ISDA Safe, Efficient Markets

# ISDA's Response to

# ESMA'S MIFID II/MIFIR Addendum published on February 18, 2015

## I. Executive summary

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 67 countries. These members include a broad range of derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – shows the strong commitment of the Association towards its primary goals of building robust, stable financial markets and a strong financial regulatory framework.

ISDA welcomes its continued engagement with ESMA on MiFID II and MiFIR. Our response to this consultation, and to all consultations on MiFID, reflects the composition of our members and therefore focuses on the operation of the derivatives market in the European Union and globally. We have responded to the Addendum on a best-efforts basis, and have included the results of the research we were able to undertake in the short time frame allowed for the consultation period (which was truncated by our March 2 response to the December 19, 2014 consultation paper). We hope that ESMA will continue its dialogue with ISDA and the industry as it develops its draft technical advice.

An overarching concern of our membership is ESMA's limited ability to move quickly to recalibrate the transparency framework when MiFID II/MiFIR comes into force from the start of 2017. The potential implications of this limitation are particularly acute, as ESMA does not have the power to grant relief to any one or set of market participants from compliance with MiFID II/MiFIR requirements in any intervening period. Consequently, not only is it absolutely necessary to build in a recalibration of the framework, given that liquidity may change with the implementation of MiFID II/MiFIR, but ESMA will need to provide solid evidence, in the first instance, that it has got the calibration right.

## II. Issues and recommendations arising from ISDA's response

We would like to take this opportunity to highlight key issues of concern arising from the Addendum, a number of which echo concerns we raised in our March 2 response.

### i. Transparency

#### a) Quality of the underlying data

The data sets used to assess CDS liquidity are too short – three months of data is insufficient. It does not take into account changes in trading patterns due to seasonality or, in the case of single name CDSs, the episodic basis on which they trade. Also, using trade repository data from the period shortly after the EMIR reporting requirement came into effect raises concerns about the quality of the data set given the widely publicised challenges that this

reporting requirement presented to the industry. It is imperative that the credit derivatives data be filtered for non-price forming trades.

Equally, inaccuracies in the FX data has also lead to FX instruments being classified as liquid, that are usually illiquid and vice-versa.

**b) Recognising market conventions**

It is essential that ESMA's proposals align better with market conventions. Requirements here include ensuring that instruments, including those traded without whole year tenors, are appropriately delineated in ESMA's product taxonomy, and classified according to these delineations before the relevant liquidity threshold/criteria are applied. Similarly, it is essential that the definitions of the on- and off-the-run status align with market convention. For all CDS instruments, liquidity is most prevalent for 5-year tenors and in on-the-run contracts.

**c) Determining the appropriate level of granularity is essential**

In defining its COFIA, ESMA must ensure that classes under consideration are appropriately granular so the liquidity assessments are applied to homogenous sub-classes of instruments. To do otherwise risks illiquid instruments being classified as liquid instruments which could have adverse consequences on the ability to transact such contracts and will increase transaction costs for end users of financial markets. Our analyses of single name CDS and CDS index options make this point clearly. There are vast differences between single name CDS, so it is necessary that the taxonomy applied to them delineates by reference entity as well as the tenor and currency. Likewise, the taxonomy for CDS index options needs to be enhanced to delineate by, at least, the tenor of the option.

**d) Getting the liquidity determinations right**

There is general concern within our membership in relation to the parameters that ESMA has used to calibrate liquidity for credit derivatives. We have sought to illustrate in the response that ESMA's approach, as applied to its data sets, has yielded too many false positives – i.e. instruments being designated as liquid when they are, in fact, illiquid.

**e) Calibrating SSTI and LIS**

Many of ESMA's proposed SSTI and LIS thresholds for CDSs significantly exceed the levels that ISDA identifies from our own analysis. In part, we believe that this misalignment stems from issues – highlighted above – with ESMA's source data. As stated in our 2 March response to the December 2014 consultation paper, we are also of the view that the proposed 50% SSTI/LIS ratio is arbitrary. Where ESMA's liquidity determination is reasonable, we propose two possible ways forward: SSTI be calibrated as the median trade size in a given class, or, if ESMA wishes to use a method based on the percentage of LIS, that a lower SSTI/LIS ratio of 10% be used. We also encourage ESMA to adequately compensate for inadequacies in the liquidity determination through calibrating SSTI/LIS at lower levels.

**ii. Commodities**

It is essential that precious metals be classed as commodities for the purposes of the MiFID. It would then follow that precious metals derivatives are commodity derivatives and therefore subject to the

MiFID II commodity derivatives regime (i.e. position limits). ESMA's inclusion of precious metals within the FX data has the potential to result in confusing and conflicting rules between the FX and Commodities asset classes and to create unhelpful incentives to repackage economic exposure into different 'wrappers' in order to obtain different regulatory treatment.

**iii. Contracts for difference**

ISDA is concerned that ESMA is proposing a definition for contracts for difference (CFD), which is very broad and does not differentiate CFDs from other instruments – such as equity swaps – which may be economically similar, but have key features that distinguish them from CFDs. ISDA therefore proposes a narrower definition for CFDs. Whilst it is crucial that such differences are recognized (for definition purposes, transparency scope and Systematic Internaliser classification), in light of the close economic similarities between CFDs and certain equity swaps, and in order to avoid any arbitrage of the transparency regime by product repackaging, ISDA members believe that these contract types should be treated as equivalent for the purposes of determining the LIS and SSTI thresholds, so that a common LIS and SSTI threshold is set.

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# Annex: ISDA's response to selected questions

## 1. Foreword to Annex:

The questions and responses listed in the Annex follow the organisation of ESMA's 18 February 2015 Addendum to its December 2014 MiFID II/MiFIR consultation paper and response form, but are only concerned with those questions that the ISDA membership have answered. As such, the question numbers listed in this document correspond to the numbering in the Addendum, but only the questions that the ISDA membership has responded to appear. Section 2 aligns with Section 2 of ESMA's Addendum, but only those sub-sections and questions that the ISDA membership has responded to are listed.

ISDA has also submitted its response to ESMA's MiFID II/MiFIR Addendum using the response form supplied, and the text contained in this Annex replicates the text submitted. In some instances, a response to one question might be repeated in the response to another related question. Text from the key messages section of this document is also repeated. This repetition is necessary as ESMA has deployed several specialist teams to review the submissions from all stakeholders and these specialist teams are being asked to focus on particular questions only.

## Contents

# 2. Transparency

## 2.1 Foreign exchange derivatives

- ***Liquid Market Definition: [FX forwards, options, swaps and spread betting]***

**Q1. Do you agree with ESMA's proposal for the definition of a liquid market? Please provide an answer detailed per asset class identified (deliverable forwards, non-deliverable forwards, options, swaps, spread betting contracts and futures) addressing the following points:**

**(1) Would you use different qualitative criteria to define the sub-classes? Please also specify if you agree in distinguishing or not distinguishing between deliverable and non-deliverable contracts. If you would distinguish between deliverable and non-deliverable contracts for other classes besides forwards, please provide your feedback as specific as possible with regard to the sub-classes that should be deemed liquid for deliverable contracts and those for non-deliverable contracts, pointing out the differences between the two sub-groups.**

**(2) Would you use different parameters or the same parameters (i.e. average number of trades per day and average notional amount traded per day) but different thresholds in order to define a sub-class as liquid?**

**(3) Would you define some specific classes declared as liquid in ESMA's proposal as illiquid (and vice versa)? Please provide reasons for your answer.**

ISDA's members have had the benefit of reviewing the GFXD's response to this question. We support and endorse the points made therein. For ease of reference, we have set out the response in full below.

The GFXD does not agree with ESMAs definition of a liquid market. We consider that ESMA has used data that is not of sufficient quality, or contains too many incorrectly classified instruments, and as a consequence has made a proposal that contains many incorrect conclusions. We recommend that ESMA instead:

- Correct for the many issues arising from poor quality data or the incorrect classification of trades. ESMA should:
    - Only utilise data from EMIR trade repositories once ESMA can be sure that trades can be appropriately classified into correct classes, correcting the apparent misclassification of trades between the deliverable forward (FX forward), non-deliverable forward (NDF) FX swap and FX option classes
    - ESMA's use of data to assess liquidity is from the period very shortly after the EMIR trade reporting requirement came into effect which has likely compounded ESMA's difficulties in performing analysis. The challenges that this reporting requirement presented to the industry have been widely publicised, and we are concerned that ESMA's dataset may, for example, contain duplicate trades or other erroneous data. ESMA may not wish to place full reliance on this dataset, or could compensate through the use of higher liquidity thresholds for the average frequency and average size of transactions liquidity parameters than might otherwise have been appropriate. Alternatively, ESMA could repeat its analysis on more recent trade repository data or use an alternate data source, which might be more accurate. Additionally, use of a dataset covering a longer period of time may produce more representative results, potentially less distorted by seasonal or short-term factors. GFXD would be prepared to assist ESMA in repeating the analysis in order to incorporate the necessary corrections

  - In the absence of the necessary corrections, make a more conservative assessment of what is liquid in order to avoid permanent harmful impacts on the liquidity of those instruments incorrectly assessed

- Remove the 'spread betting' class altogether, and instead allocate the trades into this class more granularly according to the specific nature of the transactions. The term 'spread betting' should not be used, and instead actual product types should be provided, according to market standard taxonomies. ESMA must make an appropriate determination of liquidity on each of the resultant sub-classes, a task with which GFXD is prepared to assist. Failing that, the 'spread betting' asset class should be re-labelled 'Others' and determined to be illiquid due to the non-homogeneity of the underlying instruments. We recommend that ESMA ceases to use this classification in conjunction with FX derivatives, as defined under MiFID annex C4

- Consult on all product definitions via a specific public consultation and not introduce them as fact, such as in this MiFIR consultation. We draw specific reference to the process used by ESMA in its consultation on the delineation of FX spot and FX forward in May 2014 (http://gfma.org/correspondence/item.aspx?id=591). If ESMA decide not to separately consult the industry, then we strongly recommend that in order to complete Section 6 Annex III of RTS 9, ESMA leverages those provisions in the ISDA 1998 FX and Currency Option Definitions (and subsequent Supplements), as well as those available in other jurisdictions e.g., in the US Commodities Exchange Act. The GFXD would be prepared to assist ESMA as required.

- Seek to achieve its policy objective of ensuring transparency at the aggregate level of the FX derivatives asset class, and not attempt to find at least some liquid sub-classes in as many classes of FX derivatives as possible. Some classes are simply very illiquid or extremely heterogeneous. Appropriate and consistent use of liquidity thresholds across sub-classes when defined with comparable levels of granularity will ensure that illiquid classes are not incorrectly identified as liquid. If ESMA wishes to assess whether or not it has "captured" a sufficiently broad range of derivatives as liquid instruments, it should make this assessment at the aggregate level of the FX derivatives asset class, rather than at the level of each class or sub-class.

- Compensate for that fact that two of the key elements of the definition of a liquid market have not been taken into account, specifically: the number and type of market participants; and the average size of spreads. We understand why ESMA may have encountered difficulty incorporating these liquidity parameters, but MiFIR does require their consideration, and we therefore recommend that ESMA compensate for the potential misclassification of illiquid sub-classes as liquid through higher liquidity thresholds for those liquidity parameters actually used (i.e., average frequency and average size of transactions), than would otherwise have been possible had the full set of liquidity parameters been considered.

- Recognise package transactions as a distinct class of financial transactions and ensure that they are adequately provided for in the RTS.

- Make clearer and more specific compensation for the inadequacies in, and the errors of, the liquidity assessment, through setting lower LIS and particularly SSTI thresholds than might otherwise have been possible had a more accurate determination of liquidity been utilized. This is of greatest importance where the liquidity assessment of the subclasses is most erroneous.

Below we explain in detail why we disagree with the ESMA proposal and propose an alternative using the Bank of England semi-annual FX survey.

**(1) Would you use different qualitative criteria to define the sub-classes?**

The GFXD would use different criteria to define the sub classes. Below, we discuss our observations across FX forward, FX swap, FX NDF and FX options and provide an alternative for consideration.

*EMIR trade reporting and instrument mapping:* We do not believe that EMIR trade reporting data has been categorized by ESMA to a sufficient degree of granularity to determine the liquidity of FX instruments. As per our response to the May 2014 MiFID Discussion Paper (DP), the GFXD believes that the FX instruments should be categorized as per Annex 3.6.1, included for ease in Figure 1 below. Our proposal allows the market to be considered in-line with the ISDA FX taxonomy which accurately represents how the market trades FX. For non-spot trades, participants report this data under the 'Product ID Value' field to the TRs, and we suggest that this data should be made available to ESMA for consideration. The current ISDA FX taxonomy does not contain a FX swap, due to the fact that FX swaps are reported as FX forwards and are linked with a 'link id'. Such an approach accommodates the varying booking methods used by market participants.

- The current ISDA FX taxonomy is as follows:
  - FX spot
  - FX NDF (non deliverable forwards) (Product ID Value: Foreign Exchange: NDF)
  - FX NDO (non deliverable options) (Product ID Value: Foreign Exchange: NDO)
  - FX forward (Product ID Value: Foreign Exchange: Forward)
  - FX vanilla options (Product ID Value: Foreign Exchange: Vanilla Options)
  - FX simple exotics (Product ID Value: Foreign Exchange: SimpleExotic)
  - FX complex exotics (Product ID Value: Foreign Exchange: ComplexExotic)

- EMIR trade reporting currently does not recognize this taxonomy. Instead trade repositories permit reporting firms map data submissions using the following EMIR reportable fields:
  - Product ID 1: CU (currency)
  - Product ID 2: FW (forwards), OP (options), SW (swap), OT (other)

- For example, DTCC maps their FX trade submissions as follows:
  - FX Spot – mapped to 'OT'
  - FX NDF – mapped to 'FW'
  - FX NDO – mapped to 'OP'
  - FX Fwd – mapped to 'FW'
  - FX Vanilla Option – mapped to 'OP'
  - FX Simple Exotic – mapped to 'OP'
  - FX Complex Exotic – mapped to 'OT'

ESMA also note that they have performed additional mapping of the data to the 'Other' bucket and have re-classified this as 'Spread-betting'. As discussed above, this is not appropriate to FX derivatives defined under MiFID Annex C4, so should be disaggregated and split by ESMA into the appropriate sub-product classes for in order to achieve an appropriate determination of liquidity at a suitably granular level. Annex 2.1.1 paragraph vi on page 210 of the Consultation Paper (CP) defines how ESMA have re-pointed data and created the 'Spread-betting' bucket. We believe that this approach is not accurate and grossly misrepresents what should be included in the 'Other' bucket, namely FX complex exotic options, which represent approximately 2% of the FX market and are widely considered to be bespoke and illiquid in nature.

Figure 1: GFXD proposal for Annex 3.6.1 defining FX instrument categorization under MiFIR

| Financial Instrument | Product Types | Sub-Product Types | Recommended Liquidity sub-categories |
|---|---|---|---|
| Foreign Exchange Derivatives | Futures | N/A | Currency Pair<br>Maturity |
| | Options | Non-Deliverable Option - NDO (only European type options are NDO - not any other FX options settled in non-deliverable currency) | |
| | | Vanilla Option (European and American) | |
| | Forwards | Deliverable Forward | |
| | | NDF | |
| | FX Swaps | Deliverable FX Swap | |
| | | Non-Deliverable FX Swap | |
| | Others | Simple exotic (Barrier & Digital) | |
| | | Complex Exotic | |

The GFXD would also like to support the ISDA position on package transactions, a direct extract included below for ease which we consider should be applied generically to all non-Equity instruments:

**START OF ISDA TEXT [Package transactions**

***a) Overview***

ISDA would like to propose that ESMA considers specific and tailored treatment for package transactions as the Consultation Paper does not address how these transactions might be treated under the new framework. In response to the May 2014 DP, ISDA included a number of detailed comments on the nature of package transactions which we draw ESMA's attention to. We reiterate the points made in that response and put forward a proposal which we hope ESMA will find workable and flexible enough to apply for venue and SI transparency obligations and the derivatives trading obligation. This will preserve the market for package transactions and ensure that pricing and liquidity is not negatively impacted for end investors.

We believe that Level 1 text is flexible enough to empower ESMA to specify how package transactions are treated in order to determine if such transactions are liquid or "traded on a trading venue" (both for determining whether transparency obligations apply as well as determining whether the derivatives trading obligation applies). The Level 1 text clearly sets the foundation for the pre- and post-trade transparency regimes in non-equities by defining the asset classes – "bonds, structured finance products, emission allowances and derivatives" – on which the Level 2 measures must be built. However, ESMA has flexibility to define how, within these broad asset classes, to identify whether specific financial instruments (or combinations thereof) are to be considered "liquid" or "traded on a trading venue". ESMA has chosen to adopt COFIA as the basis for determining whether a liquid market exists – which suggests to us that ESMA is

also empowered to tailor this approach to instruments which fall within one of the specified classes, but are part of a package transaction.

***b) Advantages of package transactions to clients***

Package transactions allow clients to reduce their transaction costs (i.e., a single transaction is less expensive to execute than multiple transactions) and manage their execution risk (i.e. a single execution alleviates timing and other mechanical/process type risks). They are tailored to provide risk-return characteristics in the form of a single transaction in an efficient and cost-effective manner to clients.

***c) Challenges to trading package transactions without a tailored proposal***

Below are some very realistic fact patterns which hopefully demonstrate that unless there is tailored treatment for package transactions which recognises that package transactions should be considered in their entirety when being assessed as subject to transparency requires and/or the derivatives trading obligation, there is a significant risk that such transactions may no longer be available to clients in the EU. This will be due to the individual components being treated differently and inconsistently vs. each other when they are assessed against the relevant requirements which would negate the advantages highlighted above of trading package transactions. These challenges are likely to be particularly acute where one or more of the components of a package transaction includes derivatives subject to the trading obligation:

- If some components of a package transaction are traded on a trading venue but others are not.
- If some components of a package transaction are deemed liquid but others are not.
- If some components of a package transaction are above the relevant LIS or SSTI thresholds but others are not.
- If the components of a package transaction are below the relevant LIS or SSTI thresholds but together they behave similarly to a single transaction above the LIS or SSTI.
- If the package transaction contains a listed derivative which trades on a different trading venue to other components.

If ESMA fails to provide for the appropriate trading of packages, end investors will be required to trade the components independently, resulting in increased transaction costs and increased execution risks, which would seem to conflict with ESMA's policy objectives.

***d) ISDA proposal***

We would be keen to assist ESMA with the development of a workable regime for package transactions. We consider that the following proposals could both address the challenges we have described above. We have provided both proposals for ESMA's consideration as we recognise that, whilst Option 1 is a simpler proposal, Option 2 is more accurate.

<u>Option 1:</u>

1. Subject to point 3 below, if each component of a package transaction is liquid:

    a. The package transaction should be considered liquid; and

    b. If any one component is above the relevant threshold (LIS or SSTI) then the package transaction should be deemed to be above the threshold.

2. Subject to point 3 below, if the package transaction contains liquid and illiquid components:

    a. The package transaction should be considered illiquid; and

    b. If any one component is above the relevant threshold (LIS or SSTI) then the package transaction should be deemed to be above the threshold.

3. For the purposes of MiFIR Articles 8(1), 10(1), 18(1) and 18(2), all components of a package have to be tradable on a single venue in order for the package be considered "traded on a venue".

4. If the package transaction comprises ten or more component legs, the package transaction should be considered illiquid.

If ESMA, for pre-trade transparency purposes, would prefer to represent this in a table format, we propose the following table which reflects the above:

**Table 11: ISDA Proposal for the calibration of Package Transactions for liquidity, Large in Scale, and Size Specific to the Instrument thresholds.**

| Type | Package type comprising: | Example | 1. All components above LIS | 2. All components above SSTI | 3. At least one component above LIS | 4. At least one component above SSTI | 5. All components below LIS | 6. All components below SSTI |
|---|---|---|---|---|---|---|---|---|
| A | Exclusively liquid derivatives in one derivative asset class[1] | 2yr vs 10yr EUR swap | Package is above LIS and liquid | Package is above SSTI and liquid | Package is above LIS and liquid | Package is above SSTI and liquid | Package is below LIS and liquid | Package is below SSTI and liquid |
| B | Exclusively liquid securities | 2yr vs 10yr Bund switch | Package is above LIS and liquid | Package is above SSTI and liquid | Package is above LIS and liquid | Package is above SSTI and liquid | Package is below LIS and liquid | Package is below SSTI and liquid |
| C | Liquid security(ies) and derivative(s) where the derivatives are from a single asset class[1] | Asset swap vs. cash bund | Package is above LIS and liquid | Package is above SSTI and liquid | Package is above LIS and liquid | Package is above SSTI and liquid | Package is below LIS and liquid | Package is below SSTI and liquid |
| D | Liquid & illiquid security(ies) and derivative(s) where the derivatives are from a single asset class[1] | 10yr EUR swap vs. 10yr inflation swap | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is below LIS and not liquid | Package is below SSTI and not liquid |
| E | Liquid derivative(s) & any liquid exchange traded derivative(s) in the same derivative asset class [1] | EFP transaction of swap vs. future | Package is above LIS and liquid[2] | Package is above SSTI and liquid[2] | Package is above LIS and liquid[2] | Package is above SSTI and liquid[2] | Package is below LIS and liquid[2] | Package is below SSTI and liquid[2] |
| F | Liquid security(ies) & any liquid exchange traded derivative(s) in the same derivative asset class [1] | Cash bund vs. Bund future basis trade | Package is above LIS and liquid[2] | Package is above SSTI and liquid[2] | Package is above LIS and liquid[2] | Package is above SSTI and liquid[2] | Package is below LIS and liquid[2] | Package is below SSTI and liquid[2] |
| G | Exclusively illiquid security(ies) or derivative(s) | 10yr EUR inflation vs. 30yr GBP inflation | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is above LIS and Not liquid | Package is above SSTI and Not liquid | Package is below LIS and not liquid | Package is below SSTI and not liquid |
| H | 10 or more components | Package of several swaps bundled for execution (e.g. 10yr EUR swap, 15yr EUR swap, 20yr EUR swap, 25yr EUR swap, and 30 yr EUR swap) | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is below LIS and not liquid | Package is below SSTI and not liquid |

[1] Interest Rate Derivatives, FX Derivatives, Commodity Derivatives, Equity Derivatives etc considered as distinct derivative asset classes.

[2] Assuming that ESMA agrees that, for the purposes of MiFIR articles 8(1), 10(1), 18(1) and 18(2), all components of a package have to be tradable on a single venue in order that the package be considered "traded on a venue". Otherwise, ESMA should deem packages including exchange traded derivatives to be not liquid. ISDA recommends that packages involving exchange traded derivatives should be executed using the wholesale trading facilities currently governed by venues' rulebooks

Option 2:

1. Subject to point 3 below, if each component of a package transaction is liquid:

    a. The package transaction should be considered liquid; and

    b. The percentage threshold for each individual component in a package transaction is equal to the notional of the relevant component expressed as a percentage of its relevant threshold (LIS or SSTI). If the sum of the percentage thresholds for all components in the package transaction is above 100%, then the package transaction (and each of its components) is above the relevant threshold (LIS or SSTI). See below for a more detailed explanation of the percentage threshold approach.

2. Subject to point 3 below, if the package transaction contains liquid and illiquid components:

    a. The package transaction should be considered illiquid; and

    b. The percentage threshold for each individual component in a package transaction is equal to the notional of the relevant component expressed as a percentage of its relevant threshold (LIS or SSTI). If the sum of the percentage thresholds for all components in the package transaction is above 100%, then the package transaction (and each of its components) is above the relevant threshold (LIS or SSTI). See below for a more detailed explanation of the percentage threshold approach.

3. For the purposes of MiFIR Articles 8(1), 10(1), 18(1) and 18(2), all components of a package have to be tradable on a single venue in order for the package be considered “traded on a venue”.

4. If the package transaction comprises ten or more component legs, the package transaction should be considered illiquid.

The percentage threshold approach aims to, in a simple manner, replicate the package of instruments into a single instrument to test whether it would indeed be above the threshold (SSTI or LIS purposes) or not if it were traded as a single instrument.

Example: if an investor wishes to hedge cash flows at 5-year and 15-year points using EUR interest rate swaps, to create an accurate hedge the investor would trade a package of two EUR swaps at 5-year and 15-year maturities. Alternatively, the investor could enter into a single swap with an average 10-year maturity to try to replicate the risk profile but with less accuracy.

However, whilst the individual swaps in the package of swaps could each be below the relevant threshold, the equivalent single swap would have a larger notional and could therefore be above the threshold, as illustrated below. Given the 5-year and 15-year swaps are economically similar in nature, the pricing of one swap is likely to impact the pricing of the other. By not recognising this, ESMA could create an incentive for the market to trade in the equivalent single average instruments, rather than the package of instruments that provide a more accurate hedge: the result would be to provide a less perfect hedge, thereby retaining risk in the system.

The suggested percentage threshold approach provides a way to calibrate this and ensures that package transactions are not disproportionately disadvantaged.

The below table illustrates the example described above.

**Table 12: Example of how the percentage threshold approach (Option 2) operates**

| | More accurate hedge | | Less accurate hedge |
|---|---|---|---|
| | **EUR 5yr swap** | **EUR 15yr swap** | **EUR 10yr swap** |
| Notional | 60m | 60m | 120m |
| Threshold (SSTI or LIS) | 100m | 100m | 100m |
| Percentage Threshold | 60% | 60% | 120% |

Table 11, prepared for Option 1, could easily be adapted for Option 2 if this is ESMA's preferred option and we would be happy to prepare this table if requested.

***e) Safeguarding against avoidance***

ISDA is aware that ESMA and national competent authorities may be concerned that adoption of our proposal may lead to market participants creating packages of instruments purely for the purposes of avoiding the transparency regime or the derivatives trading obligation. ISDA recognises these concerns and suggests that this could be achieved by defining a package and including, within the MiFID II/MiFIR framework, a mechanism that would support the monitoring (and therefore supervision) of the trading of packages. ISDA would welcome the opportunity to discuss these safeguards with ESMA in more detail.

1. Definition of package transaction

ISDA recommends that a "package transaction" be defined as a transaction comprising two or more components, each of which is a bond, structured finance product, emission allowance or derivative where:

(i) The components are priced as a "package" with simultaneous execution of all such components;

(ii) The execution of each component is contingent on the execution of the other components;

(iii) Each component must be able to stand alone and must be able to bear economic risk; and

(iv) Either:

i. the components are economically similar in nature such that the pricing of one component can affect the pricing of the other component; or

ii. the components must have a reasonable degree of correlation.

2. Post-trade transparency flag

With a view to assisting the monitoring of package transactions by supervisors, and as stated in our response to Question 74, ISDA recommends that an additional flag to be reported on trades that are components of package transactions be added to the list of flags set out in Table 2 of Annex II of RTS 9.

We would also draw attention to our response to Question 218 where we suggest that ESMA may wish to consider including a "link ID" field in transaction reports (for the purposes of the Article 26 MiFIR transaction reporting regime). In ISDA's response to ESMA's recent consultation paper on the review of reporting technical standards under EMIR, we recommended the inclusion of a "link ID" field to link together trade reports of components of the same package. ESMA may wish to consider whether to incorporate such a field in the transaction reports required under the MiFIR transaction reporting regime as this would give supervisors greater visibility in respect of the usage of package transactions.] **END OF ISDA TEXT**

**(2) Would you use different parameters or the same parameters but different thresholds in order to define a sub-class as liquid?**

We do not believe that the approach used by ESMA in defining the Notional Amount/Number of trades a day is appropriate in its current state.

The FX market is global in nature and forms the basis of the global payments system, resulting is a very large number of market participants. It would be very easy for a financial instrument to be traded once a day but considered illiquid by market participants. Also, the definition of 'liquid market' in Article 2(17)(a) of MiFIR requires there to be "ready and willing buyers and sellers on a continuous basis". This requires there to be more than one buyer or seller in a market for a particular sub-class of instruments for that sub-class to be determined liquid. Specifically, two trades, or in some cases one trade per day, cannot be considered consistent with this definition.

Supporting ISDA in their response to the December 2014 CP, GFXD members believe that where a product is traded by a small number of participants, ESMA should seek to understand the composition of market participants before determining the final thresholds. For example, a market with ten active participants may have two sellers and eight buyers, or just one risk management provider amongst nine participants seeking risk management services.

**(3) Would you define some specific classes declared as liquid in ESMA's proposal as illiquid (and vice versa)?**

The GFXD would define some classes declared liquid by ESMA as illiquid and vice-versa and we explain why below.

ESMA have included on page 16 of the CP 2 charts which show the notional and trade distribution of FX derivatives, essentially summarizing the data used by ESMA in this CP.

It is immediately obvious that these charts do not mirror the data published in the Bank of International Settlements (BIS) Triennial Central Bank Survey of Foreign Exchange turnover (http://www.bis.org/publ/rpfx13fx.pdf), nor that published by the Bank of England in its semi-annual FX surveys (http://www.bankofengland.co.uk/markets/Pages/forex/fxjsc/default.aspx). Both of these sources are widely accepted by the FX industry (including Central Banks) as being representative of turnover within the FX markets, both sources reporting similar market splits by instrument traded and currency pairs.

Figures 2, 3, 4a/b and 5 below show the results of these data sources (Figure 5 comparing all 3) and it should be noted that ESMA themselves used the BIS data in their recent FX NDF Clearing CP, as illustrated in Figure 3.

It is clear that the product splits in Figure 2 (ESMA Addendum CP) are considerably different to those seen in Figures 3 and 4a/b (BIS and BoE) and the difference is even more obvious in Figure 5. The volume of each product is either considerably greater/smaller than expected and there is the addition of a new product, 'spread-betting' which was unexpected (and in fact misrepresentative), and is discussed in more detail elsewhere in Q1.

Figure 2: Extract from ESMAs MiFID Addendum Consultation Paper using EMIR trade reporting data

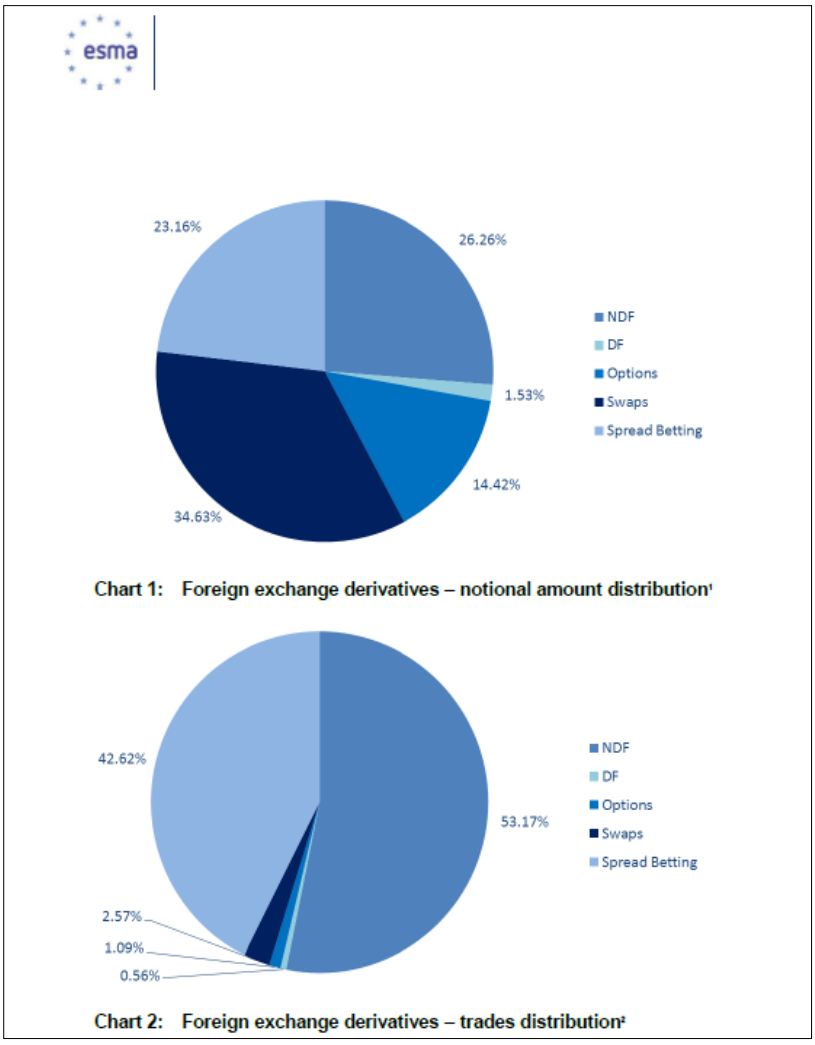
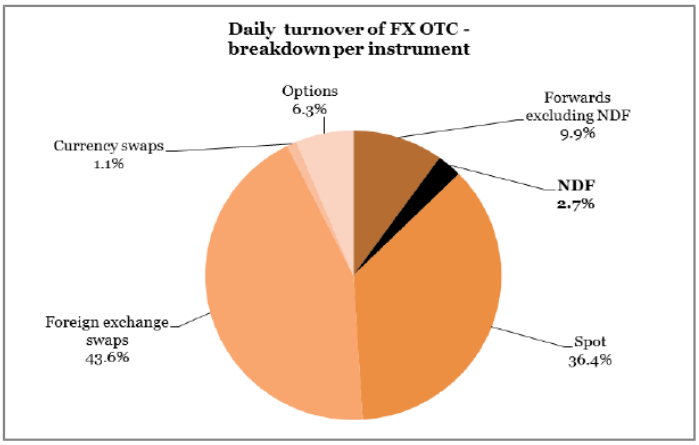


Figure 3: Extract from ESMAs FX NDF Clearing CP from October 2014 using BIS data

esma

**Figure 7: Daily turnover of FX OTC - breakdown per instrument**




*Source: BIS Triennal Central Bank Survey, data of April 2013*

Figure 4a: Extract and Representation of the BoE April 2014 Semi-Annual FX Survey

**Table 1**

**Reported UK foreign exchange market turnover by instrument[1]**

Daily averages in billions of US dollars

| Instrument | April 2014 | October 2014 |
|---|---|---|
| Spot transactions | 795 | 1110 |
| Outright forwards | 179 | 236 |
| Non-deliverable forwards | 54 | 61 |
| Foreign exchange swaps | 1212 | 1041 |
| Currency swaps | 24 | 25 |
| Foreign exchange options | 129 | 196 |
| **Total foreign exchange turnover** | **2393** | **2667** |

[1] Adjusted for double counting of deals between survey contributors.
Totals may not sum due to rounding.
Daily averages are calculated assuming 20 working days in April 2014 and 23 working days in October 2014.

Figure 4b: Chart representation of Figure 4a (BoE Oct 2014 Semi-Annual FX Survey)

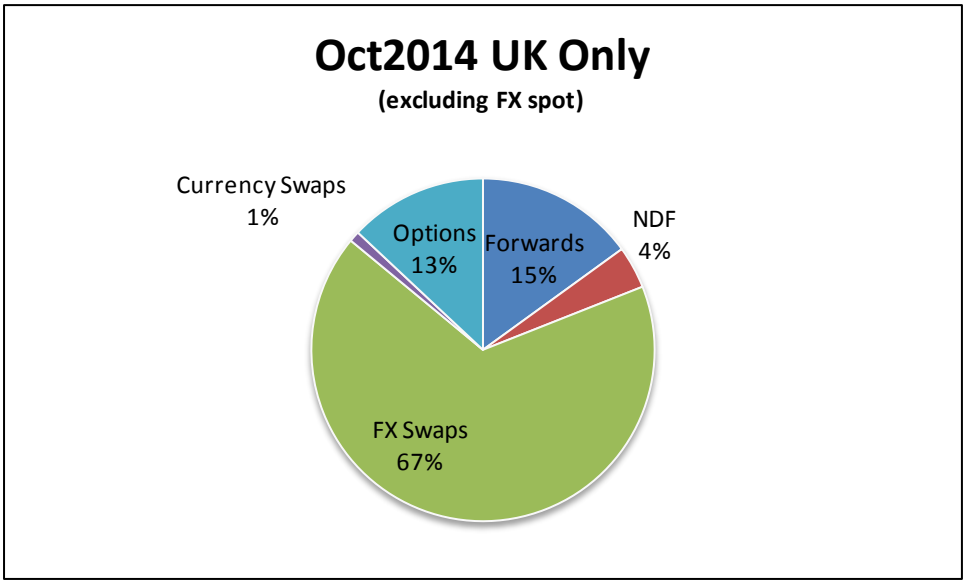
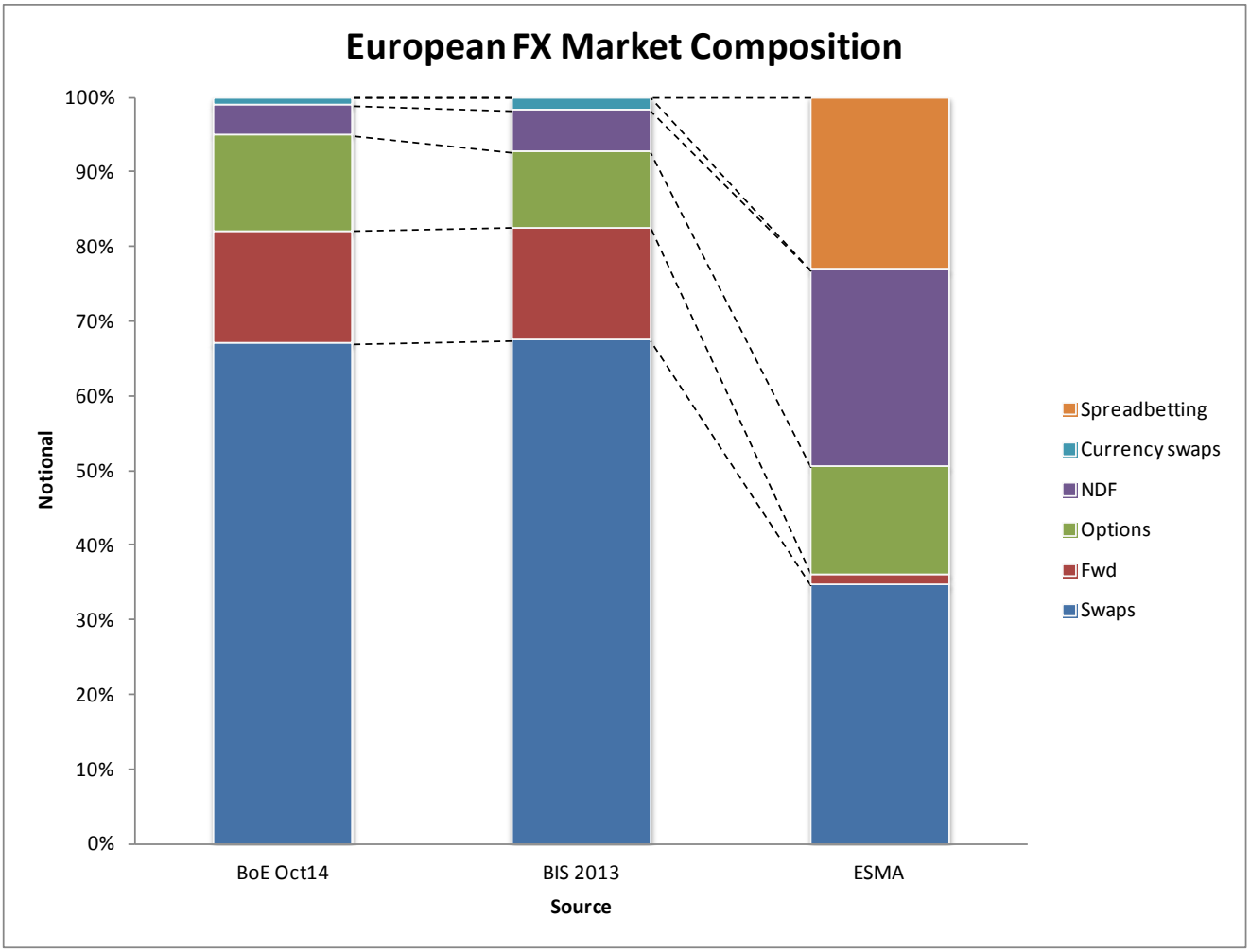



Figure 5: Comparative analysis between the ESMA CP, BIS and BoE data sets



Analysis of the underlying data, as provided in the charts on pages 22-163 of the CP, immediately illustrated examples of data inconsistencies, such as:

- Inclusion of deliverable currency crosses within the NDF bucket.
- Inclusion of non-deliverable currency crosses within the DF bucket.
- Inclusion of a new product category, Spread-betting, which appears to be being used by ESMA as a 'catch all' category for the EMIR trade reporting product category 'Other'. We also consider that there could be an overlap of this category with the Financial Contracts for Difference (CFD) product which is defined under MiFID Annex C9 and not C4 which is where FX derivatives are defined.
- Inclusion of precious metals within the FX data, which at best has the potential to result in confusing and conflicting rules between the FX and Commodities asset classes, and at worst creates unhelpful incentives to repackage economic exposure into different 'wrappers' in order to obtain different regulatory treatment. These commodity products should be removed from the requirements for FX products and addressed solely within the requirements for the Commodities asset class.

The impact of these data inconsistencies is that:

- Some FX instruments we had expected to be considered liquid have been classified as illiquid:
    - e.g., deliverable forward AUD crosses

- Some FX instruments which we had expected to be to be considered illiquid have been classified as liquid:
    - e.g., deliverable forward non-USD crosses

To illustrate the scale of these inconsistencies we have extracted the final deliverable and non-deliverable liquidity tables from the CP. Figure 6 illustrates the data from Table 48-Liquid NDF (which starts on page 329 of the CP) and Figure 7 illustrates Table 50-Liquid DF (which starts on page 336 of the CP).

## Figure 6: MiFID Addendum CP Extract of FX non-deliverable forwards – liquid classes

| NON-DELIVERABLE FORWARDS (NDF) - LIQUID CLASSES | | | |
|---|---|---|---|
| CURRENCY PAIR | TENOR | LIS (€) | SSTI (€) |
| AUD-EUR | from 1 day to 4 days | 1,000,000 | 500,000 |
| AUD-EUR | from 4 days to 7 days | 1,000,000 | 500,000 |
| AUD-EUR | from 7 days to 1 month | 1,000,000 | 500,000 |
| AUD-EUR | from 1 month to 3 months | 3,500,000 | 1,750,000 |
| AUD-EUR | from 3 months to 6 months | 1,000,000 | 500,000 |
| AUD-GBP | from 1 day to 4 days | 1,000,000 | 500,000 |
| AUD-GBP | from 4 days to 7 days | 1,000,000 | 500,000 |
| AUD-GBP | from 7 days to 1 month | 1,000,000 | 500,000 |
| AUD-GBP | from 1 month to 3 months | 20,000,000 | 10,000,000 |
| AUD-GBP | from 3 months to 6 months | 1,000,000 | 500,000 |
| AUD-JPY | from 1 day to 4 days | 1,000,000 | 500,000 |
| AUD-JPY | from 4 days to 7 days | 4,000,000 | 2,000,000 |
| AUD-JPY | from 7 days to 1 month | 1,000,000 | 500,000 |
| AUD-JPY | from 1 month to 3 months | 8,500,000 | 4,250,000 |
| AUD-JPY | from 3 months to 6 months | 15,000,000 | 7,500,000 |
| AUD-USD | from 1 day to 4 days | 1,000,000 | 500,000 |
| AUD-USD | from 4 days to 7 days | 1,000,000 | 500,000 |
| AUD-USD | from 7 days to 1 month | 1,000,000 | 500,000 |
| AUD-USD | from 1 month to 3 months | 6,000,000 | 3,000,000 |
| AUD-USD | from 3 months to 6 months | 1,000,000 | 500,000 |
| BRL-USD | from 1 day to 4 days | 40,000,000 | 20,000,000 |
| BRL-USD | from 4 days to 7 days | 40,000,000 | 20,000,000 |
| BRL-USD | from 7 days to 1 month | 15,000,000 | 7,500,000 |
| BRL-USD | from 1 month to 3 months | 15,000,000 | 7,500,000 |
| BRL-USD | from 3 months to 6 months | 35,000,000 | 17,500,000 |
| CAD-EUR | from 1 day to 4 days | 1,000,000 | 500,000 |
| CAD-EUR | from 4 days to 7 days | 1,000,000 | 500,000 |
| CAD-EUR | from 7 days to 1 month | 1,000,000 | 500,000 |
| CAD-EUR | from 1 month to 3 months | 3,000,000 | 1,500,000 |
| CAD-EUR | from 3 months to 6 months | 1,000,000 | 500,000 |
| CAD-GBP | from 1 day to 4 days | 1,000,000 | 500,000 |
| CAD-GBP | from 4 days to 7 days | 1,000,000 | 500,000 |
| CAD-GBP | from 7 days to 1 month | 1,000,000 | 500,000 |
| CAD-GBP | from 1 month to 3 months | 30,000,000 | 15,000,000 |
| CAD-USD | from 1 day to 4 days | 1,000,000 | 500,000 |
| CAD-USD | from 4 days to 7 days | 1,000,000 | 500,000 |
| CAD-USD | from 7 days to 1 month | 1,000,000 | 500,000 |
| CAD-USD | from 1 month to 3 months | 1,000,000 | 500,000 |
| CAD-USD | from 3 months to 6 months | 1,000,000 | 500,000 |
| CHF-EUR | from 1 day to 4 days | 1,000,000 | 500,000 |
| CHF-EUR | from 4 days to 7 days | 1,000,000 | 500,000 |
| CHF-EUR | from 7 days to 1 month | 1,000,000 | 500,000 |
| CHF-EUR | from 1 month to 3 months | 8,500,000 | 4,250,000 |
| CHF-EUR | from 3 months to 6 months | 1,000,000 | 500,000 |
| CHF-GBP | from 1 day to 4 days | 1,000,000 | 500,000 |
| CHF-GBP | from 4 days to 7 days | 1,000,000 | 500,000 |
| CHF-GBP | from 7 days to 1 month | 1,000,000 | 500,000 |
| CHF-GBP | from 1 month to 3 months | 20,000,000 | 10,000,000 |
| CHF-GBP | from 3 months to 6 months | 1,000,000 | 500,000 |
| CHF-JPY | from 1 day to 4 days | 1,000,000 | 500,000 |
| CHF-JPY | from 4 days to 7 days | 1,000,000 | 500,000 |
| CHF-JPY | from 7 days to 1 month | 1,000,000 | 500,000 |
| CHF-JPY | from 1 month to 3 months | 25,000,000 | 12,500,000 |
| CHF-JPY | from 3 months to 6 months | 10,000,000 | 5,000,000 |
| CHF-USD | from 1 day to 4 days | 1,000,000 | 500,000 |
| CHF-USD | from 4 days to 7 days | 1,000,000 | 500,000 |
| CHF-USD | from 7 days to 1 month | 1,000,000 | 500,000 |
| CHF-USD | from 1 month to 3 months | 10,000,000 | 5,000,000 |
| CHF-USD | from 3 months to 6 months | 1,000,000 | 500,000 |
| CLP-USD | from 7 days to 1 month | 25,000,000 | 12,500,000 |
| CLP-USD | from 1 month to 3 months | 20,000,000 | 10,000,000 |
| CLP-USD | from 3 months to 6 months | 175,000,000 | 87,500,000 |
| CNY-EUR | from 7 days to 1 month | 15,000,000 | 7,500,000 |
| CNY-EUR | from 1 month to 3 months | 15,000,000 | 7,500,000 |
| CNY-USD | from 1 day to 4 days | 1,000,000 | 500,000 |
| CNY-USD | from 4 days to 7 days | 25,000,000 | 12,500,000 |
| CNY-USD | from 7 days to 1 month | 30,000,000 | 15,000,000 |
| CNY-USD | from 1 month to 3 months | 20,000,000 | 10,000,000 |
| CNY-USD | from 3 months to 6 months | 30,000,000 | 15,000,000 |
| CNY-USD | from 6 months to 1 year | 20,000,000 | 10,000,000 |
| CNY-USD | from 1 year to 2 years | 20,000,000 | 10,000,000 |
| COP-USD | from 1 day to 4 days | 175,000,000 | 87,500,000 |
| COP-USD | from 4 days to 7 days | 700,000,000 | 350,000,000 |
| COP-USD | from 7 days to 1 month | 70,000,000 | 35,000,000 |
| COP-USD | from 1 month to 3 months | 70,000,000 | 35,000,000 |
| CZK-EUR | from 7 days to 1 month | 15,000,000 | 7,500,000 |
| CZK-EUR | from 1 month to 3 months | 15,000,000 | 7,500,000 |
| CZK-EUR | from 3 months to 6 months | 1,500,000 | 750,000 |
| DKK-EUR | from 1 day to 4 days | 7,500,000 | 3,750,000 |
| DKK-EUR | from 4 days to 7 days | 7,500,000 | 3,750,000 |
| DKK-EUR | from 7 days to 1 month | 15,000,000 | 7,500,000 |
| DKK-EUR | from 1 month to 3 months | 100,000,000 | 50,000,000 |
| DKK-EUR | from 3 months to 6 months | 90,000,000 | 45,000,000 |
| DKK-GBP | from 4 days to 7 days | 20,000,000 | 10,000,000 |
| DKK-GBP | from 7 days to 1 month | 25,000,000 | 12,500,000 |
| DKK-GBP | from 1 month to 3 months | 25,000,000 | 12,500,000 |
| DKK-USD | from 1 day to 4 days | 1,000,000 | 500,000 |
| DKK-USD | from 4 days to 7 days | 70,000,000 | 35,000,000 |
| DKK-USD | from 7 days to 1 month | 15,000,000 | 7,500,000 |
| DKK-USD | from 1 month to 3 months | 15,000,000 | 7,500,000 |
| DKK-USD | from 3 months to 6 months | 4,000,000 | 2,000,000 |
| DKK-USD | from 6 months to 1 year | 20,000,000 | 10,000,000 |
| EUR-GBP | from 1 day to 4 days | 1,000,000 | 500,000 |
| EUR-GBP | from 4 days to 7 days | 1,000,000 | 500,000 |
| EUR-GBP | from 7 days to 1 month | 1,000,000 | 500,000 |
| EUR-GBP | from 1 month to 3 months | 20,000,000 | 10,000,000 |
| EUR-GBP | from 3 months to 6 months | 1,000,000 | 500,000 |
| EUR-GBP | from 6 months to 1 year | 1,000,000 | 500,000 |
| EUR-GBP | from 1 year to 2 years | 7,000,000 | 3,500,000 |
| EUR-GBP | from 2 years to 3 years | 35,000,000 | 17,500,000 |
| EUR-HUF | from 1 day to 4 days | 1,000,000 | 500,000 |
| EUR-HUF | from 4 days to 7 days | 15,000,000 | 7,500,000 |
| EUR-HUF | from 7 days to 1 month | 15,000,000 | 7,500,000 |
| EUR-HUF | from 1 month to 3 months | 30,000,000 | 15,000,000 |
| EUR-HUF | from 3 months to 6 months | 75,000,000 | 37,500,000 |
| EUR-HUF | from 6 months to 1 year | 15,000,000 | 7,500,000 |

| NON-DELIVERABLE FORWARDS (NDF) - LIQUID CLASSES | | | |
|---|---|---|---|
| CURRENCY PAIR | TENOR | LIS (€) | SSTI (€) |
| EUR-JPY | from 1 day to 4 days | 1,000,000 | 500,000 |
| EUR-JPY | from 4 days to 7 days | 3,000,000 | 1,500,000 |
| EUR-JPY | from 7 days to 1 month | 1,000,000 | 500,000 |
| EUR-JPY | from 1 month to 3 months | 10,000,000 | 5,000,000 |
| EUR-JPY | from 3 months to 6 months | 20,000,000 | 10,000,000 |
| EUR-NOK | from 1 day to 4 days | 8,000,000 | 4,000,000 |
| EUR-NOK | from 4 days to 7 days | 8,000,000 | 4,000,000 |
| EUR-NOK | from 7 days to 1 month | 2,000,000 | 1,000,000 |
| EUR-NOK | from 1 month to 3 months | 5,000,000 | 2,500,000 |
| EUR-NOK | from 3 months to 6 months | 3,500,000 | 1,750,000 |
| EUR-PLN | from 1 day to 4 days | 4,000,000 | 2,000,000 |
| EUR-PLN | from 4 days to 7 days | 4,500,000 | 2,250,000 |
| EUR-PLN | from 7 days to 1 month | 5,500,000 | 2,750,000 |
| EUR-PLN | from 1 month to 3 months | 7,000,000 | 3,500,000 |
| EUR-PLN | from 3 months to 6 months | 2,000,000 | 1,000,000 |
| EUR-SEK | from 1 day to 4 days | 9,000,000 | 4,500,000 |
| EUR-SEK | from 4 days to 7 days | 9,000,000 | 4,500,000 |
| EUR-SEK | from 7 days to 1 month | 5,000,000 | 2,500,000 |
| EUR-SEK | from 1 month to 3 months | 9,000,000 | 4,500,000 |
| EUR-SEK | from 3 months to 6 months | 2,500,000 | 1,250,000 |
| EUR-USD | from 1 day to 4 days | 1,000,000 | 500,000 |
| EUR-USD | from 4 days to 7 days | 1,000,000 | 500,000 |
| EUR-USD | from 7 days to 1 month | 1,000,000 | 500,000 |
| EUR-USD | from 1 month to 3 months | 2,000,000 | 1,000,000 |
| EUR-USD | from 3 months to 6 months | 1,000,000 | 500,000 |
| EUR-USD | from 6 months to 1 year | 1,000,000 | 500,000 |
| EUR-USD | from 1 year to 2 years | 4,000,000 | 2,000,000 |
| EUR-USD | from 2 years to 3 years | 20,000,000 | 10,000,000 |
| GBP-HKD | from 4 days to 7 days | 40,000,000 | 20,000,000 |
| GBP-HKD | from 7 days to 1 month | 8,500,000 | 4,250,000 |
| GBP-HKD | from 1 month to 3 months | 45,000,000 | 22,500,000 |
| GBP-HUF | from 1 day to 4 days | 1,000,000 | 500,000 |
| GBP-HUF | from 4 days to 7 days | 4,000,000 | 2,000,000 |
| GBP-HUF | from 7 days to 1 month | 6,000,000 | 3,000,000 |
| GBP-HUF | from 1 month to 3 months | 2,500,000 | 1,250,000 |
| GBP-HUF | from 3 months to 6 months | 45,000,000 | 22,500,000 |
| GBP-JPY | from 1 day to 4 days | 1,000,000 | 500,000 |
| GBP-JPY | from 4 days to 7 days | 1,000,000 | 500,000 |
| GBP-JPY | from 7 days to 1 month | 1,000,000 | 500,000 |
| GBP-JPY | from 1 month to 3 months | 35,000,000 | 17,500,000 |
| GBP-JPY | from 3 months to 6 months | 20,000,000 | 10,000,000 |
| GBP-NOK | from 1 month to 3 months | 25,000,000 | 12,500,000 |
| GBP-NOK | from 3 months to 6 months | 3,000,000 | 1,500,000 |
| GBP-SEK | from 4 days to 7 days | 5,000,000 | 2,500,000 |
| GBP-SEK | from 7 days to 1 month | 5,500,000 | 2,750,000 |
| GBP-SEK | from 1 month to 3 months | 45,000,000 | 22,500,000 |
| GBP-USD | from 1 day to 4 days | 1,000,000 | 500,000 |
| GBP-USD | from 4 days to 7 days | 1,000,000 | 500,000 |
| GBP-USD | from 7 days to 1 month | 1,000,000 | 500,000 |
| GBP-USD | from 1 month to 3 months | 15,000,000 | 7,500,000 |
| GBP-USD | from 3 months to 6 months | 1,000,000 | 500,000 |
| GBP-USD | from 6 months to 1 year | 1,000,000 | 500,000 |
| HUF-USD | from 1 day to 4 days | 1,000,000 | 500,000 |
| HUF-USD | from 4 days to 7 days | 225,000,000 | 112,500,000 |
| HUF-USD | from 7 days to 1 month | 30,000,000 | 15,000,000 |
| HUF-USD | from 1 month to 3 months | 40,000,000 | 20,000,000 |
| HUF-USD | from 3 months to 6 months | 40,000,000 | 20,000,000 |
| IDR-USD | from 1 day to 4 days | 20,000,000 | 10,000,000 |
| IDR-USD | from 4 days to 7 days | 15,000,000 | 7,500,000 |
| IDR-USD | from 7 days to 1 month | 350,000,000 | 175,000,000 |
| IDR-USD | from 1 month to 3 months | 10,000,000 | 5,000,000 |
| IDR-USD | from 3 months to 6 months | 10,000,000 | 5,000,000 |
| INR-USD | from 1 day to 4 days | 15,000,000 | 7,500,000 |
| INR-USD | from 4 days to 7 days | 25,000,000 | 12,500,000 |
| INR-USD | from 7 days to 1 month | 15,000,000 | 7,500,000 |
| INR-USD | from 1 month to 3 months | 7,500,000 | 3,750,000 |
| INR-USD | from 3 months to 6 months | 20,000,000 | 10,000,000 |
| INR-USD | from 6 months to 1 year | 40,000,000 | 20,000,000 |
| INR-USD | from 1 year to 2 years | 20,000,000 | 10,000,000 |
| JPY-NZD | from 1 day to 4 days | 1,000,000 | 500,000 |
| JPY-NZD | from 4 days to 7 days | 2,500,000 | 1,250,000 |
| JPY-NZD | from 7 days to 1 month | 1,000,000 | 500,000 |
| JPY-NZD | from 1 month to 3 months | 8,000,000 | 4,000,000 |
| JPY-NZD | from 3 months to 6 months | 3,000,000 | 1,500,000 |
| JPY-USD | from 1 day to 4 days | 1,000,000 | 500,000 |
| JPY-USD | from 4 days to 7 days | 6,000,000 | 3,000,000 |
| JPY-USD | from 7 days to 1 month | 1,000,000 | 500,000 |
| JPY-USD | from 1 month to 3 months | 20,000,000 | 10,000,000 |
| JPY-USD | from 3 months to 6 months | 30,000,000 | 15,000,000 |
| KRW-USD | from 1 day to 4 days | 75,000,000 | 37,500,000 |
| KRW-USD | from 4 days to 7 days | 55,000,000 | 27,500,000 |
| KRW-USD | from 7 days to 1 month | 35,000,000 | 17,500,000 |
| KRW-USD | from 1 month to 3 months | 20,000,000 | 10,000,000 |
| KRW-USD | from 3 months to 6 months | 575,000,000 | 287,500,000 |
| MXN-USD | from 1 day to 4 days | 2,000,000 | 1,000,000 |
| MXN-USD | from 4 days to 7 days | 9,500,000 | 4,750,000 |
| MXN-USD | from 7 days to 1 month | 2,500,000 | 1,250,000 |
| MXN-USD | from 1 month to 3 months | 6,500,000 | 3,250,000 |
| MXN-USD | from 3 months to 6 months | 2,000,000 | 1,000,000 |
| MYR-USD | from 1 day to 4 days | 15,000,000 | 7,500,000 |
| MYR-USD | from 4 days to 7 days | 30,000,000 | 15,000,000 |
| MYR-USD | from 7 days to 1 month | 20,000,000 | 10,000,000 |
| MYR-USD | from 1 month to 3 months | 15,000,000 | 7,500,000 |
| NOK-USD | from 1 day to 4 days | 1,000,000 | 500,000 |
| NOK-USD | from 4 days to 7 days | 15,000,000 | 7,500,000 |
| NOK-USD | from 7 days to 1 month | 3,500,000 | 1,750,000 |
| NOK-USD | from 1 month to 3 months | 225,000,000 | 112,500,000 |
| NOK-USD | from 3 months to 6 months | 2,000,000 | 1,000,000 |
| NZD-USD | from 1 day to 4 days | 1,000,000 | 500,000 |
| NZD-USD | from 4 days to 7 days | 1,000,000 | 500,000 |
| NZD-USD | from 7 days to 1 month | 1,000,000 | 500,000 |
| NZD-USD | from 1 month to 3 months | 1,000,000 | 500,000 |
| NZD-USD | from 3 months to 6 months | 1,000,000 | 500,000 |

| NON-DELIVERABLE FORWARDS (NDF) - LIQUID CLASSES | | | |
|---|---|---|---|
| CURRENCY PAIR | TENOR | LIS (€) | SSTI (€) |
| PHP-USD | from 1 day to 4 days | 10,000,000 | 5,000,000 |
| PHP-USD | from 4 days to 7 days | 10,000,000 | 5,000,000 |
| PHP-USD | from 7 days to 1 month | 15,000,000 | 7,500,000 |
| PHP-USD | from 1 month to 3 months | 8,000,000 | 4,000,000 |
| RUB-USD | from 1 day to 4 days | 1,000,000 | 500,000 |
| RUB-USD | from 4 days to 7 days | 25,000,000 | 12,500,000 |
| RUB-USD | from 7 days to 1 month | 3,500,000 | 1,750,000 |
| RUB-USD | from 1 month to 3 months | 15,000,000 | 7,500,000 |
| RUB-USD | from 3 months to 6 months | 10,000,000 | 5,000,000 |
| SEK-USD | from 1 day to 4 days | 1,000,000 | 500,000 |
| SEK-USD | from 4 days to 7 days | 15,000,000 | 7,500,000 |
| SEK-USD | from 7 days to 1 month | 8,000,000 | 4,000,000 |
| SEK-USD | from 1 month to 3 months | 9,500,000 | 4,750,000 |
| SEK-USD | from 3 months to 6 months | 1,000,000 | 500,000 |
| TRY-USD | from 1 day to 4 days | 1,500,000 | 750,000 |
| TRY-USD | from 4 days to 7 days | 1,000,000 | 500,000 |
| TRY-USD | from 7 days to 1 month | 1,000,000 | 500,000 |
| TRY-USD | from 1 month to 3 months | 6,500,000 | 3,250,000 |
| TRY-USD | from 3 months to 6 months | 1,000,000 | 500,000 |
| TWD-USD | from 1 day to 4 days | 15,000,000 | 7,500,000 |
| TWD-USD | from 4 days to 7 days | 20,000,000 | 10,000,000 |
| TWD-USD | from 7 days to 1 month | 20,000,000 | 10,000,000 |
| TWD-USD | from 1 month to 3 months | 15,000,000 | 7,500,000 |
| TWD-USD | from 3 months to 6 months | 35,000,000 | 17,500,000 |
| USD-XAU | from 1 day to 4 days | 1,000,000 | 500,000 |
| USD-XAU | from 4 days to 7 days | 1,000,000 | 500,000 |
| USD-XAU | from 7 days to 1 month | 1,000,000 | 500,000 |
| USD-XAU | from 1 month to 3 months | 125,000,000 | 62,500,000 |
| USD-XAU | from 3 months to 6 months | 125,000,000 | 62,500,000 |
| USD-XAU | from 6 months to 1 year | 1,000,000 | 500,000 |
| USD-ZAR | from 1 day to 4 days | 8,000,000 | 4,000,000 |
| USD-ZAR | from 4 days to 7 days | 8,000,000 | 4,000,000 |
| USD-ZAR | from 7 days to 1 month | 1,000,000 | 500,000 |
| USD-ZAR | from 1 month to 3 months | 9,000,000 | 4,500,000 |
| USD-ZAR | from 3 months to 6 months | 2,000,000 | 1,000,000 |

NDF

Precious metals

We have identified (grey highlight) in Figure 6 those currency crosses which are typically non-deliverable in nature and it is clear that there are many other crosses included in this category which rarely or never trade as non-deliverable forwards. It should be noted too that some of the LIS numbers, such as the COPUSD 700million, are actually higher than the notional/per day reported on page 30 of the CP (340million), again reflective of the data quality issues facing ESMA.

For ease we have also highlighted in blue those precious metals crosses (see comment above) which have also been included within the FX data. It is clear to us that the current ESMA analysis includes a large proportion of instruments which are rarely if ever traded as FX non-deliverables.

## Figure 7: MiFID Addendum CP Extract of FX deliverable forwards – liquid classes

| DELIVERABLE FORWARDS (DF) - LIQUID CLASSES | | | |
|---|---|---|---|
| CURRENCY PAIR | TENOR | LIS (€) | SSTI (€) |
| CAD-USD | 7 days to 1 month | 6,000,000.00 | 3,000,000.00 |
| CAD-USD | 1 month to 3 months | 2,500,000.00 | 1,250,000.00 |
| CHF-EUR | 1 day to 4 days | 20,000,000.00 | 10,000,000.00 |
| CHF-EUR | 4 days to 7 days | 5,500,000.00 | 2,750,000.00 |
| CHF-EUR | 7 days to 1 month | 8,500,000.00 | 4,250,000.00 |
| CHF-EUR | 1 month to 3 months | 10,000,000.00 | 5,000,000.00 |
| CHF-EUR | 3 months to 6 months | 15,000,000.00 | 7,500,000.00 |
| CHF-USD | 1 day to 4 days | 15,000,000.00 | 7,500,000.00 |
| CHF-USD | 4 days to 7 days | 4,500,000.00 | 2,250,000.00 |
| CHF-USD | 7 days to 1 month | 4,500,000.00 | 2,250,000.00 |
| CHF-USD | 1 month to 3 months | 10,000,000.00 | 5,000,000.00 |
| CNH-USD | 7 days to 1 month | 25,000,000.00 | 12,500,000.00 |
| CNH-USD | 1 month to 3 months | 40,000,000.00 | 20,000,000.00 |
| DKK-EUR | 7 days to 1 month | 3,000,000.00 | 1,500,000.00 |
| DKK-EUR | 1 month to 3 months | 4,500,000.00 | 2,250,000.00 |
| EUR-GBP | 1 day to 4 days | 30,000,000.00 | 15,000,000.00 |
| EUR-GBP | 4 days to 7 days | 7,000,000.00 | 3,500,000.00 |
| EUR-GBP | 7 days to 1 month | 9,000,000.00 | 4,500,000.00 |
| EUR-GBP | 1 month to 3 months | 10,000,000.00 | 5,000,000.00 |
| EUR-GBP | 3 months to 6 months | 25,000,000.00 | 12,500,000.00 |
| EUR-GBP | 6 months to 1 year | 8,500,000.00 | 4,250,000.00 |
| EUR-JPY | 1 day to 4 days | 6,500,000.00 | 3,250,000.00 |
| EUR-JPY | 4 days to 7 days | 5,000,000.00 | 2,500,000.00 |
| EUR-JPY | 7 days to 1 month | 5,500,000.00 | 2,750,000.00 |
| EUR-JPY | 1 month to 3 months | 4,500,000.00 | 2,250,000.00 |
| EUR-JPY | 3 months to 6 months | 6,000,000.00 | 3,000,000.00 |
| EUR-NOK | 4 days to 7 days | 5,000,000.00 | 2,500,000.00 |
| EUR-NOK | 7 days to 1 month | 6,500,000.00 | 3,250,000.00 |
| EUR-NOK | 1 month to 3 months | 1,000,000.00 | 500,000.00 |
| EUR-PLN | 7 days to 1 month | 7,000,000.00 | 3,500,000.00 |
| EUR-PLN | 1 month to 3 months | 2,500,000.00 | 1,250,000.00 |
| EUR-RUB | 1 day to 4 days | 15,000,000.00 | 7,500,000.00 |
| EUR-RUB | 4 days to 7 days | 15,000,000.00 | 7,500,000.00 |
| EUR-RUB | 7 days to 1 month | 7,000,000.00 | 3,500,000.00 |
| EUR-RUB | 1 month to 3 months | 3,000,000.00 | 1,500,000.00 |
| EUR-SEK | 1 day to 4 days | 50,000,000.00 | 25,000,000.00 |
| EUR-SEK | 4 days to 7 days | 5,000,000.00 | 2,500,000.00 |
| EUR-SEK | 7 days to 1 month | 5,500,000.00 | 2,750,000.00 |
| EUR-SEK | 1 month to 3 months | 4,000,000.00 | 2,000,000.00 |
| EUR-SEK | 3 months to 6 months | 4,000,000.00 | 2,000,000.00 |
| EUR-SEK | 6 months to 1 year | 3,000,000.00 | 1,500,000.00 |
| EUR-USD | 1 day to 4 days | 10,000,000.00 | 5,000,000.00 |
| EUR-USD | 4 days to 7 days | 10,000,000.00 | 5,000,000.00 |
| EUR-USD | 7 days to 1 month | 6,500,000.00 | 3,250,000.00 |
| EUR-USD | 1 month to 3 months | 7,500,000.00 | 3,750,000.00 |
| EUR-USD | 3 months to 6 months | 4,500,000.00 | 2,250,000.00 |
| EUR-USD | 6 months to 1 year | 3,000,000.00 | 1,500,000.00 |
| EUR-USD | 1 year to 2 years | 5,000,000.00 | 2,500,000.00 |
| EUR-USD | 2 years to 3 years | 20,000,000.00 | 10,000,000.00 |
| GBP-USD | 1 day to 4 days | 7,000,000.00 | 3,500,000.00 |
| GBP-USD | 4 days to 7 days | 6,000,000.00 | 3,000,000.00 |
| GBP-USD | 7 days to 1 month | 15,000,000.00 | 7,500,000.00 |
| GBP-USD | 1 month to 3 months | 15,000,000.00 | 7,500,000.00 |
| GBP-USD | 3 months to 6 months | 75,000,000.00 | 37,500,000.00 |
| GBP-USD | 6 months to 1 year | 20,000,000.00 | 10,000,000.00 |
| INR-USD | 7 days to 1 month | 1,000,000.00 | 500,000.00 |
| INR-USD | 1 month to 3 months | 1,000,000.00 | 500,000.00 |
| JPY-USD | 1 day to 4 days | 10,000,000.00 | 5,000,000.00 |
| JPY-USD | 4 days to 7 days | 7,500,000.00 | 3,750,000.00 |
| JPY-USD | 7 days to 1 month | 10,000,000.00 | 5,000,000.00 |
| JPY-USD | 1 month to 3 months | 7,000,000.00 | 3,500,000.00 |
| JPY-USD | 3 months to 6 months | 3,500,000.00 | 1,750,000.00 |
| JPY-USD | 6 months to 1 year | 75,000,000.00 | 37,500,000.00 |
| JPY-USD | 1 year to 2 years | 85,000,000.00 | 42,500,000.00 |
| NOK-SEK | 7 days to 1 month | 10,000,000.00 | 5,000,000.00 |
| NOK-SEK | 1 month to 3 months | 6,500,000.00 | 3,250,000.00 |
| NOK-USD | 7 days to 1 month | 15,000,000.00 | 7,500,000.00 |
| NOK-USD | 1 month to 3 months | 5,500,000.00 | 2,750,000.00 |
| SEK-USD | 1 day to 4 days | 7,500,000.00 | 3,750,000.00 |
| SEK-USD | 4 days to 7 days | 5,500,000.00 | 2,750,000.00 |
| SEK-USD | 7 days to 1 month | 8,500,000.00 | 4,250,000.00 |
| SEK-USD | 1 month to 3 months | 6,500,000.00 | 3,250,000.00 |
| SEK-USD | 3 months to 6 months | 9,500,000.00 | 4,750,000.00 |
| SEK-USD | 6 months to 1 year | 6,000,000.00 | 3,000,000.00 |

NDF

We have used the same approach in Figure 7 as that used in Figure 6. Those currency pairs usually traded as non-deliverable are highlighted in grey. For ease we have also highlighted in blue those precious metal crosses (see comment above) which have also been included within the FX data. As mentioned in the paragraph above, it is very easy to see that the ESMA analysis includes instruments in non-deliverable currencies that are very rarely traded as deliverables, and that a large proportion of instruments that typically are not deemed liquid (e.g., non-USD crosses) in the normal course of trading have been categorized as liquid by ESMA. This is further demonstrated in the GFXD proposal at the end of our response to question 1.

We also strongly suggest that accurate data collected over a longer period than 3 months should be used to ensure a range of market events are captured within any calculations. However, the GFXD is aware that in our proposal below we have used data from a single month, October 2014, noting that this is more of a necessity to ensure the short consultation deadlines were met and we hope that ESMA will conduct a fuller analysis taking into consideration the issues we are raising.

For instance, the March-May2014 period used in this analysis contained specific CNY activity due to PBoC policy intervention as reported by Standard Chartered in the following research note, which may not be representative when considered over a longer period (https://research.standardchartered.com/configuration/ROW%20Documents/PBoC_delivers_a_decisive_band_widening_16_03_14_13_14.pdf).

We believe that the data should be collated once EMIR trade reporting is considered accurate and representative of actual trading patterns, including the correct mapping of FX instruments as traded by the market.

ESMA Approach – Data Quality Concerns

We have discussed above our initial observations concerning the quality of the data used by ESMA in its analysis in this CP. We believe it would be beneficial to expand on some of these themes.

*Trade Reporting mismatches:* EMIR trade reporting, unlike that in some other jurisdictions, is 2-sided in nature, meaning that both parties to a trade are required to report to a trade repository (TR). For FX, there are at least 6 trade repositories that have been registered in the EU, with the GFXD members all reporting to DTCC. The dual sided nature of reporting creates the need for both parties to validate that their submission matches that of their counterparty and this is usually performed via exception (or 'mismatching') reporting. During the first 3 months of data submissions (i.e., the extract used by ESMA in this CP), the ability for either party to check their submission for accuracy intra TR, or even inter TRs, did not exist due to the absence of any exception reporting. Even now, some 14 months since the go-live of EMIR trade reporting obligations, the availability of exception reporting is limited. ESMA therefore used mismatched trade data in their assessment of trading activity in Europe, impacting their assessment of notionals, financial instruments and volumes traded.

*Trading period:* Table 1 on page 17 of the CP illustrates a high-level assessment showing which FX product types are liquid. Footnote 5 on page 17 clearly states that the number of trading days for the period of data chosen for analysis was 65. However, Table 1 states that the number of trading days for each of the product types was above 65, and for NDFs was actually 92. We believe that the number of days traded should not exceed 100% which suggests that yet more of the data submitted to the TR was not representative. The number of days traded is a specific factor in the determination of liquidity, in that in order for a class of derivatives to be liquid, one of the categories assessed is the "number of days traded greater than or equal

to 80% of the available trading days in the period". We believe this is a further example impacting ESMA's ability to make an accurate liquidity assessment.

ESMA Approach – LIS/SSTI

We also believe that the relevant LIS/SSTI thresholds need to be set at a level appropriate to the liquidity (or illiquidity) of an instrument, and whilst our preference would be that ESMA make an accurate determination of liquidity, failing that we agree that ESMA can compensate to a degree through lower LIS and SSTI. It concerns us therefore that ESMA does not in practice make this compensation even though this is noted as a possibility. Furthermore, the proposed 50% SSTI/LIS ratio is arbitrary and we are concerned that it assumes a linear relationship between SSTI and LIS.

We propose two alternative solutions that would achieve a more appropriate SSTI (that would also compensate for an incorrect liquidity determination), a topic discussed in more details in our response to Question 2:

- SSTI be calibrated as the median trade size for trades below the LIS threshold in a given class; or
- A lower SSTI/LIS ratio of 10% should be used.

ESMA Approach – Ability to Re-calibrate

As referenced in the AFME and ISDA responses to the December 2014 MiFID CP, the GFXD shares the same concerns in that ESMA does not propose to recalibrate the liquidity assessment at all. In the May 2014 DP, ESMA stated (on page 125, paragraph 44) that "the liquidity of the sub-categories needs to be re-assessed periodically". Instead, it is now clear that ESMA proposes no such re-assessment. This decision also implies that ESMA has chosen not to utilise the market data that MiFIR (or EMIR) will make available to facilitate recalibration, which is an incomprehensible waste of the opportunity to refine the liquidity classification over time (particularly given the concerns over the EMIR trade repository data noted above).

This static determination is a serious weakness of ESMA's approach which implies that an incorrect initial assessment of liquidity will have permanent implications. We encourage ESMA to reconsider whether the COFIA can be recalibrated more regularly, as improved market data becomes available and to better reflect changing liquidity conditions. In the absence of regular and accurate recalibration, we urge ESMA to compensate through both a more conservative initial assessment of liquidity, and by calibrating the LIS and SSTI thresholds at lower levels. Finally, such a static approach will not leverage developments within the trade reporting requirements, most notably those being driven by ESMA as well as global standardisation through the use of the UPI.

GFXD Liquidity Proposal

The GFXD believes that due to the policy objectives of ensuring transparency at the aggregate level of the FX derivatives asset class, ESMA should not attempt to find at least some liquid sub-classes in as many classes of FX derivatives as possible. Some classes are simply very illiquid or extremely heterogeneous. For instance, the GFXD regards simple and complex exotic options as being illiquid, yet due to the current product mapping in the EMIR trade reporting data these would be deemed liquid.

We therefore propose the following alternative approach.

*Data Source:* As we have demonstrated above, we believe that the Bank of International Settlements (BIS) Triennial Central Bank Survey of Foreign Exchange turnover (http://www.bis.org/publ/rpfx13fx.pdf), and the

Bank of England (BoE) semi-annual FX surveys (http://www.bankofengland.co.uk/markets/Pages/forex/fxjsc/default.aspx) accurately reflects the FX trading landscape in Europe. Both provide a level of granularity which enables the markets to be assessed to enable a practicable application by regulators and market participants alike as well as meeting policy objectives.

- Whilst the BoE survey captures the UK market only, it is important to understand that this represents 70% of the FX market in Europe (by notional traded) and is considered representative across Europe. Both data sources have been used over a number of years (BoE since 2008, for instance), with the data collection models being refined over time. These surveys are considered accurate by the FX industry, including central banks and ESMA (BIS was used by ESMA in the 2014 CP on FX NDF Clearing). This is obviously contrary to the EMIR trade repository data available to ESMA, which as we have discussed above is not considered in its current state to be representative of the European FX industry. We suggest that ESMA considers that EMIR trade reporting data contains data reflecting the post execution status, including allocations etc which may distort several of the parameters used to measure liquidity (e.g., number of transactions). From 2018 onwards, a better approach may be to use a combination of data sources (including Central Bank data) to obtain a truer reflection of what is actually executed.

*Results:* Using the BoE October 2014 data, currency pairs and tenors were identified and agreed by GFXD members as being 'usually' liquid in the market (noting that this assessment was performed independently with the results then being applied to the BoE data) and have been highlighted blue in the following tables.

Each cell shows the notional reported in the survey in USD millions equivalent and is a direct extract from http://www.bankofengland.co.uk/markets/Pages/forex/fxjsc/default.aspx 'Results of the Semi-Annual FX Turnover Surveys, 2014 Results, October'.

We also noted that there was a considerable concentration of activity at the 3 month tenor. However, the BoE data only reports the 1-6 month tenor. Anecdotal feedback from the trading desks of GFXD members suggests that the liquidity of the 1-6 month tenor is actually concentrated within the 1-3 month range. As such, we have split the original 1-6 month tenor into a 1-3 month and 3-6 month tenors and have applied an 80/20 split to the 1-6 month tenor in-order to populate.

## Figure 8: Liquid and illiquid FX deliverable forwards

**3a. OUTRIGHT FORWARDS, Total Monthly Volume by Maturity**
Millions of U.S. Dollars

Liquid

1-6mth data split 80/20 between the 2 date ranges

| Currency Pair | Maturity: Less than 1 week | 1 week to 1 month | 1 month to 3 months | 3 months to 6 months | 6 months to 1 year | Over 1 year | Total |
|---|---|---|---|---|---|---|---|
| **U.S. DOLLAR versus** | | | | | | | |
| Euro | 894,772 | 309,274 | 336,540 | 84,135 | 25,366 | 17,489 | |
| British pound | 242,048 | 104,422 | 140,557 | 35,139 | 6,418 | 3,984 | |
| Japanese yen | 1,009,417 | 159,277 | 146,894 | 36,724 | 7,297 | 9,800 | |
| Swiss franc | 89,314 | 33,322 | 29,033 | 7,258 | 3,212 | 1,515 | |
| Australian dollar | 172,834 | 79,518 | 69,803 | 17,451 | 1,567 | 1,477 | |
| Canadian dollar | 86,569 | 35,022 | 41,462 | 10,366 | 1,424 | 5,119 | |
| Norwegian krone | 12,094 | 6,926 | 10,907 | 2,727 | 277 | 155 | |
| Swedish krona | 9,479 | 8,719 | 12,738 | 3,184 | 217 | 190 | |
| New Zealand dollar | 55,284 | 24,381 | 21,826 | 5,456 | 526 | 378 | |
| South African rand | 22,806 | 22,008 | 15,641 | 3,910 | 674 | 474 | |
| Mexican peso | 28,559 | 19,366 | 20,146 | 5,036 | 301 | 209 | |
| Polish zloty | 8,218 | 5,057 | 6,692 | 1,673 | 254 | 244 | |
| Singapore dollar | 29,683 | 17,409 | 15,844 | 3,961 | 492 | 1,733 | |
| Russian ruble | 31,420 | 5,011 | 10,616 | 2,654 | 1,992 | 923 | |
| Turkish lira | 23,686 | 24,590 | 24,762 | 6,191 | 488 | 296 | |
| Brazilian real | 7,701 | 2,343 | 2,950 | 737 | 11 | 160 | |
| South Korean won | 7,491 | 4,244 | 8,708 | 2,177 | 1,049 | 579 | |
| Chinese yuan | 19,011 | 14,186 | 24,382 | 6,095 | 5,283 | 4,526 | |
| Indian rupee | 6,071 | 7,753 | 14,901 | 3,725 | 1,121 | 811 | |
| All other currencies | 73,004 | 50,880 | 68,766 | 17,192 | 5,672 | 7,581 | |
| **EURO versus** | | | | | | | |
| British pound | 85,491 | 32,767 | 53,294 | 13,324 | 4,160 | 4,570 | |
| Japanese yen | 37,471 | 45,317 | 32,710 | 8,178 | 423 | 949 | |
| Swiss franc | 26,642 | 14,026 | 21,854 | 5,463 | 950 | 607 | |
| Swedish krona | 11,841 | 9,274 | 8,211 | 2,053 | 343 | 558 | |
| Norwegian krone | 14,043 | 14,730 | 12,985 | 3,246 | 104 | 116 | |
| Polish zloty | 4,788 | 4,563 | 7,042 | 1,760 | 443 | 242 | |
| Canadian dollar | 22,404 | 5,379 | 4,241 | 1,060 | 182 | 727 | |
| Australian dollar | 13,624 | 9,588 | 9,060 | 2,265 | 460 | 444 | |
| All other currencies | 25,957 | 18,490 | 17,419 | 4,355 | 3,491 | 1,334 | |
| **STERLING versus** | | | | | | | |
| Japanese yen | 14,546 | 80,581 | 9,187 | 2,297 | 670 | 326 | |
| Swiss franc | 6,636 | 1,997 | 3,273 | 818 | 285 | 249 | |
| Australian dollar | 10,487 | 2,897 | 3,296 | 824 | 303 | 418 | |
| Canadian dollar | 7,050 | 1,399 | 2,718 | 679 | 259 | 79 | |
| All other currencies | 13,069 | 4,353 | 6,011 | 1,503 | 1,237 | 900 | |
| **ALL OTHER CURRENCY PAIRS** | 62,264 | 33,365 | 24,602 | 6,151 | 1,568 | 1,144 | |
| **Total[a]** | **3,185,774** | **1,212,434** | **1,239,070** | **309,768** | **78,519** | **70,306** | **6,095,871** |
| **Blue total** | **2,873,749** | **903,881** | **850,294** | **212,574** | **25,366** | **0** | **4,865,864** |
| **%** | **90.21%** | **74.55%** | **68.62%** | **68.62%** | **32.31%** | **0.00%** | **79.82%** |

Figure 9: Liquid and Illiquid FX swaps

**3b. FOREIGN EXCHANGE SWAPS, Total Monthly Volume by Maturity**
Millions of U.S. Dollars

Liquid

1-6mth data split 80/20 between the 2 date ranges

| Currency Pair | Maturity: Less than 1 week | 1 week to 1 month | 1 month to 3 months | 3 months to 6 months | 6 months to 1 year | Over 1 year | Total |
|---|---|---|---|---|---|---|---|
| **U.S. DOLLAR versus** | | | | | | | |
| Euro | 6,826,644 | 1,017,434 | 1,163,500 | 290,875 | 131,273 | 94,240 | |
| British pound | 2,920,544 | 359,302 | 547,576 | 136,894 | 44,263 | 19,705 | |
| Japanese yen | 2,191,904 | 347,740 | 389,989 | 97,497 | 52,989 | 65,666 | |
| Swiss franc | 1,656,016 | 163,072 | 197,662 | 49,416 | 27,200 | 11,279 | |
| Australian dollar | 1,284,479 | 129,916 | 161,604 | 40,401 | 9,674 | 9,704 | |
| Canadian dollar | 619,833 | 71,626 | 103,958 | 25,989 | 8,508 | 13,248 | |
| Norwegian krone | 350,297 | 31,172 | 32,134 | 8,034 | 3,885 | 4,166 | |
| Swedish krona | 393,097 | 36,646 | 37,808 | 9,452 | 4,750 | 3,752 | |
| New Zealand dollar | 367,418 | 40,842 | 30,611 | 7,653 | 1,749 | 3,824 | |
| South African rand | 245,728 | 28,848 | 44,137 | 11,034 | 4,549 | 2,800 | |
| Mexican peso | 189,880 | 29,702 | 32,026 | 8,007 | 2,757 | 1,013 | |
| Polish zloty | 218,544 | 19,178 | 29,226 | 7,306 | 2,163 | 1,358 | |
| Singapore dollar | 211,555 | 29,416 | 24,322 | 6,081 | 4,311 | 3,630 | |
| Russian ruble | 177,241 | 20,760 | 26,784 | 6,696 | 7,725 | 6,839 | |
| Turkish lira | 384,583 | 64,792 | 64,575 | 16,144 | 5,255 | 2,817 | |
| Brazilian real | 488 | 1,415 | 2,648 | 662 | 0 | 0 | |
| South Korean won | 450 | 391 | 1,687 | 422 | 150 | 330 | |
| Chinese yuan | 114,499 | 20,731 | 21,934 | 5,484 | 10,446 | 20,035 | |
| Indian rupee | 1,966 | 1,644 | 2,049 | 512 | 148 | 1,197 | |
| All other currencies | 946,214 | 100,978 | 95,326 | 23,832 | 17,794 | 28,610 | |
| **EURO versus** | | | | | | | |
| British pound | 248,425 | 81,696 | 139,954 | 34,989 | 5,620 | 7,583 | |
| Japanese yen | 66,145 | 30,138 | 31,946 | 7,987 | 2,693 | 365 | |
| Swiss franc | 150,915 | 50,170 | 53,217 | 13,304 | 2,943 | 1,628 | |
| Swedish krona | 19,822 | 8,344 | 10,746 | 2,687 | 420 | 1,277 | |
| Norwegian krone | 12,735 | 5,468 | 9,362 | 2,341 | 562 | 160 | |
| Polish zloty | 10,690 | 10,520 | 11,386 | 2,846 | 214 | 883 | |
| Canadian dollar | 16,119 | 5,760 | 6,499 | 1,625 | 620 | 445 | |
| Australian dollar | 24,737 | 12,743 | 9,760 | 2,440 | 223 | 785 | |
| All other currencies | 97,177 | 36,064 | 38,214 | 9,553 | 3,420 | 2,810 | |
| **STERLING versus** | | | | | | | |
| Japanese yen | 37,951 | 6,397 | 13,798 | 3,449 | 476 | 69 | |
| Swiss franc | 24,884 | 4,306 | 12,713 | 3,178 | 1,255 | 111 | |
| Australian dollar | 9,733 | 4,728 | 3,769 | 942 | 9 | 20 | |
| Canadian dollar | 8,476 | 3,204 | 3,802 | 950 | 193 | 24 | |
| All other currencies | 10,284 | 7,383 | 10,902 | 2,726 | 473 | 481 | |
| **ALL OTHER CURRENCY PAIRS** | 245,357 | 17,890 | 23,179 | 5,795 | 1,494 | 694 | |
| **Total**[a] | **20,084,830** | **2,800,416** | **3,388,805** | **847,201** | **360,204** | **311,548** | **27,793,004** |
| **Blue total** | **18,511,014** | **2,356,728** | **2,789,406** | **697,352** | **228,525** | **0** | **24,583,025** |
| **%** | **92.16%** | **84.16%** | **65.85%** | **16.46%** | **63.44%** | **0.00%** | **88.45%** |

Liquid and illiquid FX options

GFXD members believe that as the FX options market is heterogeneous in nature, a dynamic liquidity calibration should be employed, and we note that ISDA recommended a similar approach in their submission to the December 2014 CP. This is reflected in our recommended asset classification under Annex 3.6.1 in the May 2014 DP, as well as being included above in Figure 1.

It is considered that the FX simple and complex exotic options are heterogeneous, illiquid in nature and represent approximately 15% of the total FX options market, itself believed to be approximately 6-8% of the overall FX market (including FX spot) or 13% if FX spot is excluded. With this in mind, we present 2 alternatives:

- Figure 10a uses the BoE options data as a whole, not distinguishing between simple and complex exotics and the rest of the FX options market (i.e., vanilla and NDO).

- Figure 10b, we have applied a consistent 85% ratio to include the FX vanilla options and NDO only (thus excluding simple and complex exotics).

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## Figure 10a: All options (FX vanilla options, NDO, simple and complex exotics)

**3d. FOREIGN EXCHANGE OPTIONS, Total Monthly Volume by Maturity** Liquid

Millions of U.S. Dollars

1-6mth data split 80/20 between the 2 date ranges

| Currency Pair | Maturity: Less than 1 week | 1 week to 1 month | 1 month to 3 months | 3 months to 6 months | 6 months to 1 year | Over 1 year | Total |
|---|---|---|---|---|---|---|---|
| **U.S. DOLLAR versus** | | | | | | | |
| Euro | 311,056 | 503,602 | 579,388 | 144,847 | 115,650 | 72,365 | |
| British pound | 39,953 | 74,570 | 79,516 | 19,879 | 19,425 | 6,899 | |
| Japanese yen | 118,675 | 277,057 | 442,018 | 110,504 | 80,965 | 122,783 | |
| Swiss franc | 22,543 | 25,736 | 60,282 | 15,071 | 27,225 | 22,896 | |
| Australian dollar | 34,740 | 54,293 | 86,535 | 21,634 | 18,033 | 7,159 | |
| Canadian dollar | 15,440 | 34,454 | 38,886 | 9,722 | 10,829 | 1,833 | |
| Norwegian krone | 1,703 | 2,423 | 4,240 | 1,060 | 752 | 196 | |
| Swedish krona | 637 | 1,964 | 3,456 | 864 | 717 | 89 | |
| New Zealand dollar | 13,344 | 17,212 | 21,918 | 5,480 | 6,486 | 2,902 | |
| South African rand | 3,520 | 6,802 | 9,077 | 2,269 | 2,238 | 2,463 | |
| Mexican peso | 2,466 | 8,632 | 12,606 | 3,151 | 1,144 | 2,517 | |
| Polish zloty | 208 | 483 | 1,965 | 491 | 704 | 168 | |
| Singapore dollar | 2,067 | 3,255 | 16,647 | 4,162 | 1,401 | 736 | |
| Russian ruble | 3,001 | 7,490 | 14,838 | 3,710 | 11,321 | 4,033 | |
| Turkish lira | 9,218 | 15,656 | 15,943 | 3,986 | 3,781 | 1,163 | |
| Brazilian real | 4,180 | 28,959 | 78,808 | 19,702 | 7,388 | 11,209 | |
| South Korean won | 4,618 | 11,945 | 10,071 | 2,518 | 2,394 | 1,063 | |
| Chinese yuan | 3,530 | 14,426 | 39,686 | 9,922 | 12,403 | 12,184 | |
| Indian rupee | 1,195 | 10,179 | 12,439 | 3,110 | 2,538 | 1,173 | |
| All other currencies | 14,287 | 43,551 | 74,758 | 18,690 | 37,964 | 23,123 | |
| **EURO versus** | | | | | | | |
| British pound | 20,043 | 36,006 | 65,922 | 16,481 | 20,635 | 4,110 | |
| Japanese yen | 10,642 | 13,140 | 30,186 | 7,547 | 5,767 | 4,209 | |
| Swiss franc | 4,454 | 23,589 | 112,511 | 28,128 | 17,082 | 2,316 | |
| Swedish krona | 6,161 | 5,907 | 6,059 | 1,515 | 2,410 | 584 | |
| Norwegian krone | 4,794 | 9,834 | 13,326 | 3,332 | 2,188 | 942 | |
| Polish zloty | 1,374 | 3,932 | 5,125 | 1,281 | 1,489 | 435 | |
| Canadian dollar | 1,219 | 1,171 | 5,159 | 1,290 | 793 | 244 | |
| Australian dollar | 1,894 | 4,717 | 8,648 | 2,162 | 866 | 1,182 | |
| All other currencies | 6,454 | 9,846 | 20,486 | 5,122 | 8,639 | 6,197 | |
| **STERLING versus** | | | | | | | |
| Japanese yen | 1,462 | 2,801 | 6,762 | 1,690 | 1,400 | 175 | |
| Swiss franc | 374 | 967 | 7,582 | 1,895 | 3,152 | 2,303 | |
| Australian dollar | 483 | 1,233 | 2,071 | 518 | 272 | 122 | |
| Canadian dollar | 41 | 581 | 839 | 210 | 727 | 323 | |
| All other currencies | 1,139 | 2,094 | 4,999 | 1,250 | 1,656 | 444 | |
| **ALL OTHER CURRENCY PAIRS** | 11,149 | 26,193 | 47,208 | 11,802 | 14,665 | 8,766 | |
| **Total[a]** | **678,064** | **1,284,700** | **1,939,964** | **484,991** | **445,099** | **329,306** | **5,162,124** |
| **Blue total** | **429,731** | **1,099,575** | **1,586,120** | **255,351** | **196,615** | **0** | **3,567,392** |
| **%** | **63.38%** | **85.59%** | **81.76%** | **52.65%** | **44.17%** | **0.00%** | **69.11%** |

Figure 10b: Data for FX vanilla options and NDO only (85% of the data in Figure 10a)

**3d. FOREIGN EXCHANGE OPTIONS, Total Monthly Volume by Maturity (Vanilla/NDO only)**
Millions of U.S. Dollars

Liquid

1-6mth data split 80/20 between the 2 date ranges

| Currency Pair | Maturity: Less than 1 week | 1 week to 1 month | 1 month to 3 months | 3 months to 6 months | 6 months to 1 year | Over 1 year | Total |
|---|---|---|---|---|---|---|---|
| **U.S. DOLLAR versus** | | | | | | | |
| Euro | 264,398 | 428,062 | 492,480 | 123,120 | 98,303 | 61,510 | |
| British pound | 33,960 | 63,385 | 67,589 | 16,897 | 16,511 | 5,864 | |
| Japanese yen | 100,874 | 235,498 | 375,715 | 93,929 | 68,820 | 104,366 | |
| Swiss franc | 19,162 | 21,876 | 51,240 | 12,810 | 23,141 | 19,462 | |
| Australian dollar | 29,529 | 46,149 | 73,555 | 18,389 | 15,328 | 6,085 | |
| Canadian dollar | 13,124 | 29,286 | 33,053 | 8,263 | 9,205 | 1,558 | |
| Norwegian krone | 1,448 | 2,060 | 3,604 | 901 | 639 | 167 | |
| Swedish krona | 541 | 1,669 | 2,938 | 734 | 609 | 76 | |
| New Zealand dollar | 11,342 | 14,630 | 18,631 | 4,658 | 5,513 | 2,467 | |
| South African rand | 2,992 | 5,782 | 7,715 | 1,929 | 1,902 | 2,094 | |
| Mexican peso | 2,096 | 7,337 | 10,715 | 2,679 | 972 | 2,139 | |
| Polish zloty | 177 | 411 | 1,670 | 418 | 598 | 143 | |
| Singapore dollar | 1,757 | 2,767 | 14,150 | 3,538 | 1,191 | 626 | |
| Russian ruble | 2,551 | 6,367 | 12,613 | 3,153 | 9,623 | 3,428 | |
| Turkish lira | 7,835 | 13,308 | 13,552 | 3,388 | 3,214 | 989 | |
| Brazilian real | 3,553 | 24,615 | 66,987 | 16,747 | 6,280 | 9,528 | |
| South Korean won | 3,925 | 10,153 | 8,561 | 2,140 | 2,035 | 904 | |
| Chinese yuan | 3,001 | 12,262 | 33,733 | 8,433 | 10,543 | 10,356 | |
| Indian rupee | 1,016 | 8,652 | 10,573 | 2,643 | 2,157 | 997 | |
| All other currencies | 12,144 | 37,018 | 63,545 | 15,886 | 32,269 | 19,655 | |
| **EURO versus** | | | | | | | |
| British pound | 17,037 | 30,605 | 56,034 | 14,009 | 17,540 | 3,494 | |
| Japanese yen | 9,046 | 11,169 | 25,658 | 6,415 | 4,902 | 3,578 | |
| Swiss franc | 3,786 | 20,051 | 95,635 | 23,909 | 14,520 | 1,969 | |
| Swedish krona | 5,237 | 5,021 | 5,150 | 1,288 | 2,049 | 496 | |
| Norwegian krone | 4,075 | 8,359 | 11,327 | 2,832 | 1,860 | 801 | |
| Polish zloty | 1,168 | 3,342 | 4,356 | 1,089 | 1,266 | 370 | |
| Canadian dollar | 1,036 | 995 | 4,385 | 1,096 | 674 | 207 | |
| Australian dollar | 1,610 | 4,009 | 7,351 | 1,838 | 736 | 1,005 | |
| All other currencies | 5,486 | 8,369 | 17,413 | 4,353 | 7,343 | 5,267 | |
| **STERLING versus** | | | | | | | |
| Japanese yen | 1,243 | 2,381 | 5,747 | 1,437 | 1,190 | 149 | |
| Swiss franc | 318 | 822 | 6,444 | 1,611 | 2,679 | 1,958 | |
| Australian dollar | 411 | 1,048 | 1,761 | 440 | 231 | 104 | |
| Canadian dollar | 35 | 494 | 713 | 178 | 618 | 275 | |
| All other currencies | 968 | 1,780 | 4,249 | 1,062 | 1,408 | 377 | |
| **ALL OTHER CURRENCY PAIRS** | 9,477 | 22,264 | 40,127 | 10,032 | 12,465 | 7,451 | |
| **Total[a]** | **576,354** | **1,091,995** | **1,648,969** | **412,242** | **378,334** | **279,910** | **4,387,805** |
| **Blue total** | **365,271** | **934,639** | **1,348,202** | **217,049** | **167,123** | **0** | **3,032,284** |
| **%** | **63.38%** | **85.59%** | **81.76%** | **52.65%** | **44.17%** | **0.00%** | **69.11%** |

## NDF

As demonstrated above in Figure 4 (Extract and Representation of the BoE October 2014 Semi-Annual FX survey), the NDF market in Europe is approximately 4% of the total FX market. We do not believe that the NDF market has sufficient volume to be considered liquid and recommend that, like simple and complex exotic options, that NDF are deemed illiquid. However, we are aware that there may be incentives to include the FX NDF market within the liquid categories of FX instruments. Whilst we oppose this, noting that there are differing liquidity approaches for mandatory clearing obligations and the mandatory trading obligations which may ultimately include some FX NDFs, our members anecdotally consider that the 1 week to 1 month tenors of USDBRL, USDKRW and USDCNY FX NDFs would be more liquid than other NDF crosses/tenors. Due to the parameters reported in the BIS and BoE data subsets it is difficult for us to sensibly size the markets in these NDF currency pairs.

## Spread-betting

We do not consider this to be a FX instrument under MiFID C4. ESMA admit so in the CP, notably in footnote 25 on page 210, which states “this code is not provided for by the legislation”. As such we have not performed any analysis and do not agree that this ‘bucket’ should be included within this FX section.

Instead, ESMA should either (i) remove this spread betting category and associated definition, and instead appropriately categorize the underlying instruments according to the nature of those instrument, and provide suitable definitions that permit straightforward identification of product type without creating

overlapping classes, or (ii) define an 'Others' asset class, to be determined illiquid in its entirety due to the non-homogenous nature of this product set.

Summary

We believe the above proposal achieves the policy objectives in deeming a significant percentage of the European FX market liquid. Our calculations show that using October 2014 Bank of England (BoE) semi-annual FX survey that **79% of the European FX market would be deemed liquid** (calculations illustrated in Figure 11 below)

Figure 11: GFXD summary calculation determining the % of the European Market deemed liquid as per the October 2104 Bank of England semi-annual FX survey

| | BoE Oct14 | GFXD Liquidity Analysis (% of BoE Oct14) | GFXD Adjusted BoE Oct2014 |
|---|---|---|---|
| FX Forwards | 15% | 80% | 12% |
| FX Swaps | 67% | 88% | 59% |
| FX Options (NDO & Vanilla only) | 11% | 69% | 8% |
| Total* | 93% | | 79% |

*Remaining 7% NDF, Exotic options and Currency swaps

- ***Pre-trade and Post-trade transparency requirements for non-equity instruments***

**Q2. Do you agree with ESMA's proposal for foreign exchange derivatives? Please specify, for each sub-class (non-deliverable forwards (NDF), deliverable forwards (DF), FX options, FX swaps, spread betting and FX futures) if you agree on the following points providing reasons for your answer and, if you disagree providing ESMA with your alternative proposal:**

**(1) deferral period set to 48 hours**

**(2) size specific to the instrument threshold set as 50% of the large in scale threshold**

**(3) volume measure used to set the large in scale and size specific to the instrument threshold as specified in Annex II, Table 3 of draft RTS 9**

**(4) pre-trade and post-trade thresholds set at the same size**

**(5) large in scale thresholds: (a) state your preference for the system to set the thresholds (i.e. annual recalculation of the thresholds vs. no recalculation of the thresholds) (b) in the case of a preference for a system with no recalculation (i.e. option 1), provide feedback on the thresholds determined. In the case of a preference for a system with recalculation (i.e. option 2), provide feedback on the thresholds determined for 2017 and on the methodology to recalculate the thresholds from 2018 onwards including the level of granularity of the classes on which the recalculations will be performed**

**(6) <u>for non-deliverable forwards (NDF) and spread betting contracts only</u>: express your preference for either "Alternative A" or "Alternative B". If you disagree with both ESMA's proposal provides your alternative proposal for the LIS threshold floor.**

ISDA's members have had the benefit of reviewing the GFXD's response to this question. We support and endorse the points made therein. For ease of reference, we have set out the response in full below.

For FX non-deliverable forwards (NDF), FX forwards, FX options and FX swaps, the GFXD does not agree with ESMA's proposals, each of which is discussed in more detail below.

**(1) deferral period set to 48 hours**

The GFXD does not support the 48 hour deferral and would like to reference the responses made by ISDA and AFME to question 78 of the December 2014 Consultation Paper (CP) - whilst we welcome ESMA's proposal to extend the length of the deferral period for transactions that are equal to or exceed LIS, equal to or exceed SSTI (if carried out on own account other than matched principal) and in illiquid instruments, we recommend that the deferral period be set at two business days. This is to ensure that transactions that occur close to the end of trading before a weekend/bank holiday get the full benefit of the deferral period (which they may otherwise not if the 48 hour period runs over the weekend).

As ISDA argued in their response to the May 2014 Discussion Paper (DP) and responded accordingly in the December 2014 CP, the duration of volume masking is critical. If ESMA does not accept ISDA's proposal in response to Question 83 of the December 2014 CP (that a 12 week supplementary deferral period is required for volume omission in respect of trades which are both Illiquid and LIS) then we would urge ESMA to extend the post-trade deferral period to at least 7 days for trades that are both illiquid and LIS.

We believe that even two business days may provide challenges for certain types and sizes of transactions and especially so if the LIS and SSTI thresholds are not appropriately calibrated in the final rules. This challenge will be significantly worsened if NCAs do not implement the supplemental volume omission regime. Whilst we appreciate that it is within the discretion of individual NCAs to determine whether to implement a

supplemental volume omission deferral regime, the GFXD urges ESMA to try and encourage as many NCAs as possible to adopt this regime.

**(2) size specific to the instrument threshold set as 50% of the large in scale threshold**

Size specific at 50%

We do not support the proposal that the SSTI threshold is set as 50% of the large in scale threshold and would like to reference the responses made by ISDA and AFME to question 78 of the December 2014 CP.

We believe that the proposal to set the SSTI threshold at 50% of the LIS threshold is arbitrary – there is no rationale for choosing 50% (as opposed to another percentage) and its link to the LIS threshold means that the SSTI threshold is unlikely to result in 50% of trades in a sub-class actually falling below the SSTI threshold. The use of a 50% ratio does not appear to have factored in the elements required by MiFIR under Article 9(5)(d), specifically whether liquidity providers are able to hedge their risks, and the extent of retail participation (although we recognize the practical challenges of incorporating these factors).

Furthermore, as ESMA seems to view the waiver and deferral regimes as a way to reduce the detrimental impact of an illiquid instrument being incorrectly assessed as liquid, we urge ESMA to ensure that the LIS and SSTI thresholds are set at levels sufficiently low in order to compensate for inaccuracies in the liquidity calibration. We also note that in the US, the CFTC has adopted policy-based approach to calculate block sizes, but for FX is currently applying Initial Block Sizes (CFTC 17 CFR Part 43) until accurate data can be collated and assessed.

We propose instead that the SSTI threshold should either be set at either:

- The median trade size (50$^{th}$ percentile of transaction sizes) for transactions below LIS in the relevant sub-class; or
- 10% of the LIS threshold for the relevant sub-class (if ESMA prefers to retain a method based on the percentage of LIS)

The appeal of using the median size is that ESMA can be sure that half of transactions in any liquid sub-class would be subject to pre-trade transparency, and would not experience deferred publication. We consider it would accord better with a normal market transaction at which liquidity providers could be reasonably expected to hedge their risks (as per MiFIR Article 9(5)(d)). Furthermore, breaking the link to LIS would prevent the SSTI being skewed by individual, large transactions (which could result under ESMA's current proposal for LIS calibration).

For the following reasons, we urge ESMA adopt our recommendations for the pre-trade SSTI (although we encourage ESMA to also consider doing so for the post-trade SSTI):

- The risks to firms are more significant in the pre-trade context: a firm is putting its capital at risk and pre-trade disclosure of its quoted prices increases the possibility that the market will move against the firm before it is able to execute those transactions. This would lead firms to price in these risks resulting in worse pricing for end investors

- A 50% SSTI ratio would only permit a SI to undertake two trades before taking on risk equivalent to a large in scale transaction. If the policy objective is to encourage SIs to make their quotes available to and executable by several clients, then setting the SSTI threshold at a level which takes into account multiple transactions and still allows a given quote to be maintained would enable ESMA to achieve such an objective.

The risk is of a different nature in the post-trade context. At this stage, the firm has already committed its capital. The risk it faces at this stage relate to the management of its exposure (i.e., its ability to conduct a successful hedging strategy). However, again, if the ratio is set too high for post-trade purposes, the risks the systematic internaliser faces in managing its hedging strategy in relation to certain products will be reflected in wider prices being quoted to clients.

**(3) volume measure used to set the large in scale and size specific to the instrument threshold as specified in Annex II, Table 3 of draft RTS 9**

The GFXD agrees that FX trade notional is the correct measure.

**(4) pre-trade and post-trade thresholds set at the same size**

The GFXD supports the responses made by ISDA and AFME to this equivalent question in the December 2014 CP. We believe that there should be a different SSTI for pre-trade transparency and post trade transparency because:

- The risk associated with the post trade threshold is the time permitted for the market maker to unwind and hedge risk. The pre-trade risks to the market maker are much greater than the post trade risks because the price formation process can be interfered with:
    - Other dealers could price against the market maker with regards and result in a race to the bottom in pricing that does not reflect market risk. Further, the disclosure of prices pre-trade could result in predatory pricing practices; and
    - Other dealers could take contrarian positions against the market maker prior to execution, increasing the cost of hedging or unwinding of the market maker's risk.

  Therefore, we believe that the pre-trade SSTI should differ from post trade SSTI and that the levels should be much lower. We do not believe that introducing different thresholds for pre-trade and post-trade would make the regime too operationally complex

- For post-trade transparency, if the SSTI is set too high (further exacerbated for illiquid instruments that are incorrectly classified as liquid), the larger trades will be subject to real time transparency (without NCA discretion for deferral) and market makers will be unable hedge and unwind their positions. This will ultimately discourage market makers from committing capital to facilitate trades, resulting in less depth of liquidity and wider spreads, at the expense of investors

**(5) large in scale thresholds**

Data quality issues:

As per our response to the May 2014 DP, we believe that there should be globally harmonised approaches in calculating LIS or block sizes, especially relevant in FX due to the global nature of the market, with at least 75% of the market being traded by market participants across 5 key jurisdictions.

In order to simplify the implementation of a LIS number, we propose that ESMA should look to bucket, per sub-product (e.g., FX forward) as follows:

- Tenor bucket: less than 1 week; 1 week to 3 months; 3 months to 1 year; over 1 year

- CCY buckets: super major (USDEUR, USDJPY, GBPUSD); major (USDCHF, AUDUSD, USDCAD, NZDUSD,GBPEUR, EURJPY); sub-major (USDNOK, USDSEK, USDZAR, USDMXN, USDSGD, USDTRY, USDCNY, EURCHF, EURNOK, GBPJPY)

Having examined the data in the CP we have noticed 2 trends in the LIS data which we believe are not representative of the FX markets. We suggest that the LIS calculations as they are published are not accurate and should be recalibrated at the earliest instance using accurate and representative data.

*LIS absolute values:* There are multiple examples where the LIS number is not representative of the market traded, again due to the poor quality of the data used in the assessment. For instance, USDCOP NDFs (4days to 7 days) have a LIS value of EUR 700million and USDCLP (3 months to 6 months) has a LIS value of EUR 175million. Both of these are many multiples greater than the LIS for the most liquid FX currency pairs, such as USDEUR and can be close to or more than the average daily notional amount per day that is stated in the liquidity assessment tables.

*LIS comparative values per currency cross:* On many of the instruments listed in the FX tables, the value of the LIS increases with tenor. This is contrary to what is seen in the market. Generally liquidity peaks around the 3 month tenor and drops off post that, yet there are many examples showing otherwise, e.g., GBPUSD deliverable forwards as per Table 50 of the CP.

GFXD proposal:

The GFXD supports a dynamic calibration model, re-calibrating both LIS/SSTI using the financial instrument classification (proposed below in Figure 12) at the Annex 3.6.1 level. It is essential that the LIS threshold is appropriately calibrated to ensure that end investors can continue to transact in large trade sizes. Requiring price disclosure of large trades would lead to a widening of bid-offer spreads, which may have a detrimental impact on investors wishing to trade at these large sizes.

As we have previous discussed, we are concerned with the quality of the data used in this CP, especially given the known quality issues with EMIR trade reporting. The GFXD partially supports the dynamic model proposed in Option 2, a policy based approach and we believe that this offers the best compromise given global (US, CFTC) transparency obligations.

For 2018 onwards, we propose the following for FX:

- Pre trade: LIS threshold so that either 50% of the trades would lie below the threshold or 30% of the total volume traded for that sub-class would lie below the threshold

- Post trade: LIS of 65% of the total volume traded for that sub-class would lie below the threshold

- We disagree with ESMA's proposal to include a 'floor' in Option 2. In our view, this goes beyond the Level 1 requirements

The above approach enables the FX market to be policy aligned across jurisdictions and we believe that the dynamic model proposed in Option 2 offers synergy with the CFTC approach where a similar policy based approach is used. However, we would like to clarify that whilst US transparency obligations have been calculated in a similar fashion to the above recommendation, trade data has yet to be analyzed with updated LIS (block) numbers being provided to the market. The FX market is currently reporting based on historical

futures data rather than the latest data obtained from the CFTC SDR reporting and as such we are not able to accurately predict the impact on the markets if such an approach is adopted in practice.

We believe that accurate and reflective trade data should be collated and that this should be used to calibrate the LIS number, accommodating the larger risks faced by participants when complying with pre-trade obligations (see previous comments). We believe that use of a floor in 2017 essentially provides flexibility in the near term to compensate for the know inaccuracies of EMIR trade reporting. We also believe that ESMA should correct its proposed rounding method which systematically rounds the LIS and SSTI thresholds higher. Instead, ESMA should adopt simple mathematical rounding to the nearest round number. In other words, Paragraph 3 of Article 11 of RTS 9 should be amended to "The threshold determined in accordance to paragraph (2) shall be rounded to the next nearest:".

Finally, we believe that thresholds should be applied at Annex 3.6.1 level, included below (with GFXD recommended amendments) in Figure 12.

Figure 12: GFXD proposal for Annex 3.6.1 defining FX instrument categorization under MiFIR

| **Financial Instrument** | **Product Types** | **Sub-Product Types** | **Recommended Liquidity sub-categories** |
|---|---|---|---|
| Foreign Exchange Derivatives | Futures | N/A | Currency Pair<br>Maturity |
| | Options | Non-Deliverable Option - NDO (only European type options are NDO - not any other FX options settled in non-deliverable currency) | |
| | | Vanilla Option (European and American) | |
| | Forwards | Deliverable Forward | |
| | | NDF | |
| | FX Swaps | Deliverable FX Swap | |
| | | Non-Deliverable FX Swap | |
| | Others | Simple exotic (Barrier & Digital) | |
| | | Complex Exotic | |

**6) for non-deliverable forwards (NDF) and spread betting contracts only: express your preference for either "Alternative A" or "Alternative B".**

The GFXD agrees with Alternative B.

## 2.2 Credit derivatives

- ***Liquid Market Definition: [CDS Index, single name CDS, bespoke basket CDS, CDS index options, single name CDS options]***

**Q3. Which is your preferred option for the definition of a liquid market of single name CDS? Please provide an answer detailed per underlying issuer type identified (sovereign and corporate), addressing the following points:**

**(1) Would you use different qualitative criteria to define the sub-classes?**

**(2) Would you use different parameters or the same parameters (i.e. average number of trades per day and average notional amount traded per day) but different thresholds in order to define a sub-class as liquid?**

**(3) Would you define classes declared as liquid in ESMA's proposal as illiquid (or vice versa)? Please provide reasons for your answer.**

**Executive Summary**

ISDA members do not agree with ESMA's definition of a liquid market for credit derivatives and therefore we recommend that ESMA:

- Refines its assessment of the classes of credit derivatives by:
  - Recognising that maturity is the defining feature of liquidity for all CDS instruments and incorporating this in its liquidity assessment.
  - Analysing CDS instruments with a degree of granularity that ensures each sub-class is reasonably homogenous.
  - Utilising higher liquidity thresholds which accord with the MiFIR definition of a liquid market – i.e. one where there are ready and willing buyers and sellers. This is necessary even where ESMA uses granular, homogenous classes, but is particularly critical where ESMA might continue to use broad, non-homogenous classes.
  - Refining its data analysis methods, including the classification of instruments that do not have whole year tenors and ensure that the data set is accurate.
- Seeks to achieve its policy objective of ensuring transparency at the aggregate level of the credit derivatives class, and not attempt to find at least some liquid sub-classes in as many credit derivative classes as possible. Some classes are simply very illiquid or extremely heterogeneous. Appropriate and consistent use of liquidity thresholds across sub-classes when defined at comparable levels of granularity will ensure that illiquid classes are not incorrectly identified as liquid. If ESMA wishes to assess whether or not it has "captured" a sufficiently broad range of derivatives as liquid instruments, it should make this assessment at the aggregate level for credit derivatives as a class rather than at each class or sub-class.
- Recognising package transactions as a distinct class of financial transaction and ensure that they are adequately provided for in the RTS.

ISDA is also concerned that large in scale (LIS), and therefore size specific to the instrument (SSTI) thresholds, have been calibrated with data that has not been filtered to exclude non-pricing (or compression) trades. The Addendum does not specify whether the ESMA data was filtered to exclude non-pricing (or compression) trades but the data presented in the Addendum seems abnormally inflated. We strongly believe that this is

because of the inclusion of compressions in ESMA's dataset. The consequence of this inclusion of non-pricing (or compression trades) in the dataset is that the proposed LIS and SSTI thresholds are extremely large compared to normal market size.

We note that the terms "criteria", "parameters" and "thresholds" are used inconsistently in the Addendum. In our response we use the term "criteria" to refer to the qualitative criteria used by ESMA to define sub-classes (e.g. underlying, tenor, notional currency), the term "liquidity parameter" to refer to the elements of the liquid market definition which are used by ESMA to assess the liquidity of a sub-class (e.g. average frequency of transactions, average size of transactions, the number and size of market participants, and/or the average size of spreads) and the term "liquidity threshold" to refer to the quantitative level set for each relevant liquidity parameter (e.g. if one of the chosen liquidity parameters for a sub-class is "trades per day" the liquidity threshold is the number of trades per day). Where, in our response, we refer to the LIS and SSTI waivers for pre-trade transparency and the LIS and SSTI deferrals for post-trade transparency, we refer to the quantitative level at which each waiver/deferral is set as the "LIS threshold" and the "SSTI threshold".

**(i) Issues with ESMA's proposal for the definition of liquid market: all credit derivatives**

**A. ISDA's members are concerned that ESMA has classified many illiquid credit derivatives as liquid, due to:**

1. The use of liquidity thresholds that do not accord with the MiFIR definition of liquidity, being one with ready and willing buyers and sellers on a continuous basis. Specifically one trade per day and a notional of EUR 10 million, as used for CDS index, or two trades per day and a notional of EUR 100 million as used for CDS index options, cannot be considered consistent with this definition. Furthermore, given the diversity of instruments (i.e. reference entities) in the single name CDS classes as defined by ESMA, two trades per day and a notional of EUR 100 million per day also cannot be considered consistent with this definition.

2. The difficulties encountered in factoring in two of the key elements of the definition of a liquid market, specifically the number and type of market participants, and the average size of spreads. We understand why ESMA has encountered difficulty incorporating these liquidity parameters but MiFIR does require their consideration, and therefore we recommend that ESMA compensate for the potential misclassification of illiquid sub-classes as liquid through higher liquidity thresholds for those liquidity parameters actually used (i.e. average frequency and average size of transactions), than would otherwise have been possible had all liquidity parameters been considered.

3. The classification of single name CDS at a highly insufficient level of granularity resulting in many single name CDS being labelled as liquid when in practice, as our analysis demonstrates, CDS referencing over 99% of reference entities are illiquid based on liquidity thresholds of 15 trades per day and EUR 10 million notional per day. The classification of single name CDS instruments must encompass reference entity type, region, currency and tenor to be meaningful. A similar issue arises for CDS index options which need a taxonomy, which, at the very least, includes the tenor of the option.

   ISDA's members have noted that ESMA had previously correctly identified (in paragraph 33 of page 123 of the May 2014 Discussion Paper) that "a necessary prerequisite for applying [the COFIA] approach is the proper grouping/segmentation of financial instruments into homogenous and relevant classes" in order to identify "class[es] of instruments with homogenous liquidity". ISDA's members consider that ESMA's proposals in the Addendum for single name CDS and CDS index options appear largely inconsistent with this necessary prerequisite.

4. The fact that the "number of days traded greater to or equal to 80% of the available trading days in the period" used in stage 1 of ESMA's analysis of OTC credit derivatives (described on page 232 of the Addendum) was not carried through to stage 2 of the analysis.

**B. ESMA's analysis has presented a number of data issues:**

1. ESMA has ignored roughly 72% of records for single name CDS in their stage 2 analysis of single name CDS as the calculation of tenor was not possibly due to quality issues in the data (see paragraph 18 on page 243 of the Addendum).

2. The three-month sample period does not take into account the episodic nature of single name CDS. The marked variation in the trading of reference entities likely reflects the changing credit outlook of various countries, sectors or firms. This has a "clustering" effect on the majority of CDS transactions, making them liquid when the reference entity is in play and illiquid otherwise.

3. The use of data to assess liquidity is from the period very shortly after the EMIR trade reporting requirement came into effect. The challenges that this reporting requirement presented to the industry have been widely publicised, and we are concerned that this dataset may, for example, contain duplicate trades or other erroneous data. ESMA may not wish to place full reliance on this dataset, or could compensate through the use of higher liquidity thresholds for the average frequency and average size of transactions liquidity parameters than might otherwise have been appropriate. Alternatively, ESMA could repeat its analysis on more recent trade repository data, which might be more accurate. Additionally, use of a dataset covering a longer period of time may produce more representative results, potentially less distorted by seasonal or short-term factors.

4. **Credit derivatives without whole-year tenors:** ISDA is concerned with ESMA's approach to the classification of credit derivatives which do not have whole year tenors. ESMA makes specific comments on the approaches it used for CDS index (paragraph 9.ii on page 235 of the Addendum), single name CDS (paragraph 17.b on page 243 of the Addendum) and CDS index options (paragraph 24.b on page 249 of the Addendum).

   Market convention is to use the term "5 year" to refer to trades with a tenor of between 4.75 years and 5.25 years in the on-the-run index. For simplicity (in order to avoid having to consider half-year classes), we recommend that ESMA consider 5 year trades to be those with a tenor of between 4.25 years and 5.25 years (or 51 months and 63 months).

   The consequence of ESMA's approach is that ESMA categorises, for example, too many trades that are in reality 5 year trades in the 6 year class, and too few in the 5 year bucket, resulting in an incorrect determination of liquidity for the relevant buckets. This also results in incorrect calibration of the LIS and SSTI thresholds. Page 241 of the Addendum lists the contract with the greatest number of trades per day to be the iTraxx Europe 6 year, whereas we consider that most of the trades categorised as 6 year trades were in fact 5 year trades according to market convention.

   ISDA recommends that ESMA revises its approach to ensure that trades are bucketed under the correct tenor and suggests that the following mark-up of paragraph 9.ii on page 235 of the Addendum, would correct ESMA's approach for CDS index.

   "the tenor: calculated as the difference between the maturity date and the execution date. In particular, the tenor is denominated as "x years" where x is the number obtained by rounding up the ratio of days obtained as the difference between maturity and execution date, subtracting 92 days and dividing by 365.25 ~~and 365~~ [Maturity Date – Execution Date – 92]/365.25 (e.g. 2.3) to the next whole number (3 years in this case). As a result, for the purpose of calculating the figures included in the table below [Table 36: CDS Index – liquidity assessment] a sub-class assigned with a tenor of "x years" includes all contracts with a maturity of more than "x-1 years + 3 months" and less or equal to "x years + 3 months" (e.g. 2 years + 3 months < 3 year tenor ≤ 3 years + 3 months)."

   The following table, illustrates what this correction looks like in practice.

| Table 1: Market Recommended Tenor | | | |
|---|---|---|---|
| Trade Date | Maturity Date | Year Fraction | Market Years |
| 1/1/2015 | 3/31/2016 | 0.99384 | 1 |

| | | | |
|---|---|---|---|
| 1/1/2015 | 4/1/2016 | 0.99658 | 1 |
| 1/1/2015 | 4/2/2016 | 0.99932 | 2 |
| 1/1/2015 | 4/3/2016 | 1.00205 | 2 |
| 1/1/2015 | 4/4/2016 | 1.00479 | 2 |

In our response, we will refer to this correction as the Market Recommended Tenor (as opposed to ESMA's tenor). The same corrections need to be applied to paragraph 17.b on page 243 and paragraph 24.b on page 249 of the Addendum. ESMA will also need to change the tenors used in Table 60 of draft RTS 9 (on page 346 of the Addendum). For example, instead of referring to tenors "from 5 years to 6 years", the appropriate description would be "from 51 to 63 months". In our response to Question 4, we provide further detail on how these corrections should be applied to CDS index.

Making these changes will result in a more appropriate set of sub-classes being found to be liquid. This might mean that fewer classes are found to be liquid (for example, we would expect there to be fewer instances of 5 to 6 year tenors being found liquid), but because it will result in trades being categorised in the appropriate classes according to market convention, we do not expect it to significantly affect the capture ratios of the percentages of trades and transactions found to be liquid.

5. **ESMA's definitions of on-the-run CDS index versus off-the-run CDS index**: ISDA disagrees with ESMA's definition of "on-the-run status" set out on page 345 of the Addendum as it does not accord with market convention and conflates the tenor of the contract with its contractual terms. We recommend that ESMA align with market convention, which we expect to have the consequence of some immediate off-the-run contracts in the most liquid indices being found to be liquid, which would enhance transparency for trading in these "1x off-the-run" contracts. We have marked-up the definition as follows and urge ESMA to adopt this definition in its liquidity assessment as well.

   'On-the-run status ' means the ~~period beginning 5 days before the date on which the~~ rolling most recent version (series) of the index created on the date on which the composition of the index is effective and ending ~~30 days after~~ one day prior to the date on which the composition of the next version (series) of the index is effective.

   In our response, we refer to this corrected concept of on-the-run status as the Market Recommended On-the-run Definition (as opposed to ESMA's on-the-run definition).

   We also consider that, as a consequence of making this change and of considering off-the-run index data for analysis, ESMA may identify a small number of immediately off-the-run indices to be liquid depending on the liquidity thresholds chosen. If so, we therefore recommend that ESMA include in the RTS a definition of the '1x off-the-run status'. We would suggest the following wording:

   '1x off-the-run status' means the version (series) of the index which is immediately prior to the current 'on-the-run' version (series) at a certain point in time. A version (series) ceases being 'on-the-run' and acquires its '1x off-the-run' status when the latest version (series) of the index is created.

All of these concerns are heightened by the fact that ESMA does not propose to recalibrate the liquidity assessment at all. In the May 2014 Discussion Paper, ESMA stated (paragraph 44, page 125) that "the liquidity of the sub-categories needs to be reassessed periodically". Instead, it is now clear that ESMA proposes no such reassessment. This decision also implies that ESMA has chosen not to utilise the market data that MiFIR will make available to facilitate recalibration, which is an incomprehensible waste of the opportunity to refine the liquidity classification over time (particularly given the concerns over the EMIR trade repository data noted above). This static determination is a serious weakness of ESMA's approach

which suggests that an incorrect initial assessment of liquidity will have permanent implications. We encourage ESMA to reconsider whether the COFIA can be recalibrated more regularly, as improved market data becomes available and to better reflect changing liquidity conditions. In the absence of regular and accurate recalibration, we urge ESMA to compensate through both a more conservative initial assessment of liquidity, and by calibrating the LIS and SSTI thresholds at lower levels than might otherwise have been possible with a more dynamic approach to liquidity (see ISDA's response to Question 5 below).

Upon examining ISDA's analysis, we encourage ESMA to re-run its liquidity assessments for credit derivatives and we are keen to assist ESMA in this work.

**(ii) ISDA's data analysis: all credit derivatives**

ISDA has access to public CFTC data obtained from the Depository Trust & Clearing Corporation (DTCC) US Swap Data Repository[1] which it has used to backtest ESMA's liquidity assessment of single name CDS, CDS index and CDS index options.

For single name CDS, ISDA used the DTCC Trade Information Warehouse database and the DTCC Market Risk Transaction Activity (Section IV) analysis of single names.[2] The sample period used for CDS index and CDS index options was 1 March to 31 May 2014, which aligns to the period used by ESMA. However, for single name CDS a longer dataset was used – 1 February 2013 to 1 February 2014 – to account for the episodic nature of single name CDS.

The transactions covered in this analysis only include transactions where market participants were engaging in market risk transfer activity i.e. transactions that change the risk position between two parties such as new trades, termination of an existing transaction or the assignment of an existing transaction to a third party.

Where possible non-price forming transactions, such as compression trades, delta neutral trades and intragroup trades, were filtered out of the dataset. There are 792,288 contracts included in the DTCC single name dataset, over six times as many as in ESMA's dataset (largely because the DTCC data covers a full year).

To protect the anonymity of trading in single name CDS transactions with lower volumes, DTCC only provided ISDA with weekly notional and trade count data for those reference entities which trade in excess of 50 or more contracts during the analysis period ("**Group A**") i.e. at least 0.2 trades per day. The majority of contracts (693,952, 87.6%) fell in this set which has allowed us to analyse these in greater depth at the reference entity level. The remaining contracts (98,336, 12.4%) were provided by DTCC in an aggregated format across currency, term and coupon descriptors.

The majority of total single name CDS trading was denominated in US dollar (61.8%) and euro currencies (35.6%). Contract terms were concentrated in 4Y – 6Y buckets, with the majority of activity (52.3%) occurring in 5Y – 6Y term bucket. More than half of the single name CDS had 100 basis points coupons (65.4%). We also note that unlike the data used for CDS index and CDS index options, the data used for single name CDS is less likely to be US centric.

We acknowledge that the DTCC data may not exactly match ESMA's dataset, but we hope our analysis demonstrates how ESMA can apply our recommendations and methods to ESMA's own dataset. Moreover, we note that the single name CDS data is global in coverage. We also highlight that we were unable to use the European trade repository data used by ESMA as this is not publicly available and the trade repository

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1 CFTC data from DTCC includes the following price-forming transactions: new trades, terminations and novations.

2 For more information see – http://www.dtcc.com/~/media/Files/Downloads/Settlement-Asset-Services/DerivSERV/Market_Activity_Single_Name_17-Jun-2011.pdf

data is not generally transparent at the level of detail (i.e. trade level) needed to perform the analysis. ISDA would be pleased to share the data we used and our analysis of it, upon request.[3]

We understand that ESMA would find it helpful for respondents to provide further detail on how the market understands credit derivatives products. We have set out below, therefore, a summary of how ISDA's members view these products:

- **Single Names.** The "5 year on the run" single name CDS contract is a 5 year 3 month contract launched on each quarterly roll date – 20 March, June, September and December. The contract itself does not automatically "roll" but in order to "roll" market participants close out one contract by way of an unwind or assignment and enter into a new trade on or around the relevant quarterly roll date. Other maturities operate the same way.
- **Indices.** The "5 year on the run" CDS index contract is a 5 year 3 month contract launched on each index roll date – 20 March and 20 September each year. The relevant index is determined by reference to index rules governed by the index provider. The contract itself does not automatically "roll" but in order to "roll" market participants close out an existing contract by way of an unwind or assignment and enter into a new trade on or around the relevant index roll date on the new index. Other maturities of the indices operate the same way.
- **Index options.** Physically settled "European" options are traded on the major CDS indices. The 20th of each calendar month is the market standard exercise date. The option exercises into an existing CDS index rather than an index to be created. As the CDS index rolls every 6 months the options are generally limited to a maximum of 6 months in order to capture exercise into the "on the run".

**(iii) Single name CDS: Issues with ESMA's conclusions and ISDA proposal**

ISDA's members disagree with both proposals put forward by ESMA for the definition of a liquid market for single name CDS. However, in terms of our preference between Option A and Option B (as described on page 251 of the Addendum), Option B is more acceptable. Option A would result in widely inappropriate outcomes and, as such, cannot be supported by ISDA's members. However, Option B also has its faults and we seek to explain these further in our response below and suggest an alternative proposal to ESMA which ISDA's members believe produces a better definition of a liquid market for single name CDS.

If ESMA disagrees with our proposals, it is vital that ESMA nevertheless recognises that both Option A and Option B will result in many single name CDS being incorrectly labelled as liquid. ESMA must therefore compensate for this mis-categorisation through much lower LIS and SSTI thresholds. Please see our response to Question 5 below for further detail of our proposals for appropriate LIS and SSTI thresholds.

**A. Lack of granularity has resulted in very high false positives**

ISDA members consider that ESMA's classification of single name CDS into broad classes of sovereign and corporate issuers, currencies and tenors is inadequately granular to result in homogenous sub-classes. There are vast differences in liquidity in single name CDS depending on the reference entity; most reference entities (both sovereign and corporates) trade extremely infrequently, although a small number of sovereign entities trade with reasonable frequency. It is only this latter subset of sovereign reference entities that can reasonably be considered liquid.

The high rates of incorrect liquidity determinations resulting under Options A and B of ESMA's proposals demonstrate that ESMA's approach of classifying single name CDS into broad sub-classes is not appropriate. Furthermore, since there is no liquid sovereign index but the few single name CDS that are found to be liquid when assessed on a more granular basis are sovereign CDS, Option B (as currently constructed) is also unsuitable. Therefore ISDA members consider that neither Option A nor Option B as suggested by ESMA are

[3] Similarly, we would also welcome the opportunity to share the data we used to examine interest rate derivatives and our the detailed analysis underpinning our response to ESMA's December 2014 Consultation Paper.

appropriate for the definition of a liquid market for single name CDS. Instead, we set out several alternatives below which we hope ESMA will consider. The consequences of incorrectly classifying illiquid instruments as liquid will be to deter liquidity provision to end users in the single name CDS market and to increase transaction costs in single name CDS. Ultimately, this is a cost that will be borne by the real economy, as it will make it more expensive to hedge credit risk thus raising borrowing costs for sovereign and corporate issuers.

Our backtesting of ESMA's approach demonstrates that at least 99.7% of the reference entities for which ISDA received data from DTCC that ESMA labels as liquid are in fact illiquid when using liquidity thresholds of 15 trades and EUR 10 million notional per day. The percentage of all reference entities that ESMA incorrectly labels as liquid, including both these entities as well as those for which DTCC only provided ISDA with aggregate data due to their low trading frequency is even higher, since none of the latter group entities traded more than 0.2 times per day by construction.

The backtesting approach we have taken is very similar to the backtesting analysis that ESMA presented on page 104 of the December 2014 Consultation Paper, the only differences being that instead of considering "bonds" at the instrument level, we have defined granular, homogenous classes of single name CDS and evaluated each of those at the instrument level in order to identify those sub-classes which ESMA has labelled liquid but are in fact not liquid (using relatively low liquidity thresholds). To derive appropriately homogenous single name CDS sub-classes, we utilised the following taxonomy:

- The issuer class (i.e. reference entity type);
- Currency; and
- Tenor.

We consider this backtest comparable to the backtest presented by ESMA on page 104 of the December 2014 Consultation Paper because we have classified single name CDS according to reference entity, maturity and currency, in the same matter that ESMA, by considering bonds at the level of the ISIN, implicitly identified bonds (in the backtest) as distinct according to issuing entity, maturity and currency.

Utilizing the Group A data, the below shows, for each sub-class as defined by ESMA and any other comparable sub-classes that we observed in the CFTC dataset, the number of sub-classes found to be liquid or not liquid utilising liquidity thresholds of 15 trades per day and EUR 10 million notional per day. Of the 2,575 Group A sub-classes in which we observed trade activity, all but 8 sub-classes (99.7%) are in fact illiquid. The only sub-classes which are found to be liquid are eight 5 to 6 year sovereign CDS in USD.

**Table 2: Mapping of CFTC/DTCC data to ESMA liquidity determinations**

**for an estimate of where**

**ISDA's estimates did not concur with ESMA's (i.e. false positives) and were they did (i.e. confirmed positives).**

| | ESMA Class | ESMA determination of liquidity for the broadly defined class | 1. Total Number of sub-classes with trade activity during review period mapping to this ESMA class | 2. Percentage of sub-classes correctly classified by ESMA's determination | 3. Number of sub-classes meeting ISDA's recommended liquidity thresholds | 4. Percentage of sub-classes meeting ISDA's recommended liquidity thresholds | 5. Number of sub-classes not meeting ISDA's recommended liquidity thresholds | 6. Percentage of sub-classes not meeting ISDA's recommended liquidity thresholds |
|---|---|---|---|---|---|---|---|---|
| **A** | **Grand Total** | **Liquid** | **2575** | **0.3%** | **8** | **0.3%** | **2567** | **99.7%** |
| **B** | **Grand Total** | **Illiquid** | **62** | **100.0%** | **0** | **0.0%** | **62** | **100.0%** |
| C | Corporate_1 years_USD | Liquid | 48 | 0.0% | 0 | 0.0% | 48 | 100.0% |
| D | Corporate_2 years_USD | Liquid | 122 | 0.0% | 0 | 0.0% | 122 | 100.0% |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| E | Corporate_3 years_USD | Liquid | 204 | 0.0% | 0 | 0.0% | 204 | 100.0% |
| F | Corporate_4 years_USD | Liquid | 265 | 0.0% | 0 | 0.0% | 265 | 100.0% |
| G | Corporate_5 years_USD | Liquid | 302 | 0.0% | 0 | 0.0% | 302 | 100.0% |
| H | Corporate_6 years_USD | Liquid | 360 | 0.0% | 0 | 0.0% | 360 | 100.0% |
| I | Corporate_7 years_USD | Liquid | 2 | 0.0% | 0 | 0.0% | 2 | 100.0% |
| J | Corporate_8 years_USD | Liquid | 4 | 0.0% | 0 | 0.0% | 4 | 100.0% |
| K | Corporate_9 years_USD | Illiquid | 0 | - | 0 | - | 0 | - |
| J | Corporate_10 years_USD | Illiquid | 0 | - | 0 | - | 0 | - |
| M | Corporate_11 years_USD | Liquid | 3 | 0.0% | 0 | 0.0% | 3 | 100.0% |
| N | Corporate_1 years_EUR | Illiquid | 60 | 100.0% | 0 | 0.0% | 60 | 100.0% |
| O | Corporate_2 years_EUR | Liquid | 111 | 0.0% | 0 | 0.0% | 111 | 100.0% |
| P | Corporate_3 years_EUR | Liquid | 152 | 0.0% | 0 | 0.0% | 152 | 100.0% |
| Q | Corporate_4 years_EUR | Liquid | 184 | 0.0% | 0 | 0.0% | 184 | 100.0% |
| R | Corporate_5 years_EUR | Liquid | 214 | 0.0% | 0 | 0.0% | 214 | 100.0% |
| S | Corporate_6 years_EUR | Liquid | 240 | 0.0% | 0 | 0.0% | 240 | 100.0% |
| T | Corporate_7 years_EUR | Liquid | 7 | 0.0% | 0 | 0.0% | 7 | 100.0% |
| U | Corporate_8 years_EUR | Liquid | 9 | 0.0% | 0 | 0.0% | 9 | 100.0% |
| V | Corporate_9 years_EUR | Illiquid | 0 | - | 0 | - | 0 | - |
| W | Corporate_10 years_EUR | Illiquid | 0 | - | 0 | - | 0 | - |
| X | Corporate_11 years_EUR | Liquid | 1 | 0.0% | 0 | 0.0% | 1 | 100.0% |
| Y | Corporate_1 years_JPY | Illiquid | 2 | 100.0% | 0 | 0.0% | 2 | 100.0% |
| Z | Corporate_2 years_JPY | Liquid | 1 | 0.0% | 0 | 0.0% | 1 | 100.0% |
| AA | Corporate_3 years_JPY | Liquid | 8 | 0.0% | 0 | 0.0% | 8 | 100.0% |
| AB | Corporate_4 years_JPY | Liquid | 27 | 0.0% | 0 | 0.0% | 27 | 100.0% |
| AC | Corporate_5 years_JPY | Liquid | 31 | 0.0% | 0 | 0.0% | 31 | 100.0% |
| AD | Corporate_6 years_JPY | Liquid | 41 | 0.0% | 0 | 0.0% | 41 | 100.0% |
| AE | Corporate_7 years_JPY | Illiquid | 0 | - | 0 | - | 0 | - |
| AF | Corporate_8 years_JPY | Liquid | 1 | 0.0% | 0 | 0.0% | 1 | 100.0% |
| AG | Corporate_9 years_JPY | Illiquid | 0 | - | 0 | - | 0 | - |
| AH | Corporate_10 years_JPY | Illiquid | 0 | - | 0 | - | 0 | - |
| AI | Corporate_11 years_JPY | Illiquid | 0 | - | 0 | - | 0 | - |
| AJ | Sovereign_1 years_USD | Liquid | 17 | 0.0% | 0 | 0.0% | 17 | 100.0% |
| AK | Sovereign_2 years_USD | Liquid | 28 | 0.0% | 0 | 0.0% | 28 | 100.0% |
| AJ | Sovereign_3 years_USD | Liquid | 30 | 0.0% | 0 | 0.0% | 30 | 100.0% |
| AM | Sovereign_4 years_USD | Liquid | 29 | 0.0% | 0 | 0.0% | 29 | 100.0% |
| AN | Sovereign_5 years_USD | Liquid | 37 | 0.0% | 0 | 0.0% | 37 | 100.0% |
| AO | Sovereign_6 years_USD | Liquid | 46 | 17.4% | 8 | 17.4% | 38 | 82.6% |
| AP | Sovereign_7 years_USD | Liquid | 9 | 0.0% | 0 | 0.0% | 9 | 100.0% |
| AQ | Sovereign_8 years_USD | Liquid | 8 | 0.0% | 0 | 0.0% | 8 | 100.0% |
| AR | Sovereign_9 years_USD | Liquid | 4 | 0.0% | 0 | 0.0% | 4 | 100.0% |
| AS | Sovereign_10 years_USD | Liquid | 5 | 0.0% | 0 | 0.0% | 5 | 100.0% |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| AT | Sovereign_11 years_USD | Liquid | 9 | 0.0% | 0 | 0.0% | 9 | 100.0% |
| AU | Sovereign_1 years_EUR | Liquid | 1 | 0.0% | 0 | 0.0% | 1 | 100.0% |
| AV | Sovereign_2 years_EUR | Liquid | 5 | 0.0% | 0 | 0.0% | 5 | 100.0% |
| AW | Sovereign_3 years_EUR | Liquid | 2 | 0.0% | 0 | 0.0% | 2 | 100.0% |
| AX | Sovereign_4 years_EUR | Liquid | 4 | 0.0% | 0 | 0.0% | 4 | 100.0% |
| AY | Sovereign_5 years_EUR | Liquid | 2 | 0.0% | 0 | 0.0% | 2 | 100.0% |
| AZ | Sovereign_6 years_EUR | Liquid | 1 | 0.0% | 0 | 0.0% | 1 | 100.0% |
| BA | Sovereign_7 years_EUR | Illiquid | 0 | - | 0 | - | 0 | - |
| BB | Sovereign_8 years_EUR | Illiquid | 0 | - | 0 | - | 0 | - |
| BC | Sovereign_9 years_EUR | Illiquid | 0 | - | 0 | - | 0 | - |
| BD | Sovereign_10 years_EUR | Illiquid | 0 | - | 0 | - | 0 | - |
| BE | Sovereign_11 years_EUR | Liquid | 1 | 0.0% | 0 | 0.0% | 1 | 100.0% |

The following table lists the 8 sub-classes of single name CDS we found to be liquid:

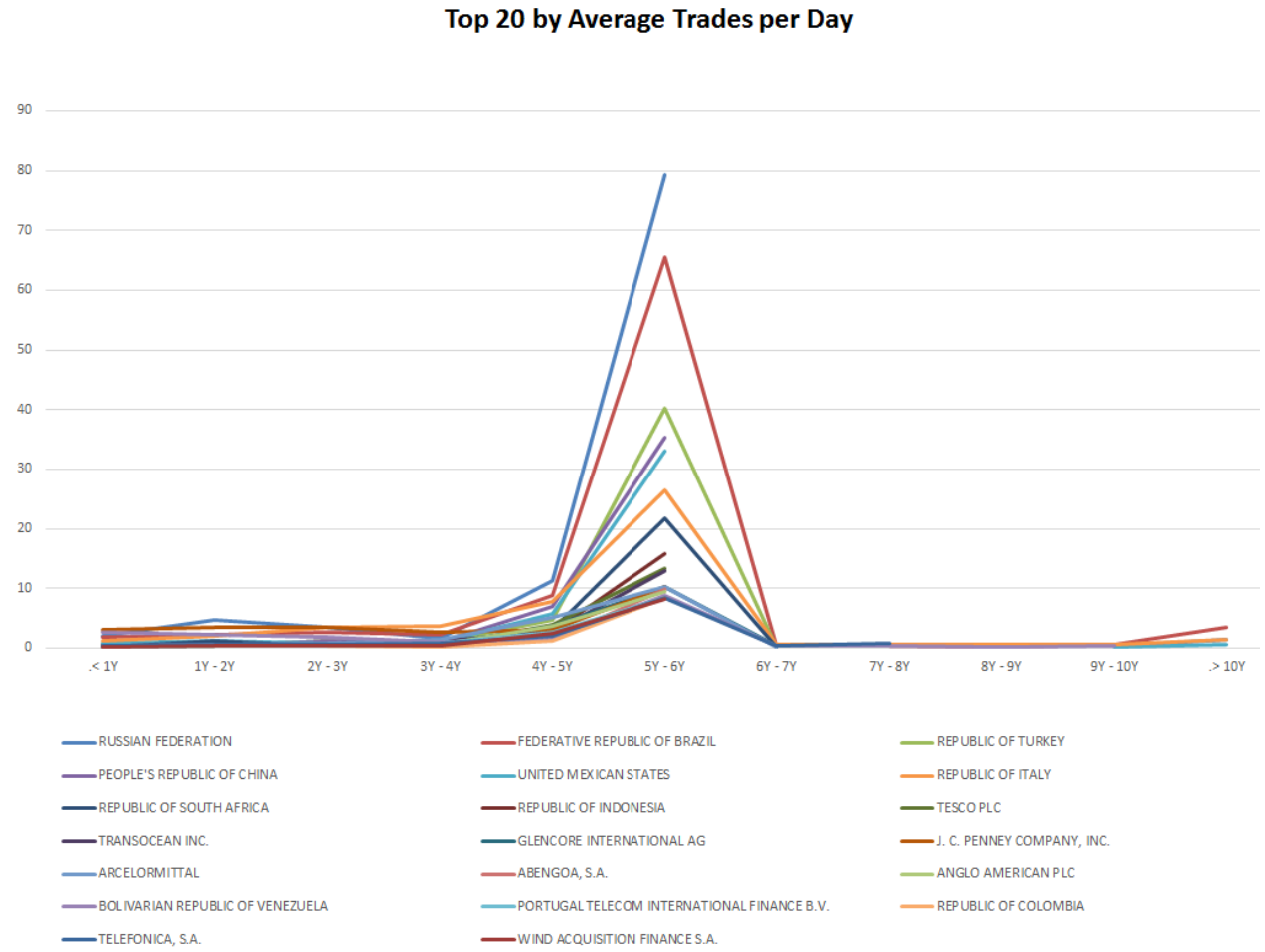
**Table 3: Single names assessed as liquid using CFTC/DTCC data and ISDA recommended liquidity parameters of 15 trades per day and 10,000,00 EUR**

| Reference Entity | Region | Currency | Term | Gross Notional (USD) | Gross Notional (EUR) @1.3117 | Contracts | Days Traded | Average Trades per Day | Average Trade Size (EUR) |
|---|---|---|---|---|---|---|---|---|---|
| FEDERATIVE REPUBLIC OF BRAZIL | SOVEREIGN | USD | 5Y - 6Y | 160,308,666,067 | 122,214,428,655 | 16,364 | 302 | 66 | 7,468,493.56 |
| RUSSIAN FEDERATION | SOVEREIGN | USD | 5Y - 6Y | 148,101,265,465 | 112,907,879,443 | 19,828 | 304 | 79 | 5,694,365.52 |
| REPUBLIC OF TURKEY | SOVEREIGN | USD | 5Y - 6Y | 103,998,889,200 | 79,285,575,360 | 10,040 | 300 | 40 | 7,896,969.66 |
| UNITED MEXICAN STATES | SOVEREIGN | USD | 5Y - 6Y | 80,374,510,500 | 61,275,070,900 | 8,263 | 286 | 33 | 7,415,596.14 |
| REPUBLIC OF ITALY | SOVEREIGN | USD | 5Y - 6Y | 73,749,603,700 | 56,224,444,385 | 6,513 | 283 | 26 | 8,632,649.22 |
| PEOPLE'S REPUBLIC OF CHINA | SOVEREIGN | USD | 5Y - 6Y | 69,799,875,166 | 53,213,292,038 | 8,831 | 287 | 35 | 6,025,737.97 |
| REPUBLIC OF SOUTH AFRICA | SOVEREIGN | USD | 5Y - 6Y | 41,660,146,500 | 31,760,422,734 | 5,426 | 279 | 22 | 5,853,376.84 |
| REPUBLIC OF INDONESIA | SOVEREIGN | USD | 5Y - 6Y | 24,053,284,587 | 18,337,489,203 | 3,966 | 266 | 16 | 4,623,673.53 |

### B. Liquidity in single name CDS in the 5 year tenor

The results highlight that liquidity in single name CDS is concentrated in the 5 year tenor.

**Chart 4** describes average trades per day sorted by tenor across the top 20 liquid single name CDS.




The table below includes data which underscores Chart 4. Interestingly, we can observe some additional liquidity in the 4Y – 5Y term but very little anywhere else. Using the ISDA criteria of at least 15 trades per day, only 8 reference entities would be considered liquid. Under the ESMA criteria of 2 trades per day, all 20 would be considered liquid by this criterion alone.

**Table 5: Top 20 single names by average trades per day distributed over tenor**

| Row Labels | .< 1Y | 1Y - 2Y | 2Y - 3Y | 3Y - 4Y | 4Y - 5Y | 5Y - 6Y | 6Y - 7Y | 7Y - 8Y | 8Y - 9Y | 9Y - 10Y | .> 10Y |
|---|---|---|---|---|---|---|---|---|---|---|---|
| RUSSIAN FEDERATION | 2.1 | 4.7 | 3.5 | 1.7 | 11.2 | 79.3 | | | | 0.3 | 1.4 |
| FEDERATIVE REPUBLIC OF BRAZIL | 1.9 | 2.3 | 2.7 | 2.3 | 8.8 | 65.5 | 0.4 | 0.3 | 0.2 | 0.7 | 3.5 |
| REPUBLIC OF TURKEY | 0.6 | 0.5 | 1.2 | 1.1 | 4.8 | 40.2 | 0.2 | | | | 0.3 |
| PEOPLE'S REPUBLIC OF CHINA | 0.5 | 0.5 | 1.2 | 1.1 | 7 | 35.3 | | | | | |
| UNITED MEXICAN STATES | 0.8 | 1.3 | 0.9 | 1.1 | 5.7 | 33.1 | | | | 0.2 | 0.6 |
| REPUBLIC OF ITALY | 1.2 | 2.1 | 3.5 | 3.7 | 7.8 | 26.5 | 0.7 | 0.7 | 0.6 | 0.6 | 1.5 |
| REPUBLIC OF SOUTH AFRICA | 0.2 | 1.2 | 0.5 | 0.6 | 3.1 | 21.7 | 0.2 | | | | 0.3 |

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| REPUBLIC OF INDONESIA | | 0.6 | 0.3 | 0.5 | 2.6 | 15.9 | | | | | 0.3 |
| TESCO PLC | 0.3 | 0.3 | 0.4 | 0.5 | 3.9 | 13.4 | | | | | |
| TRANSOCEAN INC. | 0.3 | 0.5 | 0.9 | 1.3 | 2.6 | 12.9 | | 0.2 | | | |
| GLENCORE INTERNATIONAL AG | 0.5 | 0.4 | 0.4 | 0.7 | 3.6 | 10.3 | 0.3 | 0.3 | | | |
| J. C. PENNEY COMPANY, INC. | 3 | 3.5 | 3.5 | 2.7 | 3.1 | 10.3 | | | | | |
| ARCELORMITTAL | 0.5 | 0.6 | 0.8 | 1.5 | 5.2 | 10.2 | 0.2 | | | | |
| ABENGOA, S.A. | 0.3 | 0.4 | 0.4 | 0.3 | 1.5 | 9.8 | | | | | |
| ANGLO AMERICAN PLC | 0.2 | 0.3 | 0.4 | 0.7 | 3.7 | 9.5 | | | | | |
| BOLIVARIAN REPUBLIC OF VENEZUELA | 2.7 | 2.3 | 1.9 | 1.1 | 1.6 | 8.9 | 0.3 | 0.3 | 0.2 | 0.3 | |
| PORTUGAL TELECOM INTERNATIONAL FINANCE B.V. | 0.2 | 0.4 | 0.4 | 0.8 | 2.7 | 8.5 | | | | | |
| REPUBLIC OF COLOMBIA | | 0.4 | 0.4 | 0.2 | 1.2 | 8.5 | | | | | |
| TELEFONICA, S.A. | 0.3 | 0.6 | 0.7 | 0.8 | 2.1 | 8.5 | 0.4 | 0.8 | | | |
| WIND ACQUISITION FINANCE S.A. | 0.2 | 0.4 | 0.5 | 0.5 | 2.5 | 8.2 | | | | | |

**C. ISDA's proposals for single name CDS**

As indicated above, ISDA's members disagree with both proposals put forward by ESMA for the definition of a liquid market for single name CDS. We set out below our proposals for a more appropriate approach to the definition of a liquid market for single name CDS.

If ESMA disagrees with our proposals, it is vital that ESMA nevertheless recognises that both Option A and Option B will result in many single name CDS being incorrectly labelled as liquid. ESMA must therefore compensate for this mis-categorisation through much lower LIS and SSTI thresholds. Please see our response to Question 5 below for further detail of our proposals for appropriate LIS and SSTI thresholds.

We recommend that ESMA consider the following options in the following order of appropriateness:

1. **Option 1:** Determining that all single name CDS are illiquid. This would be a similar conclusion to that made by ESMA for Non-financial Convertible Bonds and SFPs on page 102 of the December 2014 Consultation Paper, where (as ESMA describes on page 109 of the December 2014 Consultation Paper) the high proportions (>97%) of instruments underlying those classes found to be illiquid has resulted in ESMA determining those bond classes to be illiquid in their entirety.

2. **Option 2(A):** If ESMA rejects Option 1, adopting a granular COFIA approach (i.e. a name by name assessment) which is recalibrated periodically (perhaps annually) to identify those reference entities and tenors in which, based on the previous period's data, trading activity has exceeded thresholds which can be defined in the RTS.

   We propose using thresholds of 15 trades and EUR 10 million notional per day for this purpose. However, we would emphasise that the adoption of a granular COFIA approach is the key element of Option 2(A) rather than the level of the liquidity thresholds, although we believe that our recommended liquidity thresholds are appropriate to the single name CDS class.

   We expect ESMA to be well placed to undertake the periodic recalibration required by Option 2(A), utilising the trade reporting data that MiFIR will make available. ESMA would be able to make the list

of reference entities and tenors found to be liquid public on its website and give firms a reasonable period to update systems and controls with the revised list.

If adopted, we think that this approach would result in coverage of around 11% of single name CDS trades and 19% of single name CDS volumes, although we have made these assessments based on point-in-time estimates rather than attempting to produce any dynamic recalibration over time:

**Table 6: Comparative assessment of the liquidity of single name CDS**
**ESMA's proposed approach versus ISDA's recommended approach**

| | Criteria | Calculation basis | 1. Total number of sub-classes with at least one trade | 2. Liquid sub-classes | 3. Trades per day | 4. Notional per day EUR MM | 5. % of trades captured | 6. % of notional captured |
|---|---|---|---|---|---|---|---|---|
| A | – Issuer designation (sovereign or corporate)<br>– Currency<br>– Tenor | ESMA data with ESMA tenor | 42 | 18 | 2 | 100 | 97% | 98% |
| B | – Issuer class (i.e. reference entity)<br>– Currency<br>– Tenor | CFTC/DTCC data with Market Recommended Tenor | 1362 | 7 | 2 | 100 | 11% | 19% |
| C | – Issuer class (i.e. reference entity)<br>– Currency<br>– Tenor | CFTC/DTCC data with Market Recommended Tenor | 1362 | 8 | 15 | 10 | 11% | 19% |

3. **Option 2(B)**: If ESMA rejects Option 2(A), Option 2(A), as described above, without the periodic recalibration. Under this option, a more granular COFIA approach would be used to define sub-classes and each sub-class would be assessed against liquidity thresholds of 15 trades and EUR 10 million notional per day.

   Option 2(B) involves a one-time only (i.e. static) liquidity assessment, which would result in certain single name CDS being classified as liquid until such time as the RTS itself is modified. This is not sensible for a number of reasons, including:

   a) Over time, and due to changes in the circumstances of the company (news, debt outstanding, M&A activity etc), the amount of trading on a name may significantly reduce.
   b) If liquidity reduces the name will drop out of future indices which, in and of itself, will further reduce the liquidity on that name.

4. **Option 3:** If ESMA rejects Option 2(B)**,** adopt a modified version of Option B (as described on page 251 of the Addendum) which compensates for the high rates of sub-classes incorrectly classified as liquid through much lower LIS and SSTI thresholds to ensure that trading in these illiquid instruments above the LIS/SSTI thresholds benefits from the appropriate waivers/deferrals. Please see our response to Question 5 for our proposals for setting appropriate LIS and SSTI thresholds. The disadvantage of this approach is that the compensation through lower SSTI would not be available to trading on any venues not granted waivers by their NCAs or where NCAs don't permit the full range of deferrals for trades exceeding the SSTI or LIS thresholds.

We recommend however that ESMA's proposed 'Option B' also be amended by referring to a subset of the indices deemed to be liquid. Although we understand the basis of 'Option B' and can see the merits in its simplicity, it is imperative that the calibration of liquidity under MiFIR recognises that material differences in liquidity exist across the spectrum of CDS single name trading. For example, Western European Sovereigns are not constituents of a liquid index. Moreover, there are significant differences between the indices in terms of their composition. The iTraxx Europe Crossover index for example can include names which have never previously traded in the CDS market: treating these new contracts as liquid and therefore in-scope for pre-trade transparency would lead to significant impairment to the liquidity of both those names and the index. ISDA therefore recommends a different approach for Corporates compared to Sovereigns. For Corporates, we urge ESMA to distinguish between the established investment grade Corporate indices denominated in USD and EUR and other indices, comprised of more illiquid and high yield/distressed names. We therefore recommend that ESMA's 'Option B' should refer not to all indices deemed to be liquid but to the on-the-run version of two indices: the iTraxx Europe Main index and the CDX.NA.IG index. By modifying 'Option B' so that it captures the constituents of such investment grade Corporate indices, ESMA would capture the vast majority of single name CDS trading volume (excluding Sovereigns) and limit the number of instances where the transparency regime impairs rather than aids liquidity.

For Sovereigns, we would recommend that ESMA adopt a granular approach as laid out in Option 2(A) above. The number of Sovereign entities is a fraction of Corporates and yet the trading standards adopted exhibit significant regional variation, the end user base differs dramatically and there are significant differences with respect to regulation around their use. The only viable approach is therefore as assessment on a name by name basis.

If ESMA rejects Option 1, ISDA further recommends that ESMA delineate between COFIA classes according to the traded credit spread, such that where the spread exceeds a threshold defined in the RTS (we recommend a spread of 450bps), the CDS is classified into a distinct illiquid class of CDS. For the avoidance of doubt, any reference entity whose quoting convention is in "points upfront", as is the case on distressed instruments, would also be classified into this illiquid class. Since the size of bid-ask spreads tends to be wider for reference entities trading with a wider credit spread, the purpose of distinguishing this illiquid class is to ensure that these reference entities are correctly identified as illiquid. This would permit ESMA to take account of the third criterion of the liquid market definition in Article 2(17)(iii) of MiFIR. ISDA highlights again the idiosyncratic risk inherent to single name CDS that is very different from macro products. Single name CDS are impacted most directly by news and events specific to the credit or sector, which are impossible to predict. A reference entity which transitions to a lower credit quality has a higher implied probably of default and generally becomes less liquid, more volatile and trades with wider bid-ask spreads.

Regardless of which option ESMA decides upon, the idiosyncratic nature of single name CDS products requires there to be workable temporary suspension regime. Under MiFIR, NCAs have the power to temporarily suspend pre- and post-trade transparency requirements for trading venues and investment firms when the liquidity of a class of financial instruments falls below specified thresholds. ISDA recommends that ESMA permits to NCAs to suspend transparency obligations for a single name CDS when its traded credit spread cap exceeds 450bps. This is the case even if ESMA decides to incorporate the traded credit spread into its liquidity determination (as we have recommended in the paragraph above), as some NCAs may not exercise their discretion to grant waivers or deferrals for illiquid instruments but may still wish to utilise their temporary suspension powers when the credit spread cap exceeds 450bps.

**(iv) Package transactions**

***a) Overview***

ISDA would like to propose that ESMA considers specific and tailored treatment for package transactions as neither the December 2014 Consultation Paper or the Addendum address how these transactions might be

treated under the new framework. In response to the May 2014 Discussion Paper, ISDA included a number of detailed comments on the nature of package transactions which we draw ESMA's attention to. We reiterate the points made in that response and put forward a proposal which we hope ESMA will find workable and flexible enough to apply for venue and SI transparency obligations and the derivatives trading obligation. This will preserve the market for package transactions and ensure that pricing and liquidity is not negatively impacted for end investors.

We believe that Level 1 is flexible enough to empower ESMA to specify how package transactions are treated in order to determine if such transactions are liquid or "traded on a trading venue" (both for determining whether transparency obligations apply as well as determining whether the derivatives trading obligation applies). The Level 1 text clearly sets the foundation for the pre- and post-trade transparency regimes in non-equities by defining the asset classes – "bonds, structured finance products, emission allowances and derivatives" – on which the Level 2 measures must be built. However, ESMA has flexibility to define how, within these broad asset classes, to identify whether specific financial instruments (or combinations thereof) are to be considered "liquid" or "traded on a trading venue". ESMA has chosen to adopt COFIA as the basis for determining whether a liquid market exists – which suggests to us that ESMA is also empowered to tailor this approach to instruments which fall within one of the specified classes, but are part of a package transaction.

***b) Advantages of package transactions to clients***

Package transactions allow clients to reduce their transaction costs (i.e. a single transaction is less expensive to execute than multiple transactions) and manage their execution risk (i.e. a single execution alleviates timing and other mechanical/process type risks). They are tailored to provide risk-return characteristics in the form of a single transaction in an efficient and cost-effective manner to clients.

***c) Challenges to trading package transactions without a tailored proposal***

Below are some very realistic fact patterns which hopefully demonstrate that unless there is tailored treatment for package transactions which recognises that package transactions should be considered in their entirety when being assessed as subject to transparency requirements and/or the derivatives trading obligation, there is a significant risk that such transactions may no longer be available to clients in the EU. This will be due to the individual components being treated differently and inconsistently vs. each other when they are assessed against the relevant requirements which would negate the advantages highlighted above of trading package transactions. These challenges are likely to be particularly acute where one or more of the components of a package transaction includes derivatives subject to the trading obligation:

- If some components of a package transaction are traded on a trading venue but others are not.
- If some components of a package transaction are deemed liquid but others are not.
- If some components of a package transaction are above the relevant LIS or SSTI thresholds but others are not.
- If the components of a package transaction are below the relevant LIS or SSTI thresholds but together they behave similarly to a single transaction above the LIS or SSTI.
- If the package transaction contains a listed derivative which trades on a different trading venue to other components.

If ESMA fails to provide for the appropriate trading of packages, end investors will be required to trade the components independently, resulting in increased transaction costs and increased execution risks, which would seem to conflict with ESMA's policy objectives.

***d) ISDA proposal***

We would be keen to assist ESMA with the development of a workable regime for package transactions. We consider that the following proposals could both address the challenges we have described above. We have provided both proposals for ESMA's consideration as we recognise that, whilst Option 1 is a simpler proposal, Option 2 is more accurate.

Option 1:

1. Subject to point 3 below, if each component of a package transaction is liquid:

   a. The package transaction should be considered liquid; and

   b. If any one component is above the relevant threshold (LIS or SSTI) then the package transaction should be deemed to be above the threshold.

2. Subject to point 3 below, if the package transaction contains liquid and illiquid components:

   a. The package transaction should be considered illiquid; and

   b. If any one component is above the relevant threshold (LIS or SSTI) then the package transaction should be deemed to be above the threshold.

3. For the purposes of MiFIR Articles 8(1), 10(1), 18(1) and 18(2), all components of a package have to be tradable on a single venue in order for the package be considered "traded on a venue".

4. If the package transaction comprises ten or more component legs, the package transaction should be considered illiquid.

If ESMA, for pre- and post-trade transparency purposes, would prefer to represent this in a table format, we propose the following table which reflects the above:

**Table 7: ISDA Proposal for the calibration of Package Transactions for liquidity, Large in Scale, and Size Specific to the Instrument thresholds.**

| Type | Package type comprising: | Example | 1. All components above LIS | 2. All components above SSTI | 3. At least one component above LIS | 4. At least one component above SSTI | 5. All components below LIS | 6. All components below SSTI |
|---|---|---|---|---|---|---|---|---|
| A | Exclusively liquid derivatives in one derivative asset class[1] | Spread of CDX.NA.IG vs. ITraxx Europe | Package is above LIS and liquid | Package is above SSTI and liquid | Package is above LIS and liquid | Package is above SSTI and liquid | Package is below LIS and liquid | Package is below SSTI and liquid |
| B | Exclusively liquid securities | 2yr vs 10yr Bund switch* | Package is above LIS and liquid | Package is above SSTI and liquid | Package is above LIS and liquid | Package is above SSTI and liquid | Package is below LIS and liquid | Package is below SSTI and liquid |
| C | Liquid security(ies) and derivative(s) where the derivatives are from a single asset class[1] | CDS basis trade (CDS vs. liquid sovereign bond) | Package is above LIS and liquid | Package is above SSTI and liquid | Package is above LIS and liquid | Package is above SSTI and liquid | Package is below LIS and liquid | Package is below SSTI and liquid |
| D | Liquid & illiquid security(ies) and derivative(s) where the derivatives are from a single asset class[1] | CDS basis trade (CDS vs. illiquid sovereign bond) | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is below LIS and not liquid | Package is below SSTI and not liquid |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| E | Liquid derivative(s) & any liquid exchange traded derivative(s) in the same derivative asset class [1] | EFP transaction of swap vs. future* | Package is above LIS and liquid[2] | Package is above SSTI and liquid[2] | Package is above LIS and liquid[2] | Package is above SSTI and liquid[2] | Package is below LIS and liquid[2] | Package is below SSTI and liquid[2] |
| F | Liquid security(ies) & any liquid exchange traded derivative(s) in the same derivative asset class [1] | Cash bund vs. Bund future basis trade* | Package is above LIS and liquid[2] | Package is above SSTI and liquid[2] | Package is above LIS and liquid[2] | Package is above SSTI and liquid[2] | Package is below LIS and liquid[2] | Package is below SSTI and liquid[2] |
| G | Exclusively illiquid security(ies) or derivative(s) | Spread trade between two 10yr sovereign CDS | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is above LIS and Not liquid | Package is above SSTI and Not liquid | Package is below LIS and not liquid | Package is below SSTI and not liquid |
| H | 10 or more components | Package of several CDS bundled for execution | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is below LIS and not liquid | Package is below SSTI and not liquid |

[1] Interest Rate Derivatives, FX Derivatives, Commodity Derivatives, Equity Derivatives, Credit Derivatives etc considered as distinct derivative asset classes.

[2] Assuming that ESMA agrees that, for the purposes of MiFIR articles 8(1), 10(1), 18(1) and 18(2), all components of a package have to be tradable on a single venue in order that the package be considered "traded on a venue". Otherwise, ESMA should deem packages including exchange traded derivatives to be not liquid. ISDA recommends that packages involving exchange traded derivatives should be executed using the wholesale trading facilities currently governed by venues' rulebooks

* These scenarios are not directly relevant for credit derivatives (in the cases of E & F this is because there are no exchange traded credit derivatives at the time of writing). But we have left them in the table for completeness.

Option 2:

1. Subject to point 3 below, if each component of a package transaction is liquid:

   a. The package transaction should be considered liquid; and

   b. The percentage threshold for each individual component in a package transaction is equal to the notional of the relevant component expressed as a percentage of its relevant threshold (LIS or SSTI). If the sum of the percentage thresholds for all components in the packaged transaction is above 100%, then the package transaction (and each of its components) is above the relevant threshold (LIS or SSTI). See below for a more detailed explanation of the percentage threshold approach.

2. Subject to point 3 below, if the package transaction contains liquid and illiquid components:

   a. The package transaction should be considered illiquid; and

   b. The percentage threshold for each individual component in a package transaction is equal to the notional of the relevant component expressed as a percentage of its relevant threshold (LIS or SSTI). If the sum of the percentage thresholds for all components in the package transaction is above 100%, then the package transaction (and each of its components) is above the relevant threshold (LIS or SSTI). See below for a more detailed explanation of the percentage threshold approach.

3. For the purposes of MiFIR Articles 8(1), 10(1), 18(1) and 18(2), all components of a package have to be tradable on a single venue in order for the package be considered "traded on a venue".

4. If the package transaction comprises ten or more component legs, the package transaction should be considered illiquid.

The percentage threshold approach aims to, in a simple manner, replicate the package of instruments into a single instrument to test whether it would indeed be above the threshold (SSTI or LIS purposes) or not if it were traded as a single instrument.

The example below was prepared in the context of interest rate derivatives, but the same principles are applicable to credit derivatives.

Example: if an investor wishes to hedge cash flows at 5-year and 15-year points using EUR interest rate swaps, to create an accurate hedge the investor would trade a package of two EUR swaps at 5-year and 15-year maturities. Alternatively, the investor could enter into a single swap with an average 10-year maturity to try to replicate the risk profile but with less accuracy.

However, whilst the individual swaps in the package of swaps could each be below the relevant threshold, the equivalent single swap would have a larger notional and could therefore be above the threshold, as illustrated below. Given the 5-year and 15-year swaps are economically similar in nature, the pricing of one swap is likely to impact the pricing of the other. By not recognising this, ESMA could create an incentive for the market to trade in the equivalent single average instruments, rather than the package of instruments that provide a more accurate hedge: the result would be to provide a less perfect hedge, thereby retaining risk in the system.

The suggested percentage threshold approach provides a way to calibrate this and ensures that package transactions are not disproportionately disadvantaged.

The below table illustrates the example described above.

**Table 8: Example of how the percentage threshold approach (Option 2) operates**

| | **More accurate hedge** | | **Less accurate hedge** |
|---|---|---|---|
| | **EUR 5yr swap** | **EUR 15yr swap** | **EUR 10yr swap** |
| Notional | 60m | 60m | 120m |
| Threshold (SSTI or LIS) | 100m | 100m | 100m |
| Percentage Threshold | 60% | 60% | 120% |

Table 7, prepared for Option 1, could easily be adapted for Option 2.

***e) Safeguarding against avoidance***

ISDA is aware that ESMA and national competent authorities may be concerned that adoption of our proposal may lead to market participants creating packages of instruments purely for the purposes of avoiding the transparency regime or the derivatives trading obligation. ISDA recognises these concerns and suggests that this could be achieved by defining a package and including, within the MiFID II/MiFIR framework, a mechanism that would support the monitoring (and therefore supervision) of the trading of packages. ISDA would welcome the opportunity to discuss these safeguards with ESMA in more detail.

<u>1. Definition of package transaction</u>

ISDA recommends that a "package transaction" be defined as a transaction comprising two or more components, each of which is a *bond, structured finance product, emission allowance or derivative* where:

(i) The components are priced as a "package" with simultaneous execution of all such components;

(ii) The execution of each component is contingent on the execution of the other components;

(iii) Each component must be able to stand alone and must be able to bear economic risk; and

(iv) Either:

i. the components are economically similar in nature such that the pricing of one component can affect the pricing of the other component; or

ii. the components must have a reasonable degree of correlation.

2. Post-trade transparency flag

With a view to assisting the monitoring of package transactions by supervisors, and as stated in our response to Question 74 of the December 2014 Consultation Paper, ISDA recommends that an additional flag to be reported on trades that are components of package transactions be added to the list of flags set out in Table 2 of Annex II of RTS .

We would also draw attention to our response to Question 218 of the December 2014 Consultation Paper where we suggest that ESMA may wish to consider including a "link ID" field in transaction reports (for the purposes of the Article 26 MiFIR transaction reporting regime). In ISDA's response to ESMA's recent consultation paper on the review of reporting technical standards under EMIR, we recommended the inclusion of a "link ID" field to link together trade reports of components of the same package. ESMA may wish to consider whether to incorporate such a field in the transaction reports required under the MiFIR transaction reporting regime as this would give supervisors greater visibility in respect of the usage of package transactions.

**(v) ISDA's comments on the application of the trading obligation to single name CDS**

We note that ESMA, in the Addendum, has not asked for comments on the application of the trading obligation to credit derivatives. However, we would like to reiterate a number of points made in our response to the December 2014 Consultation Paper.

***a) Criteria for determining whether derivatives should be subject to the trading obligation***

It is imperative that the assessment of whether there is "*sufficient third-party buying and selling interest in the class of derivatives or subset so that such a class of derivatives is considered sufficiently liquid to trade only on venues*", takes into account all variables which may impact the liquidity and tradability of an instrument and the assessment must therefore be conducted at a suitably granular level. If this approach is not followed then there is a risk that a derivative product which is insufficiently standardised and which cannot be traded on venue or in which there insufficient third-party buying and selling interest will be declared subject to the trading obligation.

We therefore support ESMA's view that option 2 (as set out on page 126 of the December 2014 Consultation Paper) is preferred and that ESMA should distinguish between benchmark or integer tenors and broken dates and note that adoption of option 2 would help to align MiFID II/MiFIR to US regulation (since the CFTC MAT product set only contains integer tenors and a limited number of forward-starting USD swaps). However, we would reiterate that there are likely to be a number of other parameters which will determine whether a derivative can be traded on a trading venue and the liquidity of the relevant derivative.

It is therefore necessary for the sub-classes which are determined for the purpose of the liquidity assessment to be set at a granular level or (at a minimum) that the relevant "certain size" is set at a low level to reflect the fact that the liquidity assessment does not reflect the relevant parameters.

In addition, with regards to the average frequency of trades, we would note that a sub-class of derivatives should not be made subject to the trading obligation unless it trades every day during the assessment period.

Furthermore, we would highlight that in determining whether a sub-class of derivatives should be made subject to the trading obligation, ESMA is also required to "*take into consideration the anticipated impact that trading obligation might have on the liquidity of a class of derivatives or a relevant subset thereof and the commercial activities of end users which are not financial entities*" (Article 32(3) of MiFIR). In this regard, we note that ISDA's research indicates that a failure to align trading mandates on a cross-border basis has a demonstrable impact on market liquidity (see footnote 88 and Market Fragmentation: An ISDA Survey (December 2013); and Made-Available-to-Trade (MAT): Evidence of Further Market Fragmentation (April 2004); available at http://www2.isda.org/functional-areas/research/research-notes/) and underlines the importance of global harmonisation of trading obligations.

***b) Transactions below a certain size***

With respect to the assessment of whether a class of derivatives is only sufficiently liquid in transactions below a certain size, we agree with ESMA that whilst the methodology for establishing the "certain size" should be consistent with methodology establishing the LIS thresholds, the thresholds themselves may not always be identical. However, in our view it would not be appropriate to set the "certain size" at a level higher than the LIS. We therefore agree with (i) those respondents to ESMA's discussion paper that noted there is unlikely to be sufficient liquidity for trading platforms to support LIS transactions – i.e. once a transaction in an instrument is large in scale, it is no longer liquid – and (ii) the CFTC approach whereby block trades can be executed off-venue.

Accordingly, when establishing the "certain size" for a class or sub-class of derivatives, we would encourage ESMA to use the LIS as its starting point and to conduct a further liquidity assessment to determine whether the threshold should be reduced in light of the specific liquidity profile of the relevant class or sub-class.

**(vi) ISDA's comments on the definitions applicable to single name CDS**

We would recommend the following amendments to the definitions in Section 7 of Annex III of RTS 9:

- The proposed definition of 'CDS' or 'credit default swap' should be deleted and replaced by separate definitions for 'Single name CDS', 'Index CDS' and 'Bespoke basket CDS'. We would recommend the following definition of 'Single name CDS':

  'Single name CDS' or 'single name credit default swap' means a swap involving a transfer of credit risk between a protection buyer and protection seller, the terms of which reference the "Standard" transaction type in the ISDA Credit Derivative Physical Settlement Matrix. The protection buyer pays a fixed fee or premium in exchange for receiving from the other party a cash flow contingent on the default of a single reference issuer, the value of which is determined by reference to a basket of debt instruments of the reference issuer.

- It is vital that RTS 9 provides an exhaustive taxonomy to ensure that all derivatives can be appropriately classified for the purposes of the MiFIR transparency regime. If ESMA fails to provide an exhaustive taxonomy, it is possible that some derivatives will be subject to the MiFIR transparency requirements (because they are traded on a trading venue) but NCAs will be unable to grant a waiver from pre-trade transparency requirements or a deferral from post-trade transparency requirements for these instruments because ESMA has not provided a liquidity determination or set LIS or SSTI thresholds. This may have a significant impact on the liquidity of these instruments. To ensure that all credit derivatives are provided with a liquidity determination and appropriate LIS and

SSTI thresholds, it is necessary to include a new definition of "Other credit derivative'. Given the heterogeneity of derivatives in this class, we would expect it to be considered illiquid.

We would recommend the following definition:

'Other credit derivative' means a derivative instrument for the transfer of credit risk or a derivative contract relating to credit risk which is not a CDS index, single name CDS, bespoke basket CDS, CDS index option or a single name CDS option.

We also believe that it is necessary to introduce an "all other derivatives category" which would capture any derivatives that either:

- Do not fall within one of the specified asset classes (e.g. are not interest rate, equity, commodity, foreign exchange, credit etc derivatives classes). An example of a derivative that would fall within this category is a derivative with an underlier such as financial indices or financial measures (which are listed in Annex 1, Section C (4) of MiFIDII).

- Have multiple underliers, such that they can fall within multiple classes. Complex derivatives which have multiple underliers should be assigned to the "all other derivatives category" as otherwise it is possible that different trading venues and investment firms may assign them to different asset classes. This could be significant if the different underliers have different liquidity determinations or SSTI/LIS thresholds.

**Q4. For all the other classes (CDS Index, Bespoke basket CDS, CDS index options and Single name CDS options): do you agree with ESMA's proposal for the definition of a liquid market? Please provide an answer detailed per contract type (CDS and CDS options), underlying type (index, single name, bespoke basket) and underlying identified, addressing the following points:**

**(1) Would you use different qualitative criteria to define the sub-classes?**

**(2) Would you use different parameters or the same parameters (i.e. average number of trades per day and average notional amount traded per day) but different thresholds in order to define a sub-class as liquid?**

**(3) Would you define classes declared as liquid in ESMA's proposal as illiquid (or vice versa)? Please provide reasons for your answer.**

**(i) Issues with ESMA's proposal for the definition of liquid market: all credit derivatives**

**A. ISDA's members are concerned that ESMA has classified many illiquid credit derivatives as liquid, due to:**

1. The use of liquidity thresholds that do not accord with the MiFIR definition of liquidity, being one with ready and willing buyers and sellers on a continuous basis. Specifically one trade per day and a notional of EUR 10 million, as used for CDS index, or two trades per day and a notional of EUR 100 million as used for CDS index options, cannot be considered consistent with this definition. Furthermore, given the diversity of instruments (i.e. reference entities) in the single name CDS classes as defined by ESMA, two trades per day and a notional of EUR 100 million per day also cannot be considered consistent with this definition.

2. The difficulties encountered in factoring in two of the key elements of the definition of a liquid market, specifically the number and type of market participants, and the average size of spreads. We understand why ESMA has encountered difficulty incorporating these liquidity parameters but MiFIR does require their consideration, and therefore we recommend that ESMA compensate for the potential misclassification of illiquid sub-classes as liquid through higher liquidity thresholds for those liquidity parameters actually used (i.e. average frequency and average size of transactions), than would otherwise have been possible had all liquidity parameters been considered.

3. The classification of single name CDS at a highly insufficient level of granularity resulting in many single name CDS being labelled as liquid when in practice, as our analysis demonstrates, CDS referencing over 99% of reference entities are illiquid based on liquidity thresholds of 15 trades per day and EUR 10 million notional per day. The classification of single name CDS instruments must encompass reference entity type, region, currency and tenor to be meaningful. A similar issue arises for CDS index options which need a taxonomy, which, at the very least, includes the tenor of the option.

   ISDA's members have noted that ESMA had previously correctly identified (in paragraph 33 of page 123 of the May 2014 Discussion Paper) that "a necessary prerequisite for applying [the COFIA] approach is the proper grouping/segmentation of financial instruments into homogenous and relevant classes" in order to identify "class[es] of instruments with homogenous liquidity". ISDA's members consider that ESMA's proposals in the Addendum for single name CDS and CDS index options appear largely inconsistent with this necessary prerequisite.

4. The fact that the "number of days traded greater to or equal to 80% of the available trading days in the period" used in stage 1 of ESMA's analysis of OTC credit derivatives (described on page 232 of the Addendum) was not carried through to stage 2 of the analysis.

**B. ESMA's analysis has presented a number of data issues:**

1. ESMA has ignored roughly 72% of records for single name CDS in their stage 2 analysis of single name CDS as the calculation of tenor was not possibly due to quality issues in the data (see paragraph 18 on page 243 of the Addendum).
2. The three-month sample period does not take into account the episodic nature of single name CDS. The marked variation in the trading of reference entities likely reflects the changing credit outlook of various countries, sectors or firms. This has a "clustering" effect on the majority of CDS transactions, making them liquid when the reference entity is in play and illiquid otherwise.
3. The use of data to assess liquidity is from the period very shortly after the EMIR trade reporting requirement came into effect. The challenges that this reporting requirement presented to the industry have been widely publicised, and we are concerned that this dataset may, for example, contain duplicate trades or other erroneous data. ESMA may not wish to place full reliance on this dataset, or could compensate through the use of higher liquidity thresholds for the average frequency and average size of transactions liquidity parameters than might otherwise have been appropriate. Alternatively, ESMA could repeat its analysis on more recent trade repository data, which might be more accurate. Additionally, use of a dataset covering a longer period of time may produce more representative results, potentially less distorted by seasonal or short-term factors.
4. **Credit derivatives without whole-year tenors:** ISDA is concerned with ESMA's approach to the classification of credit derivatives which do not have whole year tenors. ESMA makes specific comments on the approaches it used for CDS index (paragraph 9.ii on page 235 of the Addendum), single name CDS (paragraph 17.b on page 243 of the Addendum) and CDS index options (paragraph 24.b on page 249 of the Addendum).

   Market convention is to use the term "5 year" to refer to trades with a tenor of between 4.75 years and 5.25 years in the on-the-run index. For simplicity (in order to avoid having to consider half-year classes), we recommend that ESMA consider 5 year trades to be those with a tenor of between 4.25 years and 5.25 years (or 51 months and 63 months).

   The consequence of ESMA's approach is that ESMA categorises, for example, too many trades that are in reality 5 year trades in the 6 year class, and too few in the 5 year bucket, resulting in an incorrect determination of liquidity for the relevant buckets. This also results in incorrect calibration of the LIS and SSTI thresholds. Page 241 of the Addendum lists the contract with the greatest

number of trades per day to be the iTraxx Europe 6 year, whereas we consider that most of the trades categorised as 6 year trades were in fact 5 year trades according to market convention.

ISDA recommends that ESMA revises its approach to ensure that trades are bucketed under the correct tenor and suggests that the following mark-up of paragraph 9.ii on page 235 of the Addendum, would correct ESMA's approach for CDS index.

"the tenor: calculated as the difference between the maturity date and the execution date. In particular, the tenor is denominated as "x years" where x is the number obtained by rounding up the ratio of days obtained as the difference between maturity and execution date, subtracting 92 days and dividing by 365.25 ~~and 365~~ [Maturity Date – Execution Date – 92]/365.25 (e.g. 2.3) to the next whole number (3 years in this case). As a result, for the purpose of calculating the figures included in the table below [Table 36: CDS Index – liquidity assessment] a sub-class assigned with a tenor of "x years" includes all contracts with a maturity of more than "x-1 years + 3 months" and less or equal to "x years + 3 months" (e.g. 2 years + 3 months < 3 year tenor ≤ 3 years + 3 months)."

The following table, illustrates what this correction looks like in practice.

**Table 9: Market Recommended Tenor**

| Trade Date | Maturity Date | Year Fraction | Market Years |
|---|---|---|---|
| 1/1/2015 | 3/31/2016 | 0.99384 | 1 |
| 1/1/2015 | 4/1/2016 | 0.99658 | 1 |
| 1/1/2015 | 4/2/2016 | 0.99932 | 2 |
| 1/1/2015 | 4/3/2016 | 1.00205 | 2 |
| 1/1/2015 | 4/4/2016 | 1.00479 | 2 |

As indicated above, we refer to this correction as the Market Recommended Tenor (as opposed to the ESMA tenor) in our response. The same corrections need to be applied to paragraph 17.b on page 243 and paragraph 24.b on page 249 of the Addendum. ESMA will also need to change the tenors used in Table 60 of draft RTS 9 (on page 346 of the Addendum). For example, instead of referring to tenors "from 5 years to 6 years", the appropriate description would be "from 51 to 63 months".

Making these changes will result in a more appropriate set of sub-classes being found to be liquid. This might mean that fewer classes are found to be liquid (for example, we would expect there to be fewer instances of 5 to 6 year tenors being found liquid), but because it will result in trades being categorised in the appropriate classes according to market convention, we do not expect it to significantly affect the capture ratios of the percentages of trades and transactions found to be liquid.

For CDS index, the table below illustrates the difference between the number of liquid sub-classes and coverage ratio if the Market Recommended Tenor is applied instead of the ESMA tenor. In the table below, in Row A, ESMA's tenor was applied to our analysis of CFTC/DTCC data while, in Row B, the Market Recommended Tenor was applied. We have used ESMA's proposed liquidity thresholds for the purpose of producing this table to ensure that the table only reflects the impact of adopting the Market Recommended Tenor and the Market Recommended On-the-run Definition. We do not endorse ESMA's proposed liquidity thresholds and we recommend alternative liquidity thresholds in section below.

**Table 10: CDS Index - ESMA and CFTC/DTCC liquidity calibration**

| | Calculation Basis | Total number of sub-classes with at least | Liquid sub-classes | Trades per day | Notional per day (M EUR) | %age of trades captured | %age of notional |
|---|---|---|---|---|---|---|---|

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | one trade | | | | | |
| A | CFTC/DTCC data with ESMA tenor (and Market Recommended On-the-run Definition) | 26 | 26 | 1 | 10 | 98% | 97% |
| B | CFTC/DTCC data with Market Recommended Tenor (and Market Recommended On-the-run Definition) | 24 | 24 | 1 | 10 | 98% | 97% |

The table below illustrates those classes of CDS index that fall into or out of scope through the use of the Market Recommended Tenor:

**Table 11: Sub-classes of CDS index that fall in or out of scope of what is deemed liquid through the use of the Market Recommended Tenor**

| Sub-classes that are liquid in row B but not row A | | | | Sub-classes that are liquid in row A but not row B | | | |
|---|---|---|---|---|---|---|---|
| USD | CDX.NA.IG | On-the-run | 10 years | USD | CDX.NA.HY | On-the-run | 6 years |
| USD | iTraxx Asia ex-Japan IG | On-the-run | 5 years | USD | CDX.NA.IG | On-the-run | 11 years |
| USD | iTraxx Australia | On-the-run | 5 years | USD | iTraxx Asia ex-Japan IG | On-the-run | 6 years |
| EUR | iTraxx Europe | On-the-run | 10 years | USD | iTraxx Australia | On-the-run | 6 years |
| JPY | iTraxx Japan | On-the-run | 5 years | EUR | iTraxx Europe | On-the-run | 6 years |
| USD | MCDX.NA | On-the-run | 5 years | EUR | iTraxx Europe Senior Financials | On-the-run | 6 years |
| USD | CDX.NA.IG | On-the-run | 10 years | EUR | iTraxx Europe Sub Financials | On-the-run | 6 years |
| | | | | JPY | iTraxx Japan | On-the-run | 6 years |
| | | | | USD | MCDX.NA | On-the-run | 6 years |

5. **ESMA's definitions of on-the-run CDS index versus off-the-run CDS index:** ISDA disagrees with ESMA's definition of "on-the-run status" set out on page 345 of the Addendum as it does not accord with market convention and conflates the tenor of the contract with its contractual terms. We recommend that ESMA align with market convention, which we expect to have the consequence of some immediate off-the-run contracts in the most liquid indices being found to be liquid, which would enhance transparency for trading in these "1x off-the-run" contracts. We have marked-up the definition as follows and urge ESMA to adopt this definition in its liquidity assessment as well.

'On-the-run status ' means the ~~period beginning 5 days before the date on which the~~ rolling most recent version (series) of the index created on the date on which the composition of the index is effective and ending ~~30 days after~~ one day prior to the date on which the composition of the next version (series) of the index is effective.

As indicated above, we refer to this corrected concept of on-the-run status as the Market Recommended On-the-run Definition (as opposed to ESMA's on-the-run definition) in our response.

We also consider that, as a consequence of making this change and of considering off-the-run index data for analysis, ESMA may identify a small number of immediately off-the-run indices to be liquid depending on the liquidity thresholds chosen. In our response to ESMA's May 2014 Discussion Paper, we provided analysis that showed that liquidity in the immediately off-the-run series drops

significantly after the first 5 days of trading (please see our response to Q116 of the May 2014 Discussion Paper). If ESMA determines that there is sufficient liquidity in the immediately off-the-run series, we recommend that ESMA include in the RTS a definition of the '1x off-the-run status'. We would suggest the following wording:

'1x off-the-run status' means the version (series) of the index which is immediately prior to the current 'on-the-run' version (series) at a certain point in time. A version (series) ceases being 'on-the-run' and acquires its '1x off-the-run' status when the latest version (series) of the index is created.

All of these concerns are heightened by the fact that ESMA does not propose to recalibrate the liquidity assessment at all. In the May 2014 Discussion Paper, ESMA stated (paragraph 44, page 125) that "the liquidity of the sub-categories needs to be reassessed periodically". Instead, it is now clear that ESMA proposes no such reassessment. This decision also implies that ESMA has chosen not to utilise the market data that MiFIR will make available to facilitate recalibration, which is an incomprehensible waste of the opportunity to refine the liquidity classification over time (particularly given the concerns over the EMIR trade repository data noted above). This static determination is a serious weakness of ESMA's approach which suggests that an incorrect initial assessment of liquidity will have permanent implications. We encourage ESMA to reconsider whether the COFIA can be recalibrated more regularly, as improved market data becomes available and to better reflect changing liquidity conditions. In the absence of regular and accurate recalibration, we urge ESMA to compensate through both a more conservative initial assessment of liquidity, and by calibrating the LIS and SSTI thresholds at lower levels than might otherwise have been possible with a more dynamic approach to liquidity (see ISDA's response to Question 5 below).

Upon examining ISDA's analysis, we encourage ESMA to re-run its liquidity assessments for credit derivatives and we are keen to assist ESMA in this work.

**(ii) ISDA's data analysis: all credit derivatives**

ISDA has access to public CFTC data obtained from the Depository Trust & Clearing Corporation (DTCC) US Swap Data Repository[4] which it has used to backtest ESMA's liquidity assessment of single name CDS, CDS index and CDS index options.

For single name CDS, ISDA used the DTCC Trade Information Warehouse database and the DTCC Market Risk Transaction Activity (Section IV) analysis of single names.[5] The sample period used for CDS index and CDS index options was 1 March to 31 May 2014, which aligns to the period used by ESMA. However, for single name CDS a longer dataset was used – 1 February 2013 to 1 February 2014 – to account for the episodic nature of single name CDS.

The transactions covered in this analysis only include transactions where market participants were engaging in market risk transfer activity i.e. transactions that change the risk position between two parties such as new trades, termination of an existing transaction or the assignment of an existing transaction to a third party.

[4] CFTC data from DTCC includes the following price-forming transactions: new trades, terminations and novations.

[5] For more information see – http://www.dtcc.com/~/media/Files/Downloads/Settlement-Asset-Services/DerivSERV/Market_Activity_Single_Name_17-Jun-2011.pdf

Where possible non-price forming transactions, such as compression trades, delta neutral trades and intragroup trades, were filtered out of the dataset. There are 792,288 contracts included in the DTCC single name dataset, over six times as many as in ESMA's dataset (largely because the DTCC data covers a full year).

To protect the anonymity of trading in single name CDS transactions with lower volumes, DTCC only provided ISDA with weekly notional and trade count data for those reference entities which trade in excess of 50 or more contracts during the analysis period ("**Group A**") i.e. at least 0.2 trades per day. The majority of contracts (693,952, 87.6%) fell in this set which has allowed us to analyse these in greater depth at the reference entity level. The remaining contracts (98,336, 12.4%) were provided by DTCC in an aggregated format across currency, term and coupon descriptors.

The majority of total single name CDS trading was denominated in US dollar (61.8%) and euro currencies (35.6%). Contract terms were concentrated in 4Y – 6Y buckets, with the majority of activity (52.3%) occurring in 5Y – 6Y term bucket. More than half of the single name CDS had 100 basis points coupons (65.4%). We also note that unlike the data used for CDS index and CDS index options, the data used for single name CDS is less likely to be US centric.

We acknowledge that the DTCC data may not exactly match ESMA's dataset, but we hope our analysis demonstrates how ESMA can apply our recommendations and methods to ESMA's own dataset. Moreover, we note that the single name CDS data is global in coverage. We also highlight that we were unable to use the European trade repository data used by ESMA as this is not publicly available and the trade repository data is not generally transparent at the level of detail (i.e. trade level) needed to perform the analysis. ISDA would be pleased to share the data we used and our analysis of it, upon request.[6]

We understand that ESMA would find it helpful for respondents to provide further detail on how the market understands credit derivatives products. We have set out below, therefore, a summary of how ISDA's members view these products:

- **Single Names.** The "5 year on the run" single name CDS contract is a 5 year 3 month contract launched on each quarterly roll date – 20 March, June, September and December. The contract itself does not automatically "roll" but in order to "roll" market participants close out one contract by way of an unwind or assignment and enter into a new trade on or around the relevant quarterly roll date. Other maturities operate the same way.
- **Indices.** The "5 year on the run" CDS index contract is a 5 year 3 month contract launched on each index roll date – 20 March and 20 September each year. The relevant index is determined by reference to index rules governed by the index provider. The contract itself does not automatically "roll" but in order to "roll" market participants close out an existing contract by way of an unwind or assignment and enter into a new trade on or around the relevant index roll date on the new index. Other maturities of the indices operate the same way.
- **Index options.** Physically settled "European" options are traded on the major CDS indices. The 20th of each calendar month is the market standard exercise date. The option exercises into an existing CDS index rather than an index to be created. As the CDS index rolls every 6 months the options are generally limited to a maximum of 6 months in order to capture exercise into the "on the run".

**(iii) CDS index: ISDA's proposal**

ISDA welcomes ESMA's granular classification of CDS index for the purposes of determining whether a liquid market exists for CDS index. ISDA reiterates however that ESMA should consider a more granular approach when it determines whether a derivative or class thereof is "sufficiently liquid" for the purposes of the

[6] Similarly, we would also welcome the opportunity to share the data we used to examine interest rate derivatives and our the detailed analysis underpinning our response to ESMA's 19 December 2014 Consultation Paper.

derivative trading obligation, as we set out in our response to Question 89 of the December 2014 Consultation Paper.

We note, on page 236 of the Addendum, that ESMA has commented that it "was not possible to disentangle tranched vs. untranched indices". We understand from this reference that the dataset used by ESMA to assess the liquidity of CDS indices included both tranched and untranched indices. Untranched CDS on indices are generally regarded as significantly more liquid than tranched CDS indices. For example, both the CFTC and the EMIR clearing obligations are only proposed to apply, at this stage, to untranched CDS indices. ISDA's members are concerned that ESMA's proposed list of liquid CDS indices would also capture tranched CDS indices. We would recommend that ESMA clearly distinguish between tranched and untranched CDS indices and we would expect that all tranched CDS indices would be determined illiquid for the purposes of the MiFIR transparency regime.

ISDA encourages ESMA to set higher liquidity thresholds than those proposed in the Addendum to the sub-classes of CDS index that it has identified because the liquidity thresholds used by ESMA do not accord with the MiFIR definition of a liquid market, being one with ready and willing buyers and sellers on a continuous basis.

Using CFTC/DTCC data, ISDA has applied higher liquidity thresholds for CDS index. ISDA's analysis below demonstrates that even if ESMA uses these higher liquidity thresholds, which are more representative of instruments that can be considered liquid, the coverage ratio of trades captured does not drop significantly. The table below sets out the percentage of trades captured and percentage of notional amount covered using ESMA and CFTC/DTCC data (the source of which ISDA explained in section (ii) above) both at ESMA's proposed liquidity thresholds (1 trade per day and EUR 10 million notional per day) and ISDA's suggested liquidity thresholds: The table reveals the following:

- Row B shows that, applying liquidity thresholds of 15 trades and EUR 500 million notional per day to ESMA's data presented in the Addendum, there are 5 liquid classes accounting for 79% of all CDS index trades.
- Row D shows that, using the Market Recommended Tenor and the Market Recommended On-the-run Definition, applying liquidity thresholds of 15 trades and EUR 500 million notional per day to the CFTC/DTCC data, there are 7 liquid classes (including two 1x off-the-run classes), accounting for 82% of all trades.
- Row E shows that, using the Market Recommended Tenor and the Market Recommended On-the-run Definition, applying liquidity thresholds of 9 trades and EUR 200 million notional per day, there are 10 liquid classes, accounting for 91% of all trades.

**Table 12: Comparative assessment of CDS index liquidity determinations**

**ESMA's proposed approach versus ISDA's recommend approach**

| | Calculation Basis | Total number of sub-classes with at least one trade | Liquid sub-classes | Trades per day | Notional per day (M EUR) | %age of trades captured | %age of notional |
|---|---|---|---|---|---|---|---|
| A | ESMA CP data | 25 | 25 | 1 | 10 | 98% | 98% |
| B | ESMA CP data | 25 | 5 | 15 | 500 | 79% | 68% |
| C | CFTC/DTCC data with ESMA's tenor and the Market Recommended On-the-run Definition | 26 | 9 | 15 | 500 | 76% | 80% |
| D | CFTC/DTCC data with Market Recommended Tenor and Market Recommended On-the-run Definition | 24 | 7 | 15 | 500 | 82% | 84% |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| E | CFTC/DTCC data with Market Recommended Tenor and Market Recommended On-the-run Definition | 24 | 10 | 9 | 200 | 91% | 91% |

In relation to Row D, the final column of the table below indicates which CDS indices ISDA determines to be liquid using liquidity thresholds of 15 trades and EUR 500 million notional per day:

**Table 13: A comparison of outcomes**
**ESMA liquidity thresholds vs. ISDA liquidity thresholds of 15 trades and EUR 500 million notional per day on CFTC index data with Market Recommended Tenor**

| | | | | | | | | ESMA liquidity thresholds | ISDA liquidity thresholds |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | Notional Amount per day | | | 10,000,000 | 500,000,000 |
| | | | | | Number of trades per day | | | 1.00 | 15.00 |
| **Currency** | **Underlier Name** | **On/Off the run** | **Tenor*** | **No. of trades** | **No. of trades per day** | **Notional amount** | **Notional amount per day** | | |
| USD | CDX.NA.IG | On-the-run | 51 months to 63 months | 7,621 | 117.25 | 290,534,455,714 | 4,469,760,857 | Liquid | Liquid |
| EUR | iTraxx Europe | On-the-run | 51 months to 63 months | 5,101 | 78.48 | 182,620,793,115 | 2,809,550,663 | Liquid | Liquid |
| USD | CDX.NA.HY | On-the-run | 51 months to 63 months | 8,383 | 128.97 | 115,196,290,000 | 1,772,250,615 | Liquid | Liquid |
| EUR | iTraxx Europe Crossover | On-the-run | 51 months to 63 months | 4,194 | 64.52 | 62,267,692,367 | 957,964,498 | Liquid | Liquid |
| USD | CDX.NA.IG | 1x off-the-run | 51 months to 63 months | 1,045 | 16.08 | 52,149,519,000 | 802,300,292 | Liquid | Liquid |
| USD | CDX.NA.HY | 1x off-the-run | 51 months to 63 months | 2,114 | 32.35 | 38,877,651,929 | 598,117,722 | Liquid | Liquid |
| EUR | iTraxx Europe Senior Financials | On-the-run | 51 months to 63 months | 1,361 | 20.94 | 38,560,759,745 | 593,242,458 | Liquid | Liquid |
| EUR | iTraxx Europe | 1x off-the-run | 51 months to 63 months | 622 | 9.57 | 25,753,631,104 | 396,209,709 | Liquid | Illiquid |
| USD | CDX.EM | On-the-run | 51 months to 63 months | 1,945 | 31.23 | 22,494,060,714 | 350,139,396 | Liquid | Illiquid |
| EUR | iTraxx Europe Crossover | 1x off-the-run | 51 months to 63 months | 755 | 11.62 | 15,964,058,135 | 245,600,894 | Liquid | Illiquid |
| USD | CDX.NA.IG | On-the-run | 63 months to 75 months | 199 | 3.06 | 9,387,857,143 | 144,428,571 | Liquid | Illiquid |
| EUR | iTraxx Europe | On-the-run | 63 months to 75 months | 254 | 3.91 | 8,492,289,508 | 130,650,608 | Liquid | Illiquid |
| EUR | iTraxx Europe Senior Financials | 1x off-the-run | 51 months to 63 months | 208 | 3.20 | 7,962,077,604 | 122,493,502 | Liquid | Illiquid |
| USD | CDX.EM | 1x off-the-run | 51 months to 63 months | 270 | 4.15 | 5,467,089,286 | 84,109,066 | Liquid | Illiquid |
| USD | CDX.NA.IG | On-the-run | 123 months to 135 months | 102 | 1.52 | 4,270,842,857 | 66,405,275 | Liquid | Illiquid |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| EUR | iTraxx Europe Sub Financials | On-the-run | 51 months to 63 months | 284 | 4.37 | 4,288,315,621 | 65,974,086 | Liquid | Illiquid |
| USD | iTraxx Asia ex-Japan IG | On-the-run | 51 months to 63 months | 340 | 5.23 | 2,996,574,286 | 46,101,143 | Liquid | Illiquid |
| EUR | iTraxx Europe Crossover | On-the-run | 63 months to 75 months | 133 | 2.05 | 2,832,700,653 | 43,580,010 | Liquid | Illiquid |
| EUR | iTraxx Europe | On-the-run | 123 months to 135 months | 66 | 1.02 | 2,818,090,298 | 43,355,235 | Liquid | Illiquid |
| USD | CDX.EM | On-the-run | 63 months to 75 months | 98 | 1.51 | 2,744,142,857 | 42,217,582 | Liquid | Illiquid |
| JPY | iTraxx Japan | On-the-run | 51 months to 63 months | 244 | 3.75 | 2,654,673,503 | 40,841,131 | Liquid | Illiquid |
| USD | MCDX.NA | On-the-run | 51 months to 63 months | 75 | 1.15 | 1,804,142,857 | 27,756,044 | Liquid | Illiquid |
| USD | iTraxx Australia | On-the-run | 51 months to 63 months | 99 | 1.52 | 1,360,714,286 | 20,934,066 | Liquid | Illiquid |
| USD | iTraxx Asia ex-Japan IG | 1x off-the-run | 51 months to 63 months | 67 | 1.03 | 1,263,571,429 | 19,439,560 | Liquid | Illiquid |

* Tenor has been expressed in months to reflect the use of the Market Recommended Tenor (i.e. ISDA's proposed amendments to paragraph 9.ii on page 235 of the addendum)

In relation to Row E, the final column of the table below indicates which CDS indices ISDA determines to be liquid using liquidity thresholds of 9 trades and EUR 200 million notional per day:

**Table 14: A comparison of outcomes**
**ESMA's liquidity thresholds vs. ISDA's liquidity thresholds of 9 trades and EUR 200 million notional per day on CFTC index data with Market Recommended Tenor**

| | | | | | | | | ESMA liquidity thresholds | ISDA liquidity thresholds |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | Notional Amount per day | | | 10,000,000 | 200,000,000 |
| | | | | | Number of trades per day | | | 1.00 | 9.00 |
| **Currency** | **Underlier Name** | **On/Off the run** | **Tenor*** | **No. of trades** | **No. of trades per day** | **Notional amount** | **Notional amount per day** | | |
| USD | CDX.NA.IG | On-the-run | 51 months to 63 months | 7,621 | 117.25 | 290,534,455,714 | 4,469,760,857 | Liquid | Liquid |
| EUR | iTraxx Europe | On-the-run | 51 months to 63 months | 5,101 | 78.48 | 182,620,793,115 | 2,809,550,663 | Liquid | Liquid |
| USD | CDX.NA.HY | On-the-run | 51 months to 63 months | 8,383 | 128.97 | 115,196,290,000 | 1,772,250,615 | Liquid | Liquid |
| EUR | iTraxx Europe Crossover | On-the-run | 51 months to 63 months | 4,194 | 64.52 | 62,267,692,367 | 957,964,498 | Liquid | Liquid |
| USD | CDX.NA.IG | 1x off-the-run | 51 months to 63 months | 1,045 | 16.08 | 52,149,519,000 | 802,300,292 | Liquid | Liquid |
| USD | CDX.NA.HY | 1x off-the-run | 51 months to 63 months | 2,114 | 32.35 | 38,877,651,929 | 598,117,722 | Liquid | Liquid |
| EUR | iTraxx Europe | On-the-run | 51 months to 63 months | 1,361 | 20.94 | 38,560,759,745 | 593,242,458 | Liquid | Liquid |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Senior Financials | | | | | | | | |
| EUR | iTraxx Europe | 1x off-the-run | 51 months to 63 months | 622 | 9.57 | 25,753,631,104 | 396,209,709 | Liquid | Liquid |
| USD | CDX.EM | On-the-run | 51 months to 63 months | 1,945 | 31.23 | 22,494,060,714 | 350,139,396 | Liquid | Liquid |
| EUR | iTraxx Europe Crossover | 1x off-the-run | 51 months to 63 months | 755 | 11.62 | 15,964,058,135 | 245,600,894 | Liquid | Liquid |
| USD | CDX.NA.IG | On-the-run | 63 months to 75 months | 199 | 3.06 | 9,387,857,143 | 144,428,571 | Liquid | Illiquid |
| EUR | iTraxx Europe | On-the-run | 63 months to 75 months | 254 | 3.91 | 8,492,289,508 | 130,650,608 | Liquid | Illiquid |
| EUR | iTraxx Europe Senior Financials | 1x off-the-run | 51 months to 63 months | 208 | 3.20 | 7,962,077,604 | 122,493,502 | Liquid | Illiquid |
| USD | CDX.EM | 1x off-the-run | 51 months to 63 months | 270 | 4.15 | 5,467,089,286 | 84,109,066 | Liquid | Illiquid |
| USD | CDX.NA.IG | On-the-run | 123 months to 135 months | 102 | 1.52 | 4,270,842,857 | 66,405,275 | Liquid | Illiquid |
| EUR | iTraxx Europe Sub Financials | On-the-run | 51 months to 63 months | 284 | 4.37 | 4,288,315,621 | 65,974,086 | Liquid | Illiquid |
| USD | iTraxx Asia ex-Japan IG | On-the-run | 51 months to 63 months | 340 | 5.23 | 2,996,574,286 | 46,101,143 | Liquid | Illiquid |
| EUR | iTraxx Europe Crossover | On-the-run | 51 months to 63 months | 133 | 2.05 | 2,832,700,653 | 43,580,010 | Liquid | Illiquid |
| EUR | iTraxx Europe | On-the-run | 123 months to 135 months | 66 | 1.02 | 2,818,090,298 | 43,355,235 | Liquid | Illiquid |
| USD | CDX.EM | On-the-run | 51 months to 63 months | 98 | 1.51 | 2,744,142,857 | 42,217,582 | Liquid | Illiquid |
| JPY | iTraxx Japan | On-the-run | 51 months to 63 months | 244 | 3.75 | 2,654,673,503 | 40,841,131 | Liquid | Illiquid |
| USD | MCDX.NA | On-the-run | 51 months to 63 months | 75 | 1.15 | 1,804,142,857 | 27,756,044 | Liquid | Illiquid |
| USD | iTraxx Australia | On-the-run | 51 months to 63 months | 99 | 1.52 | 1,360,714,286 | 20,934,066 | Liquid | Illiquid |
| USD | iTraxx Asia ex-Japan IG | 1x off-the-run | 51 months to 63 months | 67 | 1.03 | 1,263,571,429 | 19,439,560 | Liquid | Illiquid |

* Tenor has been expressed in months to reflect the use of the Market Recommended Tenor (i.e. ISDA's proposed amendments to paragraph 9.ii on page 235 of the addendum)

The above results, like ESMA's analysis are based on a very short sample period, so it is likely that the results may vary for a different sample set. With this in mind, we note that for the data set used, liquidity thresholds of 9 trades and EUR 200 million notional per day on the CFTC/DTCC data yield a result that accords with an identification of CDS indices that we believe are liquid. In recognition, however, of the fact that ESMA is also using a different dataset (i.e. European trade repository data) we do not propose specific liquidity thresholds. Rather, we urge ESMA to rerun its analysis of CDS indices using higher liquidity thresholds (which we expect to be similar in size to the liquidity thresholds used by ISDA in its analysis above) and we would expect that ESMA would find only the following CDS indices to be liquid:

1. The on-the-run CDX.NA.IG;
2. The on-the-run iTraxx Europe;

3. The on-the-run CDX.NA.HY;
4. The on-the-run iTraxx Europe Crossover;
5. The 1x off-the-run CDX.NA.IG;
6. The 1x off-the-run CDX.NA.HY;
7. The on-the-run iTraxx Europe Senior Financials;
8. The 1x off-the-run iTraxx Europe;
9. The on-the-run CDX.EM; and
10. The 1x off-the-run iTraxx Europe Crossover.

ISDA's members strongly assert that this outcome reflects the market understanding of liquidity in the CDS index market.

We would note that our proposal above includes some 1x off-the-run indices as liquid. This reflects the significant trading in these indices as a series rolls. However, we would like to draw ESMA's attention to our response to ESMA's May 2014 Discussion Paper, where we provided analysis to show that liquidity in the immediately off-the-run series drops significantly after the first 5 days of trading (please see our response to Q116 of the May 2014 Discussion Paper).

**(iv) CDS index option: ISDA's proposal**

ISDA members consider that, unlike ESMA's proposals for CDS index, ESMA's classification of CDS index options is not granular enough to ensure that each sub-class consists of homogeneous contracts that should be accorded similar liquidity treatment and LIS/SSTI thresholds. The consequence of this is that many CDS index options have been incorrectly labelled by ESMA as liquid, which, for the reasons set out in the sections above, may have significant liquidity and pricing consequences for end investors.

CDS index options are a very diverse class of derivatives, far more diverse than CDS index. We list below the major differences between CDS index options that could influence the liquidity of CDS index options and which could, therefore, be used as the basis of a taxonomy:

i. Currency.
ii. Underlying index.
iii. Tenor of underlier.
iv. Tenor of option.
v. Style of option exercise (e.g. American, European, cash settled, physically settled, binary, etc).
vi. Strike price.
vii. Day-count fractions.
viii. Other bespoke terms.

ESMA must, at the very least, incorporate (i) currency, (ii) the underlying index, (iii) the tenor of the underlier and (iv) the tenor of the option into its taxonomy. These are the critical elements for CDS index options, and we are concerned that ESMA has only incorporated element (i), (ii), and (iii). Elements (v) and (vi) are also relevant, although may be difficult to identify accurately and could therefore be compensated for through the use of higher liquidity thresholds (i.e. higher number of trades per day and notional per day) for CDS index options than for CDS index assuming that elements (i), (ii), (iii) and (iv) have been incorporated.

In order to derive homogenous CDS index options sub-classes, we therefore recommend that ESMA defines sub-classes for CDS index options using the following taxonomy:

- Currency.
- Underlying index.
- Tenor of underlier, classifying using the same classes used for CDS index.
- Tenor of option:
    - 1 month
    - 2 month
    - 3 month
    - 4 month
    - 5 month
    - 6 month – 1 year
    - Over 1 year

The table below illustrates that effect of incorporating option tenor into the criteria used to determine appropriate sub-classes. Even applying the very low liquidity thresholds proposed by ESMA (2 trades per day and EUR 100 million notional per day), the table shows that only a very small percentage of CDS index options are liquid when the option tenor is taken into account. Using ISDA's proposed liquidity thresholds (15 trades per day and EUR 500 million notional per day), no sub-classes of CDS index options are determined liquid. This is in-line with ISDA's members' experience of the CDS index option market – the market for these instruments is still evolving and is significantly less developed than for other types of CDS (a conclusion which is supported by the absence of any clearing offering for these instruments).

The table presents our analysis at this point in time, using the CFTC data available to ISDA, and does not attempt to produce any dynamic recalibration over time – it is therefore possible that the coverage ratios may change over time.

**Table 15: ESMA and CFTC/DTCC liquidity calibration**

**CDS options**

| | **Criteria** | **Calculation basis** | **Total number of sub-classes with at least one trade** | **Liquid sub-classes** | **Trades per day** | **Notional per day (M EUR)** | **%age of trades captured** | **%age of notional** |
|---|---|---|---|---|---|---|---|---|
| A | - Currency<br>- Index<br>- Index tenor | ESMA CP data | 28 | 10 | 2 | 100 | 94% | 98% |
| B | - Currency<br>- Index<br>- Index tenor | ESMA CP data | 28 | 3 | 15 | 500 | 62% | 73% |
| C | - Currency<br>- Index<br>- Index tenor<br>- Option tenor | CFTC/DTCC data with Market Recommended Tenor and Market Recommended On-the-run Definition | 51 | 3 | 2 | 100 | 32% | 32% |
| D | - Currency<br>- Index<br>- Index tenor<br>- Option tenor | CFTC/DTCC data with Market Recommended Tenor and Market Recommended On-the-run Definition | 51 | 0 | 15 | 500 | 0% | 0% |

Rows C and D of the table above have been prepared using the same criteria to determine sub-classes of CDS index options (in particular, they both incorporate option tenor as a relevant criterion). Row C, however, incorporates ESMA's proposed liquidity thresholds (2 trades per day and EUR 100 million notional per day) whilst Row D incorporates ISDA's proposed liquidity thresholds (15 trades per day and EUR 500 million notional per day). The application of ESMA's proposed liquidity thresholds would result in 3 sub-classes of CDS index options being found to be liquid. Using ISDA's proposed liquidity thresholds, however, would reduce the number of liquid sub-classes to zero. The table below illustrates this difference between ESMA's proposed liquidity thresholds and ISDA's recommended liquidity thresholds, when applied to sub-classes determined using option tenor as a relevant criterion:

**Table 16: A comparison of outcomes ESMA liquidity thresholds vs. ISDA recommended liquidity thresholds on CFTC/DTCC index option data with Market Recommended Tenor**

| Currency | Underlier Name | Underlier Tenor | Option Tenor | No. of trades | No. of trades per day | Notional amount | Notional amount per day | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | ESMA liquidity thresholds | ISDA liquidity thresholds |
| Notional Amount per day | | | | | | | | 100,000,000 | 500,000,000 |
| Num of trades per day | | | | | | | | 2.00 | 15.00 |
| | | | | | | | | | |
| USD | CDX.NA.IG | 5 years | 2 months | 241 | 3.71 | 14,725,714,286 | 226,549,451 | Liquid | Illiquid |
| USD | CDX.NA.IG | 5 years | 3 months | 189 | 2.91 | 12,531,428,571 | 192,791,209 | Liquid | Illiquid |
| USD | CDX.NA.HY | 5 years | 2 months | 187 | 2.88 | 7,956,428,571 | 122,406,593 | Liquid | Illiquid |

We would encourage ESMA to re-run its analysis using option tenor as a criterion to define sub-classes of CDS index options and apply ISDA's recommended liquidity thresholds of 15 days per day and EUR 500 million notional per day. ESMA has the data available to run this analysis from trade repository data and, for the reasons we highlight above, we would encourage ESMA to do this analysis to ensure that end investors are not negatively affected by CDS index options being incorrectly labelled by ESMA as liquid which may lead to significant pricing and liquidity consequences.

**(v) Package transactions**

***a) Overview***

ISDA would like to propose that ESMA considers specific and tailored treatment for package transactions as neither the December 2014 Consultation Paper or the Addendum address how these transactions might be treated under the new framework. In response to the May 2014 Discussion Paper, ISDA included a number of detailed comments on the nature of package transactions which we draw ESMA's attention to. We reiterate the points made in that response and put forward a proposal which we hope ESMA will find workable and flexible enough to apply for venue and SI transparency obligations and the derivatives trading obligation. This will preserve the market for package transactions and ensure that pricing and liquidity is not negatively impacted for end investors.

We believe that Level 1 is flexible enough to empower ESMA to specify how package transactions are treated in order to determine if such transactions are liquid or "traded on a trading venue" (both for determining whether transparency obligations apply as well as determining whether the derivatives trading

obligation applies). The Level 1 text clearly sets the foundation for the pre- and post-trade transparency regimes in non-equities by defining the asset classes – "bonds, structured finance products, emission allowances and derivatives" – on which the Level 2 measures must be built. However, ESMA has flexibility to define how, within these broad asset classes, to identify whether specific financial instruments (or combinations thereof) are to be considered "liquid" or "traded on a trading venue". ESMA has chosen to adopt COFIA as the basis for determining whether a liquid market exists – which suggests to us that ESMA is also empowered to tailor this approach to instruments which fall within one of the specified classes, but are part of a package transaction.

***b) Advantages of package transactions to clients***

Package transactions allow clients to reduce their transaction costs (i.e. a single transaction is less expensive to execute than multiple transactions) and manage their execution risk (i.e. a single execution alleviates timing and other mechanical/process type risks). They are tailored to provide risk-return characteristics in the form of a single transaction in an efficient and cost-effective manner to clients.

***c) Challenges to trading package transactions without a tailored proposal***

Below are some very realistic fact patterns which hopefully demonstrate that unless there is tailored treatment for package transactions which recognises that package transactions should be considered in their entirety when being assessed as subject to transparency requirements and/or the derivatives trading obligation, there is a significant risk that such transactions may no longer be available to clients in the EU. This will be due to the individual components being treated differently and inconsistently vs. each other when they are assessed against the relevant requirements which would negate the advantages highlighted above of trading package transactions. These challenges are likely to be particularly acute where one or more of the components of a package transaction includes derivatives subject to the trading obligation:

- If some components of a package transaction are traded on a trading venue but others are not.
- If some components of a package transaction are deemed liquid but others are not.
- If some components of a package transaction are above the relevant LIS or SSTI thresholds but others are not.
- If the components of a package transaction are below the relevant LIS or SSTI thresholds but together they behave similarly to a single transaction above the LIS or SSTI.
- If the package transaction contains a listed derivative which trades on a different trading venue to other components.

If ESMA fails to provide for the appropriate trading of packages, end investors will be required to trade the components independently, resulting in increased transaction costs and increased execution risks, which would seem to conflict with ESMA's policy objectives.

***d) ISDA proposal***

We would be keen to assist ESMA with the development of a workable regime for package transactions. We consider that the following proposals could both address the challenges we have described above. We have provided both proposals for ESMA's consideration as we recognise that, whilst Option 1 is a simpler proposal, Option 2 is more accurate.

<u>Option 1:</u>

1. Subject to point 3 below, if each component of a package transaction is liquid:

a. The package transaction should be considered liquid; and

b. If any one component is above the relevant threshold (LIS or SSTI) then the package transaction should be deemed to be above the threshold.

2. Subject to point 3 below, if the package transaction contains liquid and illiquid components:

a. The package transaction should be considered illiquid; and

b. If any one component is above the relevant threshold (LIS or SSTI) then the package transaction should be deemed to be above the threshold.

3. For the purposes of MiFIR Articles 8(1), 10(1), 18(1) and 18(2), all components of a package have to be tradable on a single venue in order for the package be considered "traded on a venue".

4. If the package transaction comprises ten or more component legs, the package transaction should be considered illiquid.

If ESMA, for pre- and post-trade transparency purposes, would prefer to represent this in a table format, we propose the following table which reflects the above.

**Table 17: ISDA Proposal for the calibration of Package Transactions for liquidity, Large in Scale, and Size Specific to the Instrument thresholds.**

| Type | Package type comprising: | Example | 1. All components above LIS | 2. All components above SSTI | 3. At least one component above LIS | 4. At least one component above SSTI | 5. All components below LIS | 6. All components below SSTI |
|---|---|---|---|---|---|---|---|---|
| A | Exclusively liquid derivatives in one derivative asset class[1] | Spread of CDX.NA.IG vs. ITraxx Europe | Package is above LIS and liquid | Package is above SSTI and liquid | Package is above LIS and liquid | Package is above SSTI and liquid | Package is below LIS and liquid | Package is below SSTI and liquid |
| B | Exclusively liquid securities | 2yr vs 10yr Bund switch* | Package is above LIS and liquid | Package is above SSTI and liquid | Package is above LIS and liquid | Package is above SSTI and liquid | Package is below LIS and liquid | Package is below SSTI and liquid |
| C | Liquid security(ies) and derivative(s) where the derivatives are from a single asset class[1] | CDS basis trade (CDS vs. liquid sovereign bond) | Package is above LIS and liquid | Package is above SSTI and liquid | Package is above LIS and liquid | Package is above SSTI and liquid | Package is below LIS and liquid | Package is below SSTI and liquid |
| D | Liquid & illiquid security(ies) and derivative(s) where the derivatives are from a single asset class[1] | CDS basis trade (CDS vs. illiquid sovereign bond) | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is below LIS and not liquid | Package is below SSTI and not liquid |
| E | Liquid derivative(s) & any liquid exchange traded derivative(s) in the same derivative asset class [1] | EFP transaction of swap vs. future* | Package is above LIS and liquid[2] | Package is above SSTI and liquid[2] | Package is above LIS and liquid[2] | Package is above SSTI and liquid[2] | Package is below LIS and liquid[2] | Package is below SSTI and liquid[2] |
| F | Liquid security(ies) & any liquid exchange traded derivative(s) in the same derivative asset class [1] | Cash bund vs. Bund future basis trade* | Package is above LIS and liquid[2] | Package is above SSTI and liquid[2] | Package is above LIS and liquid[2] | Package is above SSTI and liquid[2] | Package is below LIS and liquid[2] | Package is below SSTI and liquid[2] |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| G | Exclusively illiquid security(ies) or derivative(s) | Spread trade between two 10yr sovereign CDS | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is above LIS and Not liquid | Package is above SSTI and Not liquid | Package is below LIS and not liquid | Package is below SSTI and not liquid |
| H | 10 or more components | Package of several CDS bundled for execution | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is below LIS and not liquid | Package is below SSTI and not liquid |

[1] Interest Rate Derivatives, FX Derivatives, Commodity Derivatives, Equity Derivatives, Credit Derivatives etc considered as distinct derivative asset classes.

[2] Assuming that ESMA agrees that, for the purposes of MiFIR articles 8(1), 10(1), 18(1) and 18(2), all components of a package have to be tradable on a single venue in order that the package be considered "traded on a venue". Otherwise, ESMA should deem packages including exchange traded derivatives to be not liquid. ISDA recommends that packages involving exchange traded derivatives should be executed using the wholesale trading facilities currently governed by venues' rulebooks

* These scenarios are not directly relevant for credit derivatives (in the cases of E & F this is because there are no exchange traded credit derivatives at the time of writing). But we have left them in the table for completeness.

Option 2:

1. Subject to point 3 below, if each component of a package transaction is liquid:

   a. The package transaction should be considered liquid; and

   b. The percentage threshold for each individual component in a package transaction is equal to the notional of the relevant component expressed as a percentage of its relevant threshold (LIS or SSTI). If the sum of the percentage thresholds for all components in the packaged transaction is above 100%, then the package transaction (and each of its components) is above the relevant threshold (LIS or SSTI). See below for a more detailed explanation of the percentage threshold approach.

2. Subject to point 3 below, if the package transaction contains liquid and illiquid components:

   a. The package transaction should be considered illiquid; and

   b. The percentage threshold for each individual component in a package transaction is equal to the notional of the relevant component expressed as a percentage of its relevant threshold (LIS or SSTI). If the sum of the percentage thresholds for all components in the package transaction is above 100%, then the package transaction (and each of its components) is above the relevant threshold (LIS or SSTI). See below for a more detailed explanation of the percentage threshold approach.

3. For the purposes of MiFIR Articles 8(1), 10(1), 18(1) and 18(2), all components of a package have to be tradable on a single venue in order for the package be considered "traded on a venue".

4. If the package transaction comprises ten or more component legs, the package transaction should be considered illiquid.

The percentage threshold approach aims to, in a simple manner, replicate the package of instruments into a single instrument to test whether it would indeed be above the threshold (SSTI or LIS purposes) or not if it were traded as a single instrument.

The example below was prepared in the context of interest rate derivatives, but the same principles are applicable to credit derivatives.

Example: if an investor wishes to hedge cash flows at 5-year and 15-year points using EUR interest rate swaps, to create an accurate hedge the investor would trade a package of two EUR swaps at 5-year and 15-year maturities. Alternatively, the investor could enter into a single swap with an average 10-year maturity to try to replicate the risk profile but with less accuracy.

However, whilst the individual swaps in the package of swaps could each be below the relevant threshold, the equivalent single swap would have a larger notional and could therefore be above the threshold, as illustrated below. Given the 5-year and 15-year swaps are economically similar in nature, the pricing of one swap is likely to impact the pricing of the other. By not recognising this, ESMA could create an incentive for the market to trade in the equivalent single average instruments, rather than the package of instruments that provide a more accurate hedge: the result would be to provide a less perfect hedge, thereby retaining risk in the system.

The suggested percentage threshold approach provides a way to calibrate this and ensures that package transactions are not disproportionately disadvantaged.

The below table illustrates the example described above.

**Table 18: Example of how the percentage threshold approach (Option 2) operates**

| | **More accurate hedge** | | **Less accurate hedge** |
|---|---|---|---|
| | **EUR 5yr swap** | **EUR 15yr swap** | **EUR 10yr swap** |
| Notional | 60m | 60m | 120m |
| Threshold (SSTI or LIS) | 100m | 100m | 100m |
| Percentage Threshold | 60% | 60% | 120% |

Table 17, prepared for Option 1, could easily be adapted for Option 2.

***e) Safeguarding against avoidance***

ISDA is aware that ESMA and national competent authorities may be concerned that adoption of our proposal may lead to market participants creating packages of instruments purely for the purposes of avoiding the transparency regime or the derivatives trading obligation. ISDA recognises these concerns and suggests that this could be achieved by defining a package and including, within the MiFID II/MiFIR framework, a mechanism that would support the monitoring (and therefore supervision) of the trading of packages. ISDA would welcome the opportunity to discuss these safeguards with ESMA in more detail.

<u>1. Definition of package transaction</u>

ISDA recommends that a "package transaction" be defined as a transaction comprising two or more components, each of which is a *bond, structured finance product, emission allowance or derivative* where:

(i) The components are priced as a "package" with simultaneous execution of all such components;

(ii) The execution of each component is contingent on the execution of the other components;

(iii) Each component must be able to stand alone and must be able to bear economic risk; and

(iv) Either:

i. the components are economically similar in nature such that the pricing of one component can affect the pricing of the other component; or

ii. the components must have a reasonable degree of correlation.

2. Post-trade transparency flag

With a view to assisting the monitoring of package transactions by supervisors, and as stated in our response to Question 74 of the December 2014 Consultation Paper, ISDA recommends that an additional flag to be reported on trades that are components of package transactions be added to the list of flags set out in Table 2 of Annex II of RTS .

We would also draw attention to our response to Question 218 of the December 2014 Consultation Paper where we suggest that ESMA may wish to consider including a "link ID" field in transaction reports (for the purposes of the Article 26 MiFIR transaction reporting regime). In ISDA's response to ESMA's recent consultation paper on the review of reporting technical standards under EMIR, we recommended the inclusion of a "link ID" field to link together trade reports of components of the same package. ESMA may wish to consider whether to incorporate such a field in the transaction reports required under the MiFIR transaction reporting regime as this would give supervisors greater visibility in respect of the usage of package transactions.

**(vi) ISDA's comments on the application of the trading obligation to CDS index and CDS index options**

We note that ESMA, in the Addendum, has not asked for comments on the application of the trading obligation to credit derivatives. However, we would like to reiterate a number of points made in our response to the December 2014 Consultation Paper.

***a) Criteria for determining whether derivatives should be subject to the trading obligation***

It is imperative that the assessment of whether there is "*sufficient third-party buying and selling interest in the class of derivatives or subset so that such a class of derivatives is considered sufficiently liquid to trade only on venues*", takes into account all variables which may impact the liquidity and tradability of an instrument and the assessment must therefore be conducted at a suitably granular level. If this approach is not followed then there is a risk that a derivative product which is insufficiently standardised and which cannot be traded on venue or in which there insufficient third-party buying and selling interest will be declared subject to the trading obligation.

We therefore support ESMA's view that option 2 (as set out on page 126 of the December 2014 Consultation Paper) is preferred and that ESMA should distinguish between benchmark or integer tenors and broken dates and note that adoption of option 2 would help to align MiFID II/MiFIR to US regulation (since the CFTC MAT product set only contains integer tenors and a limited number of forward-starting USD swaps). However, we would reiterate that there are likely to be a number of other parameters which will determine whether a derivative can be traded on a trading venue and the liquidity of the relevant derivative.

It is therefore necessary for the sub-classes which are determined for the purpose of the liquidity assessment to be set at a granular level or (at a minimum) that the relevant "certain size" is set at a low level to reflect the fact that the liquidity assessment does not reflect the relevant parameters.

In addition, with regards to the average frequency of trades, we would note that a sub-class of derivatives should not be made subject to the trading obligation unless it trades every day during the assessment period.

Furthermore, we would highlight that in determining whether a sub-class of derivatives should be made subject to the trading obligation, ESMA is also required to "*take into consideration the anticipated impact that trading obligation might have on the liquidity of a class of derivatives or a relevant subset thereof and the commercial activities of end users which are not financial entities*" (Article 32(3) of MiFIR). In this regard, we note that ISDA's research indicates that a failure to align trading mandates on a cross-border basis has a demonstrable impact on market liquidity (see footnote 88 and Market Fragmentation: An ISDA Survey (December 2013); and Made-Available-to-Trade (MAT): Evidence of Further Market Fragmentation (April 2004); available at http://www2.isda.org/functional-areas/research/research-notes/) and underlines the importance of global harmonisation of trading obligations.

***b) Transactions below a certain size***

With respect to the assessment of whether a class of derivatives is only sufficiently liquid in transactions below a certain size, we agree with ESMA that whilst the methodology for establishing the "certain size" should be consistent with methodology establishing the LIS thresholds, the thresholds themselves may not always be identical. However, in our view it would not be appropriate to set the "certain size" at a level higher than the LIS. We therefore agree with (i) those respondents to ESMA's discussion paper that noted there is unlikely to be sufficient liquidity for trading platforms to support LIS transactions – i.e. once a transaction in an instrument is large in scale, it is no longer liquid – and (ii) the CFTC approach whereby block trades can be executed off-venue.

Accordingly, when establishing the "certain size" for a class or sub-class of derivatives, we would encourage ESMA to use the LIS as its starting point and to conduct a further liquidity assessment to determine whether the threshold should be reduced in light of the specific liquidity profile of the relevant class or sub-class.

**(vii) ISDA's comments on the definitions applicable to CDS Index, Bespoke basket CDS, CDS index options and Single name CDS options**

We would recommend the following amendments to the definitions in Section 7 of Annex III of RTS 9:

- The more commonly used term for CDS index is "index CDS". Therefore, we would recommend that ESMA make this change in all relevant definitions in Section 7 of Annex III of RTS 9.
- The proposed definition of 'CDS' or 'credit default swap' should be deleted and replaced by separate definitions for 'Single name CDS', 'Index CDS' and 'Bespoke basket CDS'. We would recommend the following definition of 'Index CDS' should be added, as follows:

  'Index CDS' or 'index credit default swap' means a swap whose exchange of cash flows is linked to a regularly published index relating to the creditworthiness of several issuers of financial instruments.

- The proposed definition of 'CDS' or 'credit default swap' should be deleted and replaced by separate definitions for 'Single name CDS', 'Index CDS' and 'Bespoke basket CDS'. We would recommend the following definition of 'Bespoke basket CDS' should be added, as follows:

  'Bespoke basket CDS' or 'bespoke basket credit default swap' means a swap, whose exchange of cash flows is linked to the creditworthiness of several issuers of financial instruments, which is not a index CDS.

- It is vital that RTS 9 provides an exhaustive taxonomy to ensure that all derivatives can be appropriately classified for the purposes of the MiFIR transparency regime. If ESMA fails to provide an exhaustive taxonomy, it is possible that some derivatives will be subject to the MiFIR transparency requirements (because they are traded on a trading venue) but NCAs will be unable to grant a waiver from pre-trade transparency requirements or a deferral from post-trade transparency requirements for these instruments because ESMA has not provided a liquidity determination or set LIS or SSTI thresholds. This may have a significant impact on the liquidity of these instruments. To ensure that all credit derivatives are provided with a liquidity determination and appropriate LIS and SSTI threshold, it is necessary to include a new definition of "Other credit derivative'. Given the heterogeneity of derivatives in this class, we would expect it to be considered illiquid.

  We would recommend the following definition:

  'Other credit derivative' means a derivative instrument for the transfer of credit risk or a derivative contract relating to credit risk which is not an index CDS, single name CDS, bespoke basket CDS, CDS index option or a single name CDS option.

- As mentioned above, the definition of 'On-the-run status' should be amended, as follows:

  'On-the-run status' means the ~~period beginning 5 days before the date on which the~~ rolling most recent version (series) of the index created on the date on which the composition of the index is effective and ending ~~30 days after~~ one day prior to the date on which the composition of the next version (series) of the index is effective.

- As mentioned above, a definition of '1x off-the-run status' should be added, as follows:

  '1x off-the-run status' means the version (series) of the index which is immediately prior to the current 'on-the-run' version (series) at a certain point in time. A version (series) ceases being 'on-the-run' and acquires its '1x off-the-run' status when the latest version (series) of the index is created.

We also believe that it is necessary to introduce an "all other derivatives category" which would capture any derivatives that either:

- Do not fall within one of the specified asset classes (e.g. are not interest rate, equity, commodity, foreign exchange, credit etc derivatives classes). An example of a derivative that would fall within this first category is a derivative with an underlier such as financial indices or financial measures (which are listed in Annex 1, Section C (4) of MiFIDII).

- Have multiple underliers, such that they can fall within multiple classes. Complex derivatives which have multiple underliers should be assigned to the "all other derivatives category" as otherwise it is possible that different trading venues and investment firms may assign them to different asset classes. This could be significant if the different underliers have different liquidity determination or SSTI/LIS thresholds.

➢ ***Pre-trade and Post-trade transparency requirements for non-equity instruments***

**Q5. Do you agree with ESMA's proposal for credit derivatives? Please specify, for each sub-class (single name CDS, CDS index, bespoke basket CDS, single name CDS options, CDS index options) if you agree on the following points providing reasons for your answer and, if you disagree providing ESMA with your alternative proposal:**

**(1) deferral period set to 48 hours**

**(2) size specific to the instrument threshold set as 50% of the large in scale threshold**

**(3) volume measure used to set the large in scale and size specific to the instrument threshold as specified in Annex II, Table 3 of draft RTS 9**

**(4) pre-trade and post-trade thresholds set at the same size**

**(5) large in scale thresholds: (a) state your preference for the system to set the thresholds (i.e. annual recalculation of the thresholds vs. no recalculation of the thresholds) (b) in the case of a preference for a system with no recalculation (i.e. option 1), provide feedback on the thresholds determined. In the case of a preference for a system with recalculation (i.e. option 2), provide feedback on the thresholds determined for 2017 and on the methodology to recalculate the thresholds from 2018 onwards including the level of granularity of the classes on which the recalculations will be performed.**

The calibration of appropriate LIS and SSTI thresholds is essential to compensate for inadequacies elsewhere in the liquidity analysis. We have expressed, in our responses to Question 3 and Question 4, our concerns that ESMA has conducted its analysis on sub-classes of credit derivatives that are far too heterogeneous to produce accurate liquidity determinations. The LIS and SSTI thresholds must be set at a sufficiently low level to compensate for these incorrect liquidity determinations, otherwise there will be significant liquidity and pricing consequences for market participants, including end-investors.

**(i) 48 hours deferral – all credit derivatives**

No, ISDA does not agree with ESMA's proposals. While we welcome ESMA's proposal to extend the length of the deferral period for transactions that are equal to or exceed LIS, equal to or exceed SSTI (if carried out on own account other than matched principal) and in illiquid instruments, we recommend that the deferral period be set at two business days. This is to ensure that transactions that occur close to the end of trading before a weekend/bank holiday get the full benefit of the deferral period (which they may otherwise not if the 48 hour period runs over the weekend).

As we argued in our response to the May 2014 Discussion Paper, the duration of volume masking is critical. If ESMA does not accept our proposal in answer to Question 83 of the December 2014 Consultation Paper (that a 12-week supplementary deferral period is required for volume omission in respect of trades which are both illiquid and LIS), then we would urge ESMA to extend the post-trade deferral period to at least seven days for trades that are both illiquid and LIS. If a longer supplementary deferral period is permitted for volume omission, in line with our proposal in answer to Question 83 of the December 2014 Consultation Paper, we would recommend that ESMA permits NCAs that do not adopt the supplementary deferral regime (which is within the discretion of NCAs) to allow a post-trade deferral period of at least seven days for trades that are both illiquid and above LIS.

Even two business days may be challenging for certain types and sizes of transactions and especially so if the LIS and SSTI thresholds are not appropriately calibrated in the final rules. This challenge will be significantly worsened if NCAs do not implement the supplemental volume omission regime. While we appreciate that it is within the discretion of individual NCAs to determine whether to implement a supplemental volume omission deferral regime, ISDA urges ESMA to try and encourage as many NCAs as possible to adopt this regime.

**(ii) LIS and SSTI thresholds – CDS index**

It is essential that the LIS and SSTI thresholds are appropriately calibrated to ensure that end investors can continue to transact in large trade sizes. Requiring disclosure of large trades without appropriate deferrals will lead to a widening of bid-offer spreads, having a detrimental impact on investors wishing to trade at these large sizes.

Given the importance of setting the LIS threshold at the correct level, ISDA's members have significant concerns about the data used by ESMA to calculate LIS thresholds. For CDS index, we have been able to compare the 90$^{th}$ percentile found by ESMA using its data against the 90$^{th}$ percentile found by ISDA using

CFTC/DTCC data. The table below sets out our analysis and clearly shows that ESMA's proposed LIS thresholds for CDS index are significantly larger than the 90th percentile found using CFTC/DTCC data. It is not clear to ISDA's members why there should be such a large discrepancy between European trade repository data and the CFTC/DTCC data. We would, therefore, urge ESMA to re-run its analysis.

**Table 19: CDS Index LIS analysis based on CFTC/DTCC data , on-the-run contracts only**

**Notional amounts expressed in Euros (exchange rate of 1.4 EUR/USD)**

| Index | Tenor | Currency | Total trade count | 90th %tile | Max | ESMA LIS | ESMA vs. Market |
|---|---|---|---|---|---|---|---|
| iTraxx Europe | 3 years | EUR | 46 | 146,932,058 | 149,037,214 | 900,000,000 | 6:1 |
| iTraxx Europe | 4 years | EUR | 3 | 139,101,400 | 139,101,400 | 1,350,000,000 | 10:1 |
| iTraxx Europe | 5 years | EUR | 5101 | 78,492,933 | 87,435,166 | 250,000,000 | 3:1 |
| iTraxx Europe | 7 years | EUR | 7 | 59,614,886 | 59,614,886 | 100,000,000 | 2:1 |
| iTraxx Europe | 8 years | EUR | 1 | 79,486,514 | 79,486,514 | 375,000,000 | 5:1 |
| iTraxx Europe | 10 years | EUR | 66 | 92,802,841 | 94,390,236 | 175,000,000 | 2:1 |
| iTraxx Europe | 11 years | EUR | 3 | 99,358,143 | 99,358,143 | 350,000,000 | 4:1 |
| CDX.NA.IG | 3 years | USD | 8 | 142,857,143 | 142,857,143 | 1,650,000,000 | 12:1 |
| CDX.NA.IG | 4 years | USD | 2 | 142,857,143 | 142,857,143 | 850,000,000 | 6:1 |
| CDX.NA.IG | 5 years | USD | 7621 | 78,571,429 | 78,571,429 | 300,000,000 | 4:1 |
| CDX.NA.IG | 7 years | USD | 8 | 78,571,429 | 78,571,429 | 3,250,000,000 | 41:1 |
| CDX.NA.IG | 8 years | USD | 3 | 78,571,429 | 78,571,429 | 100,000,000 | 1:1 |
| CDX.NA.IG | 10 years | USD | 102 | 92,857,143 | 92,857,143 | 100,000,000 | 1:1 |
| CDX.NA.IG | 11 years | USD | 7 | 92,857,143 | 92,857,143 | 100,000,000 | 1:1 |
| iTraxx Europe Crossover | 5 years | EUR | 4194 | 34,775,350 | 79,486,514 | 50,000,000 | 1:1 |
| iTraxx Europe Crossover | 7 years | EUR | 12 | 19,745,286 | 19,745,286 | 25,000,000 | 1:1 |
| iTraxx Europe Crossover | 10 years | EUR | 3 | 7,898,114 | 7,898,114 | 100,000,000 | 13:1 |
| iTraxx Europe Senior Financials | 5 years | EUR | 1361 | 75,512,189 | 85,448,003 | 425,000,000 | 6:1 |
| iTraxx Europe Senior Financials | 10 years | EUR | 4 | 17,884,466 | 17,884,466 | 100,000,000 | 6:1 |
| CDX.NA.HY | 3 years | USD | 3 | 71,428,571 | 71,428,571 | 375,000,000 | 5:1 |
| CDX.NA.HY | 5 years | USD | 8383 | 35,714,286 | 78,571,429 | 100,000,000 | 3:1 |
| CDX.EM | 5 years | USD | 1945 | 25,000,000 | 78,571,429 | 50,000,000 | 2:1 |
| iTraxx Japan | 5 years | JPY | 244 | 21,141,053 | 77,517,194 | 100,000,000 | 5:1 |
| iTraxx Asia ex-Japan IG | 5 years | USD | 340 | 21,428,571 | 78,571,429 | 100,000,000 | 5:1 |
| iTraxx Australia | 5 years | USD | 99 | 35,714,286 | 71,428,571 | 100,000,000 | 3:1 |
| iTraxx CEEMEA | 5 years | USD | 22 | 27,142,857 | 35,714,286 | 100,000,000 | 4:1 |
| MCDX.NA | 5 years | USD | 75 | 42,857,143 | 78,571,429 | 100,000,000 | 2:1 |
| MCDX.NA | 10 years | USD | 28 | 28,571,429 | 92,857,143 | 100,000,000 | 4:1 |
| iTraxx Europe HiVol | 5 years | EUR | 3 | 9,935,814 | 9,935,814 | 100,000,000 | 10:1 |
| iTraxx Europe Sub Financials | 5 years | EUR | 284 | 39,743,257 | 79,486,514 | 100,000,000 | 3:1 |

As set out in our response to the December 2014 Consultation Paper, ISDA is of the view that the LIS should be recalibrated on a dynamic basis. However, we do not endorse Option 2 as currently constructed. In particular, we disagree with:

- Criterion 2 (the proposed volume measure). The determination of whether a transaction is large compared to market size should not be conflated with the volume of trading in that market and instead can be derived from the distribution of trade sizes alone. The volume measure would appear to be policy driven, without any basis in a natural reading of transactions that are large compared to normal market size.
- Criterion 3 (the proposed threshold floor). We disagree with ESMA's proposal to include a "floor" in option 2 once annual recalibration commences after 2017. In our view, this is an arbitrary device intended to result in an extra-large number that is inconsistent with the definition of a large in scale transaction in MiFIR.

Therefore, we recommend using only the percentile of trades to calibrate the LIS (i.e. Criterion 1).

As indicated in our response to Question 4 above, we believe that only the indices listed in the table below are liquid. For each of these CDS indices, we present the 90$^{th}$ percentile of trades using the CFTC/DTCC data. ISDA's members believe that the CFTC/DTCC data provides a more accurate reflection of the 90$^{th}$ percentile of trades than those presented by ESMA in Section 7 of Annex III of the RTS. Should ESMA re-run its analysis for CDS indices, as we have recommended above, we would expect ESMA to find LIS thresholds more in line with the figures set out below for each CDS index.

It is important to note, however, that while the percentile notional for some off-the-run indices is higher than the on-the-run equivalent, this is due to trading style factors such as aggregating a position to roll into the on-the-run and relative trades that off-set between an on-the-run and an off-the-run index. These factors point to the percentile of the on-the-run index being the appropriate cap for that index given the reduced liquidity of the off-the-run. The same considerations apply to tenors other than the 5 year where, for example, curve trades are a common strategy.

**Table 20: CDS index analysis based on CFTC/DTCC data**

**for contracts assessed as liquid using liquidity thresholds of 9 trades per day and EUR 200 million per day**

**Notional amounts expressed in Euros (exchange rate of 1.4 EUR/USD)**

| Index | Tenor | Currency | Total trade count | 50$^{th}$ %tile | 10% of 90$^{th}$ %tile | 90$^{th}$ %tile | Max | On/off the run |
|---|---|---|---|---|---|---|---|---|
| iTraxx Europe | 5 years | EUR | 5,101 | 24,839,536 | 7,849,293 | 78,492,933 | 87,435,166 | On-the-run |
| CDX.NA.IG | 5 years | USD | 7,621 | 35,714,286 | 7,857,143 | 78,571,429 | 78,571,429 | On-the-run |
| iTraxx Europe Crossover | 5 years | EUR | 4,194 | 9,935,814 | 3,477,535 | 34,775,350 | 79,486,514 | On-the-run |
| iTraxx Europe Senior Financials | 5 years | EUR | 1,361 | 23,845,954 | 7,551,219 | 75,512,189 | 85,448,003 | On-the-run |
| CDX.NA.HY | 5 years | USD | 8,383 | 7,142,857 | 3,571,429 | 35,714,286 | 78,571,429 | On-the-run |
| CDX.EM | 5 years | USD | 1,945 | 7,142,857 | 2,500,000 | 25,000,000 | 78,571,429 | On-the-run |
| CDX.NA.HY | 5 years | USD | 2,114 | 10,714,286 | 3,571,429 | 35,714,286 | 78,571,429 | 1x off-the-run |
| CDX.NA.IG | 5 years | USD | 1,045 | 53,571,429 | 7,857,143 | 78,571,429 | 78,571,429 | 1x off-the-run |
| iTraxx Europe | 5 years | EUR | 622 | 26,826,699 | 7,948,651 | 79,486,514 | 79,486,514 | 1x off-the-run |
| iTraxx Europe Crossover | 5 years | EUR | 755 | 12,916,559 | 5,464,698 | 54,646,979 | 72,531,444 | 1x off-the-run |

ISDA disagrees with ESMA's proposed SSTI thresholds for credit derivatives and, more fundamentally, its proposed methodology for calibrating the SSTI. In particular, the proposed SSTI thresholds set out in Tables

60 to 67 of Section 7 of Annex III of RTS 9 are too high and do not reflect the normal trading size in the market.

We believe that the proposal to set the SSTI threshold at 50% of the LIS threshold is arbitrary – there is no rationale for choosing 50% (as opposed to another percentage) and its link to the LIS threshold means that the SSTI threshold is unlikely to result in 50% of trades in a sub-class actually falling below the SSTI threshold. Use of a 50% ratio does not appear to have factored in the elements required by MiFIR under Article 9(5)(d), specifically whether liquidity providers are able to hedge their risks, and the extent of retail participation (although we recognise the practical challenges of incorporating these factors).

Furthermore, as ESMA seems to view the waiver and deferral regimes as a way to reduce the detrimental impact of an illiquid instrument being incorrectly assessed as liquid, we urge ESMA to ensure that the LIS and SSTI thresholds are set at levels sufficiently low in order to compensate for inaccuracies in the liquidity calibration.

We propose instead that the SSTI threshold should be set at either:

- The median trade size (50$^{th}$ percentile of transaction sizes) for transactions in the relevant sub-class, or
- 10% of the LIS threshold for the relevant sub-class (if ESMA prefers to retain a method based on the percentage of LIS).

Using CFTC/DTCC data, the table above shows both the median trade size and 10% of the LIS threshold for each CDS index regarded as liquid by ISDA members.

The appeal of using the median size is that ESMA can be sure that half of the transactions in any liquid sub-class would be subject to pre-trade transparency, and would not experience deferred publication. We consider it would accord better with a normal market transaction at which liquidity providers could be reasonably expected to hedge their risks (as per MiFIR Article 9(5)(d)). Furthermore, breaking the link to LIS would prevent the SSTI being skewed by individual, large transactions (which could result under ESMA's current proposal for LIS calibration).

For the following reasons, it is most important that ESMA adopt our recommendations for the pre-trade SSTI (although we encourage ESMA to also consider doing so for the post-trade SSTI):

- The risks to firms are more significant in the pre-trade context; a firm is putting its capital at risk and pre-trade disclosure of its quoted prices increases the possibility that the market will move against the firm before it is able to execute those transactions. This would lead firms to price-in these risks resulting in worse pricing for end investors.
- A 50% SSTI ratio would only permit a SI to undertake two trades before taking on risk equivalent to a large in scale transaction. If the policy objective is to encourage SIs to make their quotes available to and executable by several clients, then setting the SSTI threshold at a level which takes into account multiple transactions and still allows a given quote to be maintained would enable ESMA to achieve such an objective.

The risk is of a different nature in the post-trade context. At this stage, the firm has already committed its capital. The risks it faces at this stage relate to the management of its exposure (i.e. its ability to conduct a successful hedging strategy). However, again, if the ratio is set too high for post-trade purposes, the risks the systematic internaliser faces in managing its hedging strategy in relation to certain products will be reflected in wider prices being quoted to clients.

**(iii) LIS and SSTI thresholds – single name CDS and CDS index options**

In paragraph 35 on page 100 of the December 2014 Consultation Paper, ESMA states that it "is aware of the risks that might arise from COFIA. Therefore ESMA intends to design it with an appropriate level of

granularity and will strive to remedy the weakness. In particular, if some relatively illiquid instrument happens to be wrongly classified as liquid, it is important that the potential adverse impact on liquidity is mitigated by means of the waivers and deferrals for transactions that are large-in-scale (LIS) or above the size specific to the instrument (SSTI)."

ISDA's members agree that, where sub-classes are not defined with sufficient granularity, the LIS and SSTI thresholds can be used to mitigate the potential impact on liquidity provided they are set at an appropriately low level. Therefore, the percentile level used for the LIS threshold should vary according to the homogeneity of the class in order to compensate for inaccuracies in the liquidity determination. For homogenous classes of financial instruments (such as CDS indices), the proposed LIS threshold of the 90th percentile of transaction size is appropriate. However, for less homogenous classes, the LIS threshold should be lower than the 90th percentile of transaction size, in order to compensate for the lack of granularity in the composition of the class.

If ESMA rejects our proposals (set out in our responses to Question 3 and Question 4 above) for a more granular assessment of the single name CDS and CDS index option classes, we recommend that lower LIS and SSTI thresholds are set to compensate for the inaccuracies in the liquidity assessment. We recommend that:

- The LIS threshold should be set at the 50th percentile of transaction sizes for the relevant sub-class; and
- The SSTI threshold should be set at either:
    - The 25th percentile of transaction sizes for the relevant sub-class; or
    - 10% of the LIS threshold for the relevant sub-class (if ESMA prefers to retain a method based on the percentage of LIS).

**(iv) Volume measure used to set the LIS and SSTI thresholds – all CDS**

We agree with the proposed use of "notional amount of traded contracts" as the appropriate volume measure for credit derivatives.

**(v) Other recommendations**

The LIS and SSTI thresholds in all of the tables in section7 (credit derivatives) of Annex III should be defined in local currency terms rather than Euro (since the need to apply a currency conversion results in an additional layer of complexity, and results in inflexibility as exchange rates move).

ESMA should correct its proposed rounding method which systematically rounds the LIS and SSTI thresholds higher. Instead, ESMA should adopt simple mathematical rounding to the nearest round number. In other words, Paragraph 3 of Article 11 of RTS 9 should be amended to "The threshold determined in accordance to paragraph (2) shall be rounded ~~up~~ to the ~~next~~ nearest:".

ESMA should ensure that the level of the LIS threshold is consistent for derivatives that have comparable economic terms but are transacted in different forms and ESMA should ensure that the LIS threshold are set consistently, and at a sufficiently low level, for all illiquid classes regardless of which asset class they fall into.

**(vi) Package transactions**

***a) Overview***

ISDA would like to propose that ESMA considers specific and tailored treatment for package transactions as neither the December 2014 Consultation Paper or the Addendum address how these transactions might be treated under the new framework. In response to the May 2014 Discussion Paper, ISDA included a number of detailed comments on the nature of package transactions which we draw ESMA's attention to. We

reiterate the points made in that response and put forward a proposal which we hope ESMA will find workable and flexible enough to apply for venue and SI transparency obligations and the derivatives trading obligation. This will preserve the market for package transactions and ensure that pricing and liquidity is not negatively impacted for end investors.

We believe that Level 1 is flexible enough to empower ESMA to specify how package transactions are treated in order to determine if such transactions are liquid or "traded on a trading venue" (both for determining whether transparency obligations apply as well as determining whether the derivatives trading obligation applies). The Level 1 text clearly sets the foundation for the pre- and post-trade transparency regimes in non-equities by defining the asset classes – "bonds, structured finance products, emission allowances and derivatives" – on which the Level 2 measures must be built. However, ESMA has flexibility to define how, within these broad asset classes, to identify whether specific financial instruments (or combinations thereof) are to be considered "liquid" or "traded on a trading venue". ESMA has chosen to adopt COFIA as the basis for determining whether a liquid market exists – which suggests to us that ESMA is also empowered to tailor this approach to instruments which fall within one of the specified classes, but are part of a package transaction.

***b) Advantages of package transactions to clients***

Package transactions allow clients to reduce their transaction costs (i.e. a single transaction is less expensive to execute than multiple transactions) and manage their execution risk (i.e. a single execution alleviates timing and other mechanical/process type risks). They are tailored to provide risk-return characteristics in the form of a single transaction in an efficient and cost-effective manner to clients.

***c) Challenges to trading package transactions without a tailored proposal***

Below are some very realistic fact patterns which hopefully demonstrate that unless there is tailored treatment for package transactions which recognises that package transactions should be considered in their entirety when being assessed as subject to transparency requirements and/or the derivatives trading obligation, there is a significant risk that such transactions may no longer be available to clients in the EU. This will be due to the individual components being treated differently and inconsistently vs. each other when they are assessed against the relevant requirements which would negate the advantages highlighted above of trading package transactions. These challenges are likely to be particularly acute where one or more of the components of a package transaction includes derivatives subject to the trading obligation:

- If some components of a package transaction are traded on a trading venue but others are not.
- If some components of a package transaction are deemed liquid but others are not.
- If some components of a package transaction are above the relevant LIS or SSTI thresholds but others are not.
- If the components of a package transaction are below the relevant LIS or SSTI thresholds but together they behave similarly to a single transaction above the LIS or SSTI.
- If the package transaction contains a listed derivative which trades on a different trading venue to other components.

If ESMA fails to provide for the appropriate trading of packages, end investors will be required to trade the components independently, resulting in increased transaction costs and increased execution risks, which would seem to conflict with ESMA's policy objectives.

***d) ISDA proposal***

We would be keen to assist ESMA with the development of a workable regime for package transactions. We consider that the following proposals could both address the challenges we have described above. We have provided both proposals for ESMA's consideration as we recognise that, whilst Option 1 is a simpler proposal, Option 2 is more accurate.

Option 1:

1. Subject to point 3 below, if each component of a package transaction is liquid:

   a. The package transaction should be considered liquid; and

   b. If any one component is above the relevant threshold (LIS or SSTI) then the package transaction should be deemed to be above the threshold.

2. Subject to point 3 below, if the package transaction contains liquid and illiquid components:

   a. The package transaction should be considered illiquid; and

   b. If any one component is above the relevant threshold (LIS or SSTI) then the package transaction should be deemed to be above the threshold.

3. For the purposes of MiFIR Articles 8(1), 10(1), 18(1) and 18(2), all components of a package have to be tradable on a single venue in order for the package be considered "traded on a venue".

4. If the package transaction comprises ten or more component legs, the package transaction should be considered illiquid.

If ESMA, for pre- and post-trade transparency purposes, would prefer to represent this in a table format, we propose the following table which reflects the above.

**Table 21: ISDA Proposal for the calibration of Package Transactions for liquidity, Large in Scale, and Size Specific to the Instrument thresholds.**

| Type | Package type comprising: | Example | 1. All components above LIS | 2. All components above SSTI | 3. At least one component above LIS | 4. At least one component above SSTI | 5. All components below LIS | 6. All components below SSTI |
|---|---|---|---|---|---|---|---|---|
| A | Exclusively liquid derivatives in one derivative asset class[1] | Spread of CDX.NA.IG vs. ITraxx Europe | Package is above LIS and liquid | Package is above SSTI and liquid | Package is above LIS and liquid | Package is above SSTI and liquid | Package is below LIS and liquid | Package is below SSTI and liquid |
| B | Exclusively liquid securities | 2yr vs 10yr Bund switch* | Package is above LIS and liquid | Package is above SSTI and liquid | Package is above LIS and liquid | Package is above SSTI and liquid | Package is below LIS and liquid | Package is below SSTI and liquid |
| C | Liquid security(ies) and derivative(s) where the derivatives are from a single asset class[1] | CDS basis trade (CDS vs. liquid sovereign bond) | Package is above LIS and liquid | Package is above SSTI and liquid | Package is above LIS and liquid | Package is above SSTI and liquid | Package is below LIS and liquid | Package is below SSTI and liquid |
| D | Liquid & illiquid security(ies) and derivative(s) where the derivatives are from a single asset class[1] | CDS basis trade (CDS vs. illiquid sovereign bond) | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is below LIS and not liquid | Package is below SSTI and not liquid |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| E | Liquid derivative(s) & any liquid exchange traded derivative(s) in the same derivative asset class [1] | EFP transaction of swap vs. future* | Package is above LIS and liquid[2] | Package is above SSTI and liquid[2] | Package is above LIS and liquid[2] | Package is above SSTI and liquid[2] | Package is below LIS and liquid[2] | Package is below SSTI and liquid[2] |
| F | Liquid security(ies) & any liquid exchange traded derivative(s) in the same derivative asset class [1] | Cash bund vs. Bund future basis trade* | Package is above LIS and liquid[2] | Package is above SSTI and liquid[2] | Package is above LIS and liquid[2] | Package is above SSTI and liquid[2] | Package is below LIS and liquid[2] | Package is below SSTI and liquid[2] |
| G | Exclusively illiquid security(ies) or derivative(s) | Spread trade between two 10yr sovereign CDS | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is above LIS and Not liquid | Package is above SSTI and Not liquid | Package is below LIS and not liquid | Package is below SSTI and not liquid |
| H | 10 or more components | Package of several CDS bundled for execution | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is above LIS and not liquid | Package is above SSTI and not liquid | Package is below LIS and not liquid | Package is below SSTI and not liquid |

[1] Interest Rate Derivatives, FX Derivatives, Commodity Derivatives, Equity Derivatives, Credit Derivatives etc considered as distinct derivative asset classes.

[2] Assuming that ESMA agrees that, for the purposes of MiFIR articles 8(1), 10(1), 18(1) and 18(2), all components of a package have to be tradable on a single venue in order that the package be considered "traded on a venue". Otherwise, ESMA should deem packages including exchange traded derivatives to be not liquid. ISDA recommends that packages involving exchange traded derivatives should be executed using the wholesale trading facilities currently governed by venues' rulebooks

* These scenarios are not directly relevant for credit derivatives (in the cases of E & F this is because there are no exchange traded credit derivatives at the time of writing). But we have left them in the table for completeness.

Option 2:

1. Subject to point 3 below, if each component of a package transaction is liquid:

   a. The package transaction should be considered liquid; and

   b. The percentage threshold for each individual component in a package transaction is equal to the notional of the relevant component expressed as a percentage of its relevant threshold (LIS or SSTI). If the sum of the percentage thresholds for all components in the packaged transaction is above 100%, then the package transaction (and each of its components) is above the relevant threshold (LIS or SSTI). See below for a more detailed explanation of the percentage threshold approach.

2. Subject to point 3 below, if the package transaction contains liquid and illiquid components:

   a. The package transaction should be considered illiquid; and

   b. The percentage threshold for each individual component in a package transaction is equal to the notional of the relevant component expressed as a percentage of its relevant threshold (LIS or SSTI). If the sum of the percentage thresholds for all components in the package transaction is above 100%, then the package transaction (and each of its components) is above the relevant threshold (LIS or SSTI). See below for a more detailed explanation of the percentage threshold approach.

3. For the purposes of MiFIR Articles 8(1), 10(1), 18(1) and 18(2), all components of a package have to be tradable on a single venue in order for the package be considered "traded on a venue".

4. If the package transaction comprises ten or more component legs, the package transaction should be considered illiquid.

The percentage threshold approach aims to, in a simple manner, replicate the package of instruments into a single instrument to test whether it would indeed be above the threshold (SSTI or LIS purposes) or not if it were traded as a single instrument.

The example below was prepared in the context of interest rate derivatives, but the same principles are applicable to credit derivatives.

Example: if an investor wishes to hedge cash flows at 5-year and 15-year points using EUR interest rate swaps, to create an accurate hedge the investor would trade a package of two EUR swaps at 5-year and 15-year maturities. Alternatively, the investor could enter into a single swap with an average 10-year maturity to try to replicate the risk profile but with less accuracy.

However, whilst the individual swaps in the package of swaps could each be below the relevant threshold, the equivalent single swap would have a larger notional and could therefore be above the threshold, as illustrated below. Given the 5-year and 15-year swaps are economically similar in nature, the pricing of one swap is likely to impact the pricing of the other. By not recognising this, ESMA could create an incentive for the market to trade in the equivalent single average instruments, rather than the package of instruments that provide a more accurate hedge: the result would be to provide a less perfect hedge, thereby retaining risk in the system.

The suggested percentage threshold approach provides a way to calibrate this and ensures that package transactions are not disproportionately disadvantaged.

The below table illustrates the example described above.

**Table 22: Example of how the percentage threshold approach (Option 2) operates**

| | **More accurate hedge** | | **Less accurate hedge** |
|---|---|---|---|
| | **EUR 5yr swap** | **EUR 15yr swap** | **EUR 10yr swap** |
| Notional | 60m | 60m | 120m |
| Threshold (SSTI or LIS) | 100m | 100m | 100m |
| Percentage Threshold | 60% | 60% | 120% |

Table 21, prepared for Option 1, could easily be adapted for Option 2.

***e) Safeguarding against avoidance***

ISDA is aware that ESMA and national competent authorities may be concerned that adoption of our proposal may lead to market participants creating packages of instruments purely for the purposes of avoiding the transparency regime or the derivatives trading obligation. ISDA recognises these concerns and suggests that this could be achieved by defining a package and including, within the MiFID II/MiFIR framework, a mechanism that would support the monitoring (and therefore supervision) of the trading of packages. ISDA would welcome the opportunity to discuss these safeguards with ESMA in more detail.

<u>1. Definition of package transaction</u>

ISDA recommends that a "package transaction" be defined as a transaction comprising two or more components, each of which is a *bond, structured finance product, emission allowance or derivative* where:

(i) The components are priced as a "package" with simultaneous execution of all such components;

(ii) The execution of each component is contingent on the execution of the other components;

(iii) Each component must be able to stand alone and must be able to bear economic risk; and

(iv) Either:

i. the components are economically similar in nature such that the pricing of one component can affect the pricing of the other component; or

ii. the components must have a reasonable degree of correlation.

2. Post-trade transparency flag

With a view to assisting the monitoring of package transactions by supervisors, and as stated in our response to Question 74 of the December 2014 Consultation Paper, ISDA recommends that an additional flag to be reported on trades that are components of package transactions be added to the list of flags set out in Table 2 of Annex II of RTS .

We would also draw attention to our response to Question 218 of the December 2014 Consultation Paper where we suggest that ESMA may wish to consider including a "link ID" field in transaction reports (for the purposes of the Article 26 MiFIR transaction reporting regime). In ISDA's response to ESMA's recent consultation paper on the review of reporting technical standards under EMIR, we recommended the inclusion of a "link ID" field to link together trade reports of components of the same package. ESMA may wish to consider whether to incorporate such a field in the transaction reports required under the MiFIR transaction reporting regime as this would give supervisors greater visibility in respect of the usage of package transactions.

## 2.3 Other derivatives

- ***Liquid Market Definition: [freight derivatives, emission derivatives, weather derivatives and other exotic derivatives]***

**Q6. Do you agree with ESMA's proposal for the definition of a liquid market? Please provide an answer detailed per class of derivatives (freight derivatives, emissions derivatives, weather derivatives and other exotic derivatives) and contract type identified (options, futures, forwards, swaps, others). If you do not agree with ESMA's proposal for the definition of a liquid market, please specify per class of derivatives and contract type identified:**

**(1) your alternative proposal;**

**(2) which qualitative criteria would you use to define the sub-classes;**

**(3) which parameters and related threshold values would you use in order to define a sub-class as liquid. Please, provide reasons for your answer.**

**Summary remarks**

We note that the terms "criteria", "parameters" and "thresholds" are used inconsistently in the CP. In our response we use the term "criteria" to refer to the qualitative criteria used by ESMA to define sub-classes (e.g. underlying, tenor, notional currency), the term "liquidity parameter" to refer to the elements of the liquid market definition which are used by ESMA to assess the liquidity of a sub-class (e.g. average frequency of transactions, average size of transactions, the number and size of market participants, and/or the average size of spreads) and the term "liquidity threshold" to refer to the quantitative level set for each relevant liquidity parameter (e.g. if one of the chosen liquidity parameters for a sub-class is "trades per day" the liquidity threshold is the number of trades per day). Where, in our response, we refer to the large-in-scale (LIS) and size specific to the instrument (SSTI) waivers for pre-trade transparency and the LIS and SSTI deferrals for post-trade transparency, we refer to the quantitative level at which each waiver/deferral is set as the "LIS threshold" and the "SSTI threshold".

**Other exotic derivatives – inflation rates**

Annex I section C.10 of MiFID includes derivative contracts relating to inflation rates. In our view such inflation derivatives should therefore fall within the definition of "others " under Section 8 of RTS 9. However, we also note that certain inflation derivative contracts were assessed and classified as part of the December 2014 CP. We would therefore welcome clarity from ESMA as to whether inflation rate derivatives (i) have been included within the CP assessment and (ii) fall within the definition of "others" under Section 8 of RTS.

**Liquidity Assessment and Criteria**

We agree with ESMA's conclusion that none of the sub-classes of derivatives (freights, emissions, weather and other exotic derivatives) or contract type (options, futures, forwards, swaps, others) are liquid when assessed under the current taxonomies.

In respect of the appropriate criteria for defining the sub-classes at which the liquidity assessment is conducted, as we set out in our response to Question 7 below, we favour a more granular approach. We therefore support (i) Alternative B for freights, other exotics and weather derivatives and (ii) an amended Alternative B for emissions derivatives which sub-divides the asset class by instrument type (i.e. European Union Allowances (EUA), Certified Emission Reductions (CER), European Union Aviation Allowance (EUAA), and Emission Reducing Units (ERU) and other) rather than by contract type (ie. future, option, forward). We are however aware that a more granular approach would require a reassessment of the relevant LIS and SSTI thresholds.

In terms of the proposed liquidity parameters and liquidity thresholds, we would make the following points:

a) a large number of energy commodity contracts are traded in currencies other than euros (for example, USD, GBP). Expressing the thresholds in a currency other than the currency in which the relevant contracts are traded could lead to arbitrary and inconsistent results as contracts become liquid or illiquid based solely on movements in the relevant exchange rate;

b) irrespective of the currency in which the contracts are traded, we believe the more appropriate liquidity parameter for assessing the liquidity of the relevant sub-class is the open interest and units or lots of the relevant underlying. The open-interest metric reflects all relevant market factors relating to the trading of the relevant contract (e.g., maturity, volatility, number and size of market participants, thereby ensuring flexibility to prevailing market conditions for the relevant underlying). Furthermore, as we state under the heading *"LIS threshold" and the "SSTI threshold"* below, thresholds in lots or in the units in which the underlying is traded (that the exchanges can translate into lots) would more accurately reflect the trading activity in the relevant market and be understood by market participants. In addition, such thresholds would be stable over time because they would not be subject to FX and price fluctuations;

c) the assessment of the liquidity of all classes has to appropriately consider the tenor of the contracts as the liquidity of these instruments varies along the curve and, generally, they become more liquid as they approach the expiry date; and

(d) we note that the basis of the liquidity assessments conducted in the CP differs from the basis of liquidity assessments conducted in respect of other commodity derivatives in the December 2014 CP. In particular we note that ESMA assessed the liquidity of the classes of derivatives covered in the CP based on an average notional amount per day of greater or equal to €500m whilst a €100,000 notional was used for assessing liquidity for other commodities derivatives (specifically metals and energy) in the December 2014 CP, notwithstanding that such derivatives trade with higher notionals. As we stated in our response to the December 2014 CP, we believe that €100,000 is inappropriately low. We would therefore encourage ESMA to conduct further analytical assessments to establish whether the €500m notional or a broadly equivalent figure is more appropriate for other asset classes. In this regard we would stress that setting the LIS and SSTI thresholds too high could lead to whole classes of instruments that the market generally considers to be liquid being traded away from central limit order books / transparent trading venues and ultimately undermine the aims of MiFID 2. We do however recognise that if a €500m threshold applied to commodity derivatives generally, liquid contracts (such as certain cocoa commodity derivatives) may be deemed to be illiquid. Therefore ISDA members would encourage ESMA to conduct detailed analytical analysis before moving to a €500 million notional criteria for all commodity derivatives (if indeed that is what ESMA is planning).

**"LIS threshold" and the "SSTI threshold"**

In our view, the liquidity assessments should be undertaken and the LIS and SSTI thresholds should be denominated in the unit in which the relevant underlying is traded rather than Euro, in order to provide an accurate representation of the trading activity in the relevant market. This approach is consistent with the approach adopted in Table 49 of RTS 9 in respect of Emission Allowances for which the LIS threshold is denominated in Tons of Carbon Dioxide. We are therefore of the view that the LIS and SSTI thresholds for Freight should be denominated in metric tons of cargo rather and that the LIS and SSTI thresholds for emissions derivatives should be denominated in Tons of Carbon Dioxide.

- ***Pre-trade and Post-trade transparency requirements for non-equity instruments***

**Q7. Which is your preferred option? Please express your preference either for "Alternative A" or for "Alternative B". If you disagree with both ESMA's proposals pro-vide your alternative proposal by answering the following question.**

ISDA members support additional granularity as in our view it results in a more accurate assessment. We therefore prefer Alternative B to Alternative A. However, in respect of emissions derivatives we believe the asset classes should be sub-divided by relevant instrument type (European Union Allowances (EUA), Certified Emission Reductions (CER), European Union Aviation Allowance (EUAA), and Emission Reducing Units (ERU) and other) rather than by contract type (ie. future, option, forward).

This approach would be consistent with the approach adopted in Table 49 of RTS 9 in respect of Emission Allowances. Furthermore, market participants consider the liquidity of the relevant product (i.e. EUA or ERA derivatives) rather than assessing whether a group of similar instruments are liquid when traded as futures as opposed to options. The approach would therefore more closely align with the way in which market participants assess liquidity for emissions derivatives. In this regard, we note that some EUA derivatives are commonly considered to be relatively liquid (though the liquidity is concentrated in specific maturities). Provided that accurate and complete data underlies the analysis, there may be benefit in assessing EUA derivatives separately from the other instrument types.

We note, however that such a more granular approach would necessitate a reassessment of the relevant LIS and SSTI thresholds.

**Q8. Please specify, for each class (defined as follows if you have stated your preference for Alternative A: freight derivatives, emissions derivatives, weather derivatives and other exotic derivatives. Defined as combination of underlying type and contract type if you have stated a preference for Alternative B: freight options, freight futures, freight forwards, etc.) if you agree on the following points providing reasons for your answer and, if you disagree, providing ESMA with your alternative proposal:**

**(1) deferral period set to 48 hours**

**(2) size specific to the instrument threshold set as 50% of the large in scale threshold**

**(3) volume measure used to set the large in scale and size specific to the instrument threshold as specified in Annex II, Table 3 of draft RTS 9**

**(4) pre-trade and post-trade thresholds set at the same size**

**(5) large in scale thresholds: (a) state your preference for the system to set the thresholds (i.e. annual recalculation of the thresholds vs. no recalculation of the thresholds) (b) in the case of a preference for a system with no recalculation (i.e. option 1), provide feedback on the thresholds determined. In the case of a preference for a system with recalculation (i.e. option 2), provide feedback on the thresholds determined for 2017 and on the methodology to recalculate the thresholds from 2018 onwards including the level of granularity of the classes on which the recalculations will be performed.**

***Deferral period***

We believe that the transparency calibration is critical for ensuring that the Level 1 objective of increased market transparency is achieved without compromising liquidity.

Whilst we support ESMA's extension of the deferral period for LIS trades from end-of-day (as proposed in ESMA's May 2014 Discussion Paper) to 48 hours, the price deferral period remains too short, particularly for truly illiquid markets involving large trade sizes. To ensure a continuation of liquidity by market participants and to reduce the potential negative effects of the post trade transparency regime, in line with the AFME's suggestion in the Fixed Income context in its response to the CP, we would suggest for large trades in illiquid commodity derivatives a price deferral of at least 28 days.

***Setting the thresholds***

As we set out in our response to the December 2014 CP we are concerned that the current proposals for commodity derivatives are based on a dataset which is too narrow and therefore the assessments do not provide an accurate representation of liquidity in the relevant commodity markets. Therefore, we have serious concerns that these proposals are not be workable and could have significant adverse consequences if implemented.

Whilst, the approach taken in the CP is preferable to the approach taken in the December 2014 CP, it remains difficult for members to assess the impact of the proposed thresholds. Accordingly we remain of the view that, in order to establish appropriate thresholds for the SSTI and LIS for the commodity derivatives addressed in the December 2014 CP and the "other derivatives" addressed in the CP, it is necessary for ESMA to conduct an appropriate market assessment of the liquidity of the contracts that will subject to the MiFID2 transparency regime based on complete data available

from the major commodities trading venues, for on venue contracts, and the data from trade repositories for the contracts which are currently traded OTC. We do not believe that the SSTI should be linked to the LIS and reiterate the need to conduct a full analysis in order to consider the potential impact on the market. On the basis of an initial analysis we prepared in the context of the December 2014 CP and by way of example, we would consider the following values as a more workable LIS and SSTI thresholds for an ICE Brent Future contract: LIS (200 lots, 12 USD million) and SSTI (50 lots; 3 USD million).

In terms of our preference for the system to set the thresholds, we strongly believe that an annual recalculation of the thresholds would be more appropriate.

We offer our assistance to continue the discussion for a more appropriate framework with ESMA after the end of this consultation period.

### 2.4 Contracts for difference

- ***Liquid Market Definition: [equity, bond, futures on equity, option on equity, commodity, and currency (FX)]***

**Q9. Do you agree with the approach taken for shares where any CFD based on a liquid share would be considered as having a liquid market? More specifically, please provide feedback on the following:**

**(1) Would you prefer to follow a similar approach as that proposed in option 2 on liquidity for equity derivatives (paragraph 90 page 132 of December CP), i.e. qualify all CFDs on equity as liquid irrespectively of the liquidity of the underlying?**

**(2) Would you have used different criteria to define the classes or sub-classes?**

**(3) Would you have used different parameters or the same parameters (i.e. average number of trades per day and average notional amount traded per day) but different thresholds in order to define a sub-class as liquid?**

**(4) Would you support extending the approach taken for shares to other equity (ETFs, depositary receipts and certificates) and equity-like instruments?**

**Summary remarks**

ISDA's members wish to note that they do not agree with ESMA's definition of financial contracts for difference (CFDs). In particular, ISDA's members believe that ESMA's proposed CFD definition is too broad and should therefore be narrowed, in order to make clear that equity swaps do not fall within the CFD definition. ISDA's members believe that, whilst there are close economic similarities between CFDs on equity and certain types of equity swaps, it is important to make a distinction between CFDs and equity swaps generally as there are certain key features that differentiate these derivative products. Unlike a CFD, an equity swap is a highly bespoke derivative product that is typically negotiated on a client-by-client basis. For example, an equity swap counterparty would be able to negotiate on terms relating to the treatment of dividends, corporate actions, disruption events, the maturity date of the contract and the ability to close-out the contract prior to the maturity date.

In addition, ISDA's members note that for the purposes of Draft RTS 9, Annex III, Section 4 and Annex I, Sections C(4) – C(7) of Directive 2014/65/EU, equity swaps fall within the definition of 'equity derivatives'. For this reason, ISDA's members strongly feel that it is important to narrow the definition of CFDs so that derivative products such as equity swaps are not captured within two distinct definitions. ISDA's members believe that any failure to clarify the CFD definition would result in contractual and operational uncertainty, including problems in relation to pairing trades under the EMIR dual-reporting regime, as certain firms may categorise the same transaction differently.

For these reasons, ISDA's members propose that the definition in RTS 9, Annex III, Section 9(1) be amended as follows:

(1) 'Financial contract for difference' or 'CFD' means a cash-settled, open-ended derivative product, which can be entered into by both retail and wholesale investors under a master agreement, that gives the holder an ~~economic~~ exposure, which can be long or short, to the difference between the price of an underlying asset ~~at the start of~~ when it is added to the ~~contract~~ agreement and the price when it is closed out from the ~~contract~~ agreement ~~is closed~~, and which is not a cash-settled option, swap or other similar contract.

**(1) Would you prefer to follow a similar approach as that proposed in option 2 on liquidity for equity derivatives (paragraph 90 page 132 of December CP), i.e. qualify all CFDs on equity as liquid irrespectively of the liquidity of the underlying?**

ISDA members broadly agree with ESMA's proposal to define as liquid any CFD where the underlying is a share for which there is a liquid market, as determined in accordance with article 2(1)(17)(b) of Regulation 600/2014, provided that such CFD definition does not include any equity swaps. However, ISDA's members are concerned that ESMA's data analysis on CFDs incorporated data relating to both CFDs and equity swaps.

As indicated above, ISDA members do not believe that equity swaps should or can fall within the definition of CFDs. Accordingly, any determination as to the liquidity of an equity swap should only be made once ESMA has undertaken sufficiently-detailed analysis on equity swaps. In this regard, and consistent with the views expressed in the ISDA and BBA Response to ESMA's Discussion Paper on the Clearing Obligation under EMIR, ISDA's members note that whilst a particular share may be liquid, there may not be equivalent liquidity in the corresponding derivative contracts. For this reason, we would suggest that, from a liquidity perspective, both the liquidity of the derivative contract and the liquidity of the underlier need to be considered in any liquidity determination on equity swaps.

As noted in the ISDA response to the December Consultation Paper, ISDA's members understand that the data on which ESMA proposed its liquidity determination for equity derivatives was drawn solely from trading venues and concerned only exchange-traded equity derivative contracts. For this reason, ISDA's members were of the view that any determination based solely on data applicable to exchange-traded equity derivatives should only apply to exchange-traded equity-derivatives. ISDA's members would therefore like to reiterate that ESMA can only make a valid determination of liquidity for OTC equity derivative contracts such as equity swaps, if it undertakes detailed analysis at a sufficiently granular level for each class of OTC equity derivative contract.

ISDA would welcome the opportunity to assist ESMA with this work. However, if ESMA is not prepared to undertake such analysis, ISDA cannot support the determination that any OTC equity derivative contracts are liquid.

**(2) Would you have used different criteria to define the classes or sub-classes?**

No.

**(3) Would you have used different parameters or the same parameters (i.e. average number of trades per day and average notional amount traded per day) but different thresholds in order to define a sub-class as liquid?**

No.

**(4) Would you support extending the approach taken for shares to other equity (ETFs, depositary receipts and certificates) and equity-like instruments?**

Yes, ISDA's members would be supportive of such an approach.

- ***Pre-trade and Post-trade transparency requirements for non-equity instruments***

**Q12. Please specify, for each class (defined as follows if you have stated your preference for Alternative A: freight derivatives, emissions derivatives, weather derivatives and other exotic derivatives. Defined as combination of underlying type and contract type if you have stated a preference for Alternative B: freight options, freight futures, freight forwards, etc.) if you agree on the following points providing reasons for your answer and, if you disagree, providing ESMA with your alternative proposal:**

**(1) deferral period set to 48 hours**

**(2) size specific to the instrument threshold set as 50% of the large in scale threshold**

**(3) volume measure used to set the large in scale and size specific to the instrument threshold as specified in Annex II, Table 3 of draft RTS 9**

**(4) pre-trade and post-trade thresholds set at the same size**

**(5) large in scale thresholds: (a) state your preference for the system to set the thresholds (i.e. annual recalculation of the thresholds vs. no recalculation of the thresholds) (b) in the case of a preference for a system with no recalculation (i.e. option 1), provide feedback on the thresholds determined. In the case of a preference for a system with recalculation (i.e. option 2), provide feedback on the thresholds determined for 2017 and on the methodology to recalculate the thresholds from 2018 onwards including the level of granularity of the classes on which the recalculations will be performed.**

**Summary remarks**

Please note that the responses below are given only in respect of CFDs on equity.

**(1) deferral period set to 48 hours**

Consistent with our responses to the 19 December 2014 Consultation Paper, ISDA does not agree with ESMA's proposals. Whilst we welcome ESMA's proposal to extend the length of the deferral period for transactions that are large in scale, above SSTI (if carried out on own account other than matched principal)

and in illiquid instruments, we strongly recommend that the deferral period be set at two business days. This is to ensure that transactions that occur close to the end of trading before a weekend/bank holiday get the full benefit of the deferral period (which they may otherwise not if the 48 hour period runs over the weekend).

As we argued in our responses to the May and December 2014 Discussion Papers, the duration of volume masking is critical. If ESMA does not accept our proposal (that a 12 week supplementary deferral period is required for volume omission in respect of trades which are both Illiquid and LIS) then we would urge ESMA to extend the post-trade deferral period to at least 7 days for trades that are both illiquid and LIS. If a longer supplementary deferral period is permitted for volume omission, we would recommend that ESMA permits NCA's that do not adopt the supplementary deferral regime (which is within the discretion of NCAs) to allow a post-trade deferral period of at least 7 days for trades that are both illiquid and above LIS.

Even two business days may be challenging for certain types and sizes of transactions and especially so if the LIS and SSTI thresholds are not appropriately calibrated in the final rules. This challenge will be significantly worsened if NCAs do not implement the supplemental volume omission regime. Whilst we appreciate that it is within the discretion of individual NCAs to determine whether to implement a supplemental volume omission deferral regime, ISDA urges ESMA to try and encourage as many NCAs as possible to adopt this regime.

**(2) size specific to the instrument threshold set as 50% of the large in scale threshold**

Consistent with our responses to the 19 December 2014 Consultation Paper, ISDA disagrees with ESMA's proposals for calibrating SSTI. We believe that the proposal to set the SSTI threshold at 50% of the LIS threshold is arbitrary – there is no rationale for choosing 50% (as opposed to another percentage) and its link to the LIS threshold means that the SSTI threshold is unlikely to result in 50% of trades in a sub-class actually falling below the SSTI threshold. Use of a 50% ratio does not appear to have factored in the elements required by MiFIR under Article 9(5)(d), specifically whether liquidity providers are able to hedge their risks, and the extent of retail participation (although we recognise the practical challenges of incorporating these factors).

We propose instead that the SSTI threshold should either be set at either:

- The median trade size (50$^{th}$ percentile of transaction sizes) for transactions in the relevant sub-class; or
- 10% of the LIS threshold for the relevant sub-class (if ESMA prefers to retain a method based on the percentage of LIS).

The appeal of using the median size is that ESMA can be sure that half of transactions in any liquid sub-class would be subject to pre-trade transparency, and would not experience deferred publication. We consider it would accord better with a normal market transaction at which liquidity providers could be reasonably expected to hedge their risks (as per MiFIR Article 9(5)(d)). Furthermore, breaking the link to LIS would

prevent the SSTI being skewed by individual, large transactions (which could result under ESMA's current proposal for LIS calibration).

For the following reasons, it is most important that ESMA adopt our recommendations for the pre-trade SSTI (although we encourage ESMA to also consider doing so for the post-trade SSTI):

- The risks to firms are more significant in the pre-trade context; a firm is putting its capital at risk and pre-trade disclosure of its quoted prices increases the possibility that the market will move against the firm before it is able to execute those transactions. This would lead firms to price in these risks resulting in worse pricing for end investors.
- A 50% SSTI ratio would only permit a SI to undertake two trades before taking on risk equivalent to a large in scale transaction. If the policy objective is to encourage SIs to make their quotes available to and executable by several clients, then setting the SSTI threshold at a level which takes into account multiple transactions and still allows a given quote to be maintained would enable ESMA to achieve such an objective.

The risk is of a different nature in the post-trade context. At this stage, the firm has already committed its capital. The risk it faces at this stage relates to the management of its exposure (i.e. its ability to conduct a successful hedging strategy). However, again, if the ratio is set too high for post-trade purposes, the risks the SI faces in managing its hedging strategy in relation to certain products will be reflected in wider prices being quoted to clients.

**(3) volume measure used to set the large in scale and size specific to the instrument threshold as specified in Annex II, Table 3 of draft RTS 9**

We agree with the proposed use of "notional amount of traded contracts" as the appropriate volume measure for CFDs on equity.

**(4) pre-trade and post-trade thresholds set at the same size**

The appeal of using the median size (described above) is that ESMA can be sure that half of transactions in any liquid sub-class would be subject to pre-trade transparency, and would not experience deferred publication. We consider it would accord better with a normal market transaction at which liquidity providers could be reasonably expected to hedge their risks (as per MiFIR Article 9(5)(d)). Furthermore, breaking the link to LIS would prevent the SSTI being skewed by individual, large transactions (which could result under ESMA's current proposal for LIS calibration).

For the following reasons, it is most important that ESMA adopt our recommendations for the pre-trade SSTI (although we encourage ESMA to also consider doing so for the post-trade SSTI):

- The risks to firms are more significant in the pre-trade context; a firm is putting its capital at risk and pre-trade disclosure of its quoted prices increases the possibility that the market will move against the firm before it is able to execute those transactions. This would lead firms to price in these risks resulting in worse pricing for end investors.

- A 50% SSTI ratio would only permit a SI to undertake two trades before taking on risk equivalent to a large in scale transaction. If the policy objective is to encourage SIs to make their quotes available to and executable by several clients, then setting the SSTI threshold at a level which takes into account multiple transactions and still allows a given quote to be maintained would enable ESMA to achieve such an objective.

The risk is of a different nature in the post-trade context. At this stage, the firm has already committed its capital. The risk it faces at this stage relates to the management of its exposure (i.e. its ability to conduct a successful hedging strategy). However, again, if the ratio is set too high for post-trade purposes, the risks the SI faces in managing its hedging strategy in relation to certain products will be reflected in wider prices being quoted to clients.

**(5) large in scale thresholds: (a) state your preference for the system to set the thresholds (i.e. annual recalculation of the thresholds vs. no recalculation of the thresholds) (b) in the case of a preference for a system with no recalculation (i.e. option 1), provide feedback on the thresholds determined. In the case of a preference for a system with recalculation (i.e. option 2), provide feedback on the thresholds determined for 2017 and on the methodology to recalculate the thresholds from 2018 onwards including the level of granularity of the classes on which the recalculations will be performed.**

ISDA members agree with the large in scale thresholds that have been determined for 2017.

In light of the close economic similarities between CFDs and certain equity swaps (such as total return swaps on a single share or on other single equity-like instruments), and in order to avoid any arbitrage of the transparency regime by product repackaging, ISDA members believe that these contract types should be treated as equivalent for the purposes of determining the LIS and SSTI thresholds, so that a common LIS and SSTI threshold is set. ISDA would welcome the opportunity to assist ESMA in a separate detailed analysis to determine appropriate LIS and SSTI thresholds on all types of equity swaps.

Consistent with our responses to the 19 December 2014 Consultation Paper, ISDA members believe that it is essential that the LIS threshold is appropriately calibrated to ensure that end investors can continue to transact in large trade sizes. Requiring price disclosure of large trades would lead to a widening of bid-offer spreads, which may have a detrimental impact on investors wishing to trade at these large sizes.

ISDA is of the view that the LIS should be recalibrated on a dynamic basis. However, we do not endorse Option 2 as currently constructed. In particular, we disagree with:

- Criterion 2 (the proposed volume measure). The determination of whether a transaction is large compared to market size should not be conflated with the volume of trading in that market and instead can be derived from the distribution of trade sizes alone. The volume measure would appear to be policy driven, without any direct link to LIS.
- Criterion 3 (the proposed threshold floor). We disagree with ESMA's proposal to include a "floor" in option 2. In our view, this goes beyond the Level 1 requirements.

Therefore, we recommend using only the percentile of trades to calibrate the LIS (i.e. Criterion 1).

Whilst we agree with the use of Criterion 1, we believe that the percentile level used for the LIS threshold should relate to the homogeneity of the class in order to compensate for inaccuracies in the liquidity determination. For homogenous classes of financial instruments the proposed LIS threshold of the 90$^{th}$ percentile transaction size is appropriate. However, for less homogenous classes, the LIS threshold should be lower than the 90$^{th}$ percentile transaction size, potentially as low as the 50$^{th}$ percentile, in order to compensate for the lack of granularity in the composition of the class.