple third-party buying and selling interests in financial instruments – in the system <u>and in accordance with non-discretionary rules</u> – in a way that results in a contract

OTFs (new)

- A multilateral system or facility, which is not a regulated market or MTF, ... in which multiple third-party buying and selling interests in financial instruments are able to interact in the system in a way that results in a contract

Multilateral system

- any system or facility in which multiple third parties buying and selling trading interests in financial instruments are able to interact

Bilateral

SIs

- an investment firm which, on an organised, frequent, systematic and substantial basis, deals on own account by executing client orders outside a regulated market or an MTF or an OTF, without operating a multilateral system.

  (Level 2 to specify criteria)

OTC transactions

- Not defined in MiFID2 or MiFIR

<u>Relevant Articles</u>
MiFIR Article 4

Market structure under MiFID2

	RMs	MTFs	OTFs[1]	SIs	OTC
Operator	Exchange	Exchange or Firm	Exchange or Firm	Firm	Firm
Non-discretionary execution	Yes	Yes	No	Where quotes binding	No
Conduct of business rules	No	No	Yes	Yes	Yes
Operator can use own capital	No	No	No	Yes	Yes
Access to facilities	Transparent, non-discriminatory rules, objective criteria	Transparent, non-discriminatory rules, objective criteria	Transparent, non-discriminatory rules, objective criteria	Commercial policy (in objective, non-discriminatory way)	Commercial policy
Admission to trading	Clear, transparent rules (+ other criteria)	Transparent rules (+ adequate PAI[2])	Transparent rules (+ adequate PAI[2])	N/A	N/A
Resilience, circuit breakers, tick size	Yes	Yes	Yes	No	No
Surveillance required (MAR)	Yes	Yes	Yes	No	No

1. Non-equities only; 2. Publicly available information

Market structure under MiFID2 (continued)

	RMs	MTFs	OTFs[1]	SIs	OTC
Pre-trade transparency	Yes (incl. non-equities)	Yes (incl. non-equities)	Yes	Yes (incl. non-equities)	No
Pre-trade waiver available	Yes (incl. non-equities)	Yes (incl. non-equities)	Yes	No	N/a
Post trade transparency	Yes (incl. non-equities)	Yes (incl. non-equities)	Yes	Yes (incl. non-equities)	Yes (incl. non-equities)
Publish execution quality data	Yes	Yes	Yes	Yes	No
Eligible OTC derivs platform	Yes	Yes	Yes	No	No
Authorities can suspend trading	Yes	Yes	Yes	Yes	Yes
Record orders	Yes	Yes	Yes	Yes	Yes

1. Non-equities only

Clearing mandate

The new clearing requirements for derivatives

Extension of clearing obligation to ETD

- Article 29(1) MiFIR extends the clearing obligation to ETD products
- RM must ensure that all transactions that are concluded on it are cleared by a CCP

Straight-through processing

- **CCPs, trading venues and clearing members** are required to put in place effective systems, procedures and arrangements to ensure that transactions in cleared derivatives* are accepted for clearing **as quickly as technologically practicable using automated systems**

ETD indirect clearing arrangements

- MiFIR requires ESMA to develop an RTS specifying the types of permissible indirect clearing arrangements and to ensure consistency with the requirements established for OTC derivatives
- EMIR indirect clearing requirements are problematic
- Indirect clearing arrangements are an established feature of the ETD market

* Cleared derivatives are those derivatives which are
(i) subject to the EMIR clearing obligation,
(ii) subject to the MiFIR clearing obligation or
(iii) which are voluntarily cleared

Reference: MiFIR, Articles 29 and 30

Derivatives execution

Overview: The trading obligation for derivatives

OTC derivative subject to the clearing obligation under EMIR

Not an intragroup transaction under Article 3 EMIR	Not subject to transitional provisions under Article 89 EMIR

Relevant class/sub-class declared subject to mandatory venue trading obligation

Must be traded only on:

RM	MTF	OTF	Equivalent third country market

"Bottom up" process

1. Class of OTC derivatives is declared subject to mandatory clearing under EMIR
2. ESMA consults on whether to impose mandatory trading on that class or a subset of that class
3. ESMA proposes draft regulatory technical standards (RTS) to Commission within six months after adoption of RTS on clearing under EMIR
4. Mandatory trading may be phased-in for some counterparty types

"Top down" process

1. Where a class of OTC derivatives has not been declared subject to mandatory trading
2. ESMA shall regularly monitor activity in those derivatives to identify cases where this may pose systemic risk and to prevent regulatory arbitrage
3. ESMA shall, on its own initiative, identify and notify to the Commission derivatives that should be subject to the trading obligation but which no CCP is authorised to clear under EMIR or which are not admitted to trading.

Trading obligation: The venue and liquidity tests

Derivatives

Venue Test	Liquidity Test

Is the relevant class/sub-class of instruments admitted to trading on a RM/MTF/OTF or equivalent third country market?
- In contrast to the US regime, the test is not 'venue led'
- If the class/sub-class fails the venue test no need to consider liquidity. However, ESMA may consider using 'top-down' process
	Is there sufficient third-party buying and selling interest in the class/ sub-class so that such class/sub-class is considered sufficiently liquid to trade only on venue?
	- ESMA will first assess which specific liquidity factors are relevant in a particular case
	- ESMA will then apply the four liquidity criteria based on different weightings as appropriate for the case
	- Ultimately requires an overall assessment of whether a class or sub-class sufficiently liquid to support the introduction of a trading obligation
	- ESMA must also:
	  – Consider **anticipated impact** on liquidity of relevant derivatives and commercial activities of end users
	  – Consider whether the derivatives are only sufficiently liquid in **transactions below a certain size**
	  – **periodically review** the liquidity of the relevant instrument/class and the liquidity thresholds

Trading obligation – Liquidity criteria and other key issues

Derivatives

Key Issues

- Liquidity Criteria
- Packaged Transactions
- Exclusion of technical and risk reducing trades

Liquidity Criteria	ESMA's Proposed RTS
Average frequency of trades	Number of days on which trading took place AND the number of trades over a specified time period
Average size of trades	Average daily turnover AND average value of transactions over a specified time period
Number and type of active market participants	Not less than two participants, number of trading venues admitting or trading the class of derivatives AND the number of market makers and other market participants bound to provide liquidity
Average size of spreads	Size of weighted spreads, size of volume weighted spreads and observed spreads at different moments

What venues qualify?

OTC derivative subject to the clearing obligation under EMIR

Not an intragroup transaction under Article 3 EMIR	Not subject to transitional provisions under Article 89 EMIR

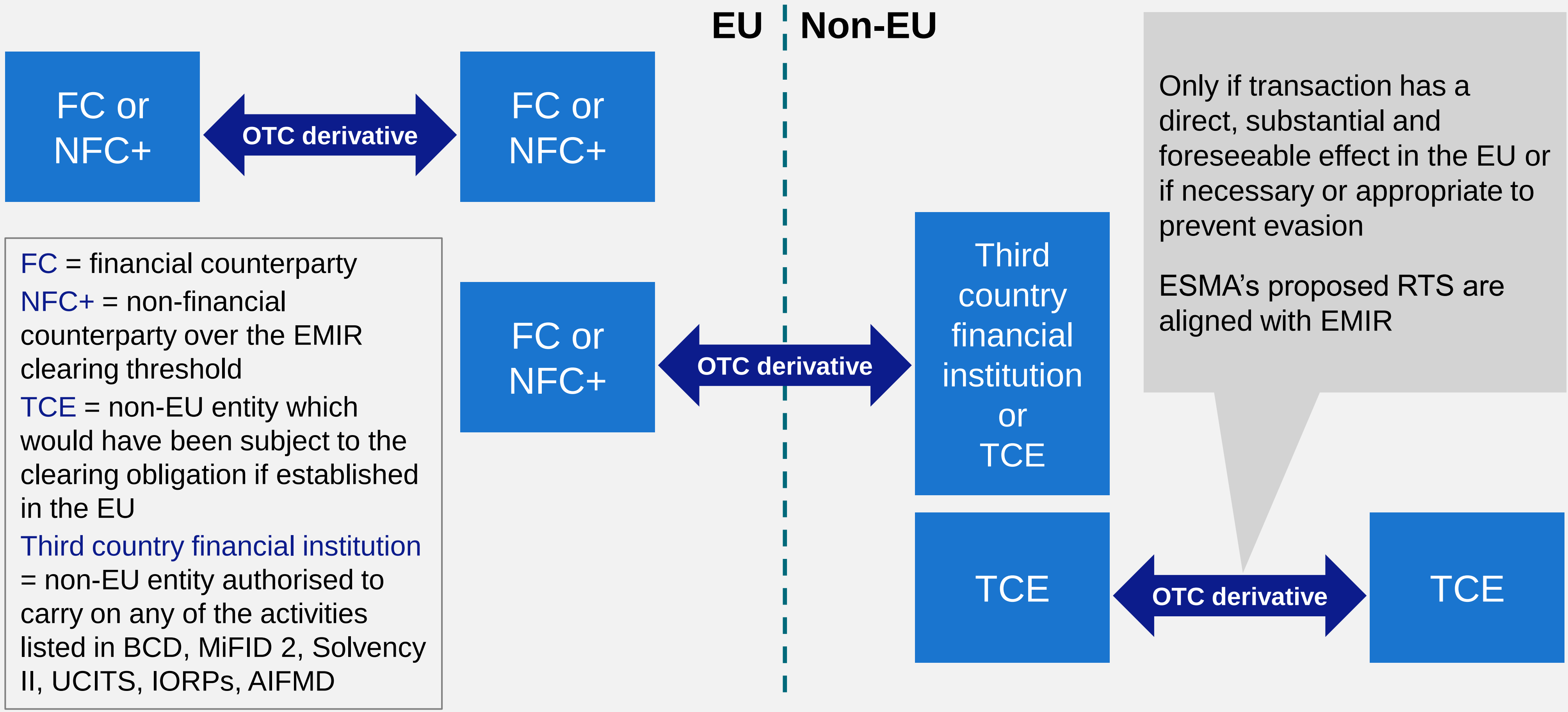
Relevant class/sub-class declared subject to mandatory venue trading obligation

Must be traded only on:

RM	MTF	OTF	Equivalent third country market

- Commission decision that there are equivalent legally binding requirements:
  - Authorisation and supervision;
  - Venue has clear and transparent rules on admission to trading;
  - Issuers are subject to periodic information requirements;
  - Market abuse rules
- Effective equivalent recognition for EU trading venues for derivatives
- Commission decision only for purposes of determining eligibility as a trading venue for these purposes, and may be limited to a category or categories of trading venues
- Also need to address licensing issues for third country firms

Who is subject to mandatory trading?



FC = financial counterparty
NFC+ = non-financial counterparty over the EMIR clearing threshold
TCE = non-EU entity which would have been subject to the clearing obligation if established in the EU
Third country financial institution = non-EU entity authorised to carry on any of the activities listed in BCD, MiFID 2, Solvency II, UCITS, IORPs, AIFMD

Note: Exemption for duplicative or conflicting obligations.
Treatment of entities exempt under Article 1(4) or 1(5) EMIR?
Treatment of branches of non-EU entities and EU branches of non-EU entities

Duplicative and conflicting rules

	Requirement for equivalence?	Criteria for equivalence?	Who decides?	Comments
Avoiding duplicating or conflicting rules **(*Article 33 MiFIR*)**	A counterparty to a derivative will be deemed to have complied with the mandatory derivatives trading and clearing obligations under MiFIR where: ■ at least one counterparty is established in an **<u>equivalent non-EU jurisdiction</u>** and ■ the counterparties are in compliance with the relevant rules in that jurisdiction	The legal, supervisory and enforcement arrangements of the relevant third country: ■ are equivalent to the requirements resulting from Articles 28 and 29 MiFIR ■ ensure protection of professional secrecy that is equivalent to that set out in MiFIR ■ are being effectively applied and enforced in an equitable and non-distortive manner so as to ensure effective supervision and enforcement in that third country	■ European Commission ■ Implement-ing act on equivalence	■ The European Commission (together with ESMA) is required to monitor the laws of any jurisdiction declared equivalent, and report on at least an annual basis to the European Parliament and Council ■ The equivalence decision may be withdrawn

Derivatives markets transparency

Transparency rules for derivatives

Scope

Derivatives traded on a trading venue

RMs, MTFs, OTFs, SIs, firms

Exemptions

Pre-trade waivers

Post-trade deferral

Key variables

Liquidity definition (Art 2(1)(17a) MiFIR)

ESMA RTS to calibrate waiver and deferral regimes

Relevant articles
MiFIR articles 2, 8, 9, 11

Transparency rules for derivatives (trading venues pre-trade)

Obligations

- All RMs, MTFs, OTFs to publish bid/offer and depth of trading interest
- Applies to actionable indications of interest
- Continuous basis during normal trading hours
- Give access to publication arrangements on reasonable commercial terms and non-discriminatory basis to firms subject to the obligation to make public firm quotes relating to bonds, structured finance products, emission allowances and derivatives

Waivers

- Granted by NCAs following ESMA opinion

  1. Orders large in scale relative to normal market size

  2. Indications of interest in RFQ and voice trading systems above a specific size that would expose liquidity providers to undue risk

  3. Derivatives not subject to trading obligation / other instruments without liquid market.
- NCA can temporarily suspend the obligations relating to publication of bid offer and depth of trading if liquidity drops (3 month rolling period)
- ESMA RTS to cover variables (size and liquidity thresholds)

Relevant Articles
MiFIR Articles 8, 9,

Transparency rules for derivatives (Trading venues post-trade)

Obligation

- Publish price, volume and time of trade
- As close to real-time as reasonably possible
- Give access to publication arrangements on reasonable commercial terms and non-discriminatory basis to firms subject to the post-trade disclosure obligation relating to bonds, structured finance products, emission allowances and derivatives

Deferral

- Granted by NCAs following ESMA opinion
- 1. Orders large in scale relative to normal market size
- 2. No liquid market
- 3. Size of trade would expose liquidity providers to undue risk
- Limited publication during deferral period / volume omission during extended deferral period possible
- NCA can temporarily suspend the post-trade transparency obligation for trading venues if liquidity drops (3 month rolling period)
- ESMA RTS to specify what data to be published and conditions/criteria for deferral

Relevant Articles
MiFIR Articles 10, 11

Transparency rules for derivatives (SIs and OTC pre-trade and post-trade)

Pre-trade

- SIs must publish firm quotes for liquid derivatives traded on a trading venue and make those quotes available to other clients if prompted for quote by client or agree to quote.
- For other derivatives traded on a trading venue, SIs must disclose quotes to clients on request if agree to quote.
- Undertaking to transact with other clients to whom quote made available where trade below a specified size.
- SIs can set non-discriminatory limits on number of transactions per quote and the clients they permit to access the quotes.
- No obligation to make public firm quotes if trade above specified size threshold as will be stated in ESMA RTS

Post-trade

- SIs and investment firms must publish volume, price and time of trades in derivatives traded on a trading venue via APA
- Scope and time limits for deferral (and temporary suspension of obligation) analogous to Trading Venues post-trade transparency rules for non-equities (deferred publication, limited publication, volume omission, etc.)
- ESMA RTS will specify disclosable data and application of the obligation to transactions not determined by current market valuation

Relevant Articles
MiFIR Articles 18, 21

Conclusion

Key issues

What venues will trade OTC derivatives?

Calibration of which firms are SIs

Scope of the trading mandate and phase in requirements

Equivalence assessments for non-EU venues and licensing issues for operators of those venues

How the regime deals with duplicative and conflicting rules

Calibration of liquidity thresholds and deferral arrangements for pre- and post-trade transparency

Coherence with US and other non-EU regimes

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