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| 10 March 2020 |

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| Reply form for the Consultation Paper on MiFID II/ MiFIR review report on the transparency regime for non-equity and the trading obligations for derivatives |
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| Date: 10 March 2020 |

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the Consultation Paper on the transparency regime for non-equity instruments and the trading obligations for derivatives MiFID II/ MiFIR review report published on the ESMA website.

*Instructions*

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

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

Responses are most helpful:

* if they respond to the question stated;
* indicate the specific question to which the comment relates;
* contain a clear rationale; and
* describe any alternatives ESMA should consider.

**Naming protocol**

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

ESMA\_CP\_MIFID\_NQT\_NAMEOFCOMPANY\_NAMEOFDOCUMENT.

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

ESMA\_CP\_MIFID\_NQT\_ESMA\_REPLYFORM or

ESMA\_CP\_MIFID\_NQT\_ANNEX1

***Deadline***

Responses must reach us by **19 April 2020.**

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

***Publication of responses***

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

***Data protection***

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

# General information about respondent

|  |  |
| --- | --- |
| Name of the company / organisation | Europex |
| Activity | Regulated markets/Exchanges/Trading Systems |
| Are you representing an association? |  |
| Country/Region | Belgium |

# Introduction

Please make your introductory comments below, if any:

<ESMA\_COMMENT\_CP\_MIFID\_NQT\_1>

TYPE YOUR TEXT HERE

<ESMA\_COMMENT\_CP\_MIFID\_NQT\_1>

1. What benefits or impacts would you see in increased pre-trade transparency in the different non-equity markets? How could the benefits/impacts of such pre-trade transparency be achieved/be mitigated via changes of the Level 1 text?.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_1>

Europex fully supports the objectives of MiFID II / MiFIR and the G-20 Pittsburgh commitments to “improve the functioning and transparency of financial and commodity markets and address excessive commodity price volatility”. We equally agree with the general intention of the MiFIR pre-trade transparency regime which is meant to work towards this larger policy objective. However, we believe the current calibration of the illiquid (“IL”) and Large in Scale (“LIS”) waiver thresholds severely limits the development of niche and nascent contracts traded on secure and transparent exchanges and cleared through risk mitigating CCP clearing houses. We therefore consider that transparency requirements must be balanced to avoid damaging liquidity, undermining price discovery processes and pushing market participants towards uncleared bilateral trading.

In sum, the pre-trade transparency regime should better reflect that non-equity markets are fundamentally different from equity markets. Furthermore, there are significant differences across the underlying non-equity markets themselves. For example, it is important to understand that commodity markets have specific characteristics and often suffer from a one-size fits all regulatory approach to financial instruments.

Additionally, when compared to other financial instruments, commodity instruments are often less liquid. In order to achieve execution, trades are pre-negotiated outside the regulated venues according to the rules of a specific exchange. They are then brought to the exchange to be immediately cleared at the exchanges’ respective central counterparty (CCP), rather than entered in a central order book where a satisfactory execution would be less likely. This ensures an appropriate level of transparency for these nascent markets.

Moreover, energy markets are – by nature – characterised by a wide range of different contract types, including former swaps, forwards, futures and options with various combinations of quality, location, delivery type, duration and size. These markets are used by professional investors to hedge risk connected to the production or consumption of an actual commodity; therefore, they often require liaison via a broker to find a counter party without incurring undue risk.

We explicitly welcome ESMA’s willingness to review the current pre-trade transparency regime design for commodity derivatives on both Level 1 and 2. A better tailored transparency regime would help to foster EU commodity markets, notably energy markets denominated in Euro, and contribute to the strengthening of international role of the Euro.

Certain exemptions from the general requirement to publish pre-trade transparency data can rightly be granted to trading venues to preserve orderly price discovery processes and allow in particular illiquid and nascent markets to develop. However, we believe the current MiFIR pre-trade transparency regime and the calibration of the waiver methodologies do not sufficiently take into account the above considerations.

Notably, the methodology for the threshold calculation is setting boundaries to the pre-trade transparency regime. The Illiquid Instrument (IL) and Large in Scale (LIS) waivers are therefore flawed. These calculation flaws result in many illiquid derivative contracts being wrongly classified as liquid and thus made subject to unduly high LIS thresholds. Counterintuitively, LIS thresholds end up being very low for liquid derivative products. The consequences are particularly visible in commodity derivatives markets which forces larger volumes to be executed in fully bilateral transactions.

In order to mitigate the negative consequences of the currently ill-calibrated IL and LIS waiver thresholds, changes should be made to Level 2 legislation.

Against this background, we generally welcome that ESMA acknowledges the need to review the current design of the pre-trade transparency regime for commodity derivative contracts in both Level 1 and Level 2 legislation.

As for Level 1, Europex proposes that the hedging exemption available in MiFIR Article 8(1) is extended to cover all market participants managing risks arising from activity in the physical market, including financial counterparties. Such a solution would allow for more order book liquidity without jeopardising the ability of commodity derivatives markets to fulfil their function. In addition, it would better take into account the important risk management function of commodity derivatives trading.

Reaction to ESMA analysis

The consultation paper argues that the overall level of PTT in non-equity markets appears to be limited, as evidenced by the high share of financial instruments benefitting from a waiver. While this may be the case across other asset classes in general, the IL and LIS waivers have proven to be ill-calibrated to commodity derivatives markets. Particularly the RTS 2 methodology for calculating LIS thresholds and determining illiquid instruments has proven unworkable and counterintuitive in practice.

Furthermore, because there was no EU-wide transparency regime for non-equity prior to MiFID II, it is impossible to compare the current levels of pre-trade transparency (PTT) with pre-MiFID II PTT levels.

The consultation paper concludes that after two years of application of MiFID II, the impact on most market participants from pre-trade transparency was rather limited (paragraph 42). This conclusion, however, cannot apply to commodity derivatives markets given that the full PTT regime was not applied to pre-negotiated trades during these two years. In accordance with the ESMA supervisory briefing published in June 2019, the concerned trading venues prepared to ensure compliance by 31 December 2019.

Further distinction must be drawn between the different non-equity asset classes when considering the application and effectiveness of PTT. There are fundamental differences in how market participants use non-equity derivatives instruments for hedging and commercial purposes. These need to be reflected in the design of the PTT regime so that it can fulfil its objectives, contributing to more efficient price formation process as well as the timely valuation of products.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_1>

1. What proposals do you have for improving the level of pre-trade transparency available? Do you believe that the simplification of the regime for pre-trade transparency waivers would contribute to the improvement of the level of pre-trade transparency available?

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_2>

MiFIR rightly recognises that certain exemptions can be granted to trading venues from the general requirement to publish pre-trade transparency data to preserve orderly price discovery processes and allow illiquid and nascent markets to develop.

We believe the current calibration of the illiquid (“IL”) and Large in Scale (“LIS”) waiver thresholds severely limits the development of niche and nascent contracts. The reason for this is that a number of niche and nascent products are incorrectly classified as liquid based on the two liquidity criteria in table 7.1, Annex III, RTS 2, thus becoming subject to significant broader transparency requirements and made subject to excessive LIS thresholds.

The current shortcomings of the regime have sometimes prevented market participants from moving to transparent and regulated venues and central clearing. As outlined in Q1, following the specific market reality and the role of pre-negotiated transactions in energy markets, we recommend a review of the current ill-calibrated IL and LIS waiver thresholds size and methodology. Furthermore, we propose that the hedging exemption in Article 8(1) of MiFIR be extended to financial counterparties for pre-trade transparency purposes.

In doing so, the regime would allow for pre-negotiated trades of the most illiquid and new contracts to be brought to an exchange and subsequently familiarise energy commodity traders with the beneficial features of increased transparency and secure on-venue trading.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_2>

1. Are you supportive of ESMA’s proposal to delete the pre-trade SSTI-waiver? Would you compensate for this by lowering the pre-trade LIS-thresholds across all asset classes or only for selected asset classes? What would be the appropriate level for such adjusted LIS-thresholds? If you do not support ESMA’s proposal to delete the pre-trade SSTI-waiver, what should be the way forward on the SSTI-waiver in your view?

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_3>

Europex agrees with ESMA’s proposal to delete the pre-trade SSTI waiver due to its limited use. At the same time, we support the proposal to lower LIS waiver thresholds. We recommend that the LIS calculation methodology is revised to remove factors leading to counterintuitive results, namely less liquid instruments receiving very high LIS thresholds and vice versa.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_3>

1. What are your views on the use of the SSTI for the SI-quoting obligations. Should it remain (Option 1) or be replaced by linking the quoting obligation to another threshold (e.g. a certain percentage of the LIS-threshold) (Option 2)? Please explain.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_4>

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<ESMA\_QUESTION\_CP\_MIFID\_NQT\_4>

1. Would you support turning the hedging exemption into a limited negotiated trade waiver? If so, would you support Option 1 or Option 2? If not, please explain why.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_5>

We do not see merit in replacing the current hedging exemption with a waiver that has the exact same scope. Such a change would increase the administrative burden and procedural obligations for market participants, outweighing any potential benefits a waiver could bring.

Further, we explicitly support extending the hedging exemption to financial counterparties. Such a solution would allow liquidity to continue to build in the order book without jeopardising the ability of commodity derivatives markets to fulfil their function. Moreover, a dedicated (pre-)negotiated trade waiver for non-equity instruments should be considered. However, such a waiver should be introduced in addition to the existing, and ideally extended, hedging exemption but not replace it.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_5>

1. Do you agree with ESMA’s observations on the emergence of new trading systems and the proposed way forward requiring a Level 1 change and ESMA to issue an Opinion for each new trading system defining its characteristics and the transparency requirements? Would you have suggestions for the timeline and process of such Opinions? Please explain.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_6>

Europex agrees that the current catalogue of trading systems in Annex 1 of RTS 2 may not fully capture all available trading systems. However, having an opinion issued by ESMA for every new system might result in very extensive acknowledgement processes and likely result in undue stress on ESMA’s resources. Any backlog in such an approval process (as has been observed with the approval process for waiver applications) bears the risk of delaying innovation and will result in longer periods of trading in less regulated environments (i.e. OTC market). For the same reason, we propose to have changes work solely in a forward-looking way.

Instead, we believe a more efficient way forward is to extend the existing definitions of trading systems. We propose to amend the definitions of Annex 1 in such a way that they cover variations of the initial system types, which might share main characteristics but are also partly innovative. This way, the currently misused “hybrid systems” definition with its significant leeway in choice of applicable transparency would be phased out for such cases and instead replaced by an efficient regime. The transparency requirement for such innovative systems should, however, be sufficiently amended, reflecting the fact that it might prove difficult to provide the same level of transparency. Such an amendment would additionally pose a change on Level 2 as opposed to Level 1, offering the possibility of a quicker amendment process.

Europex could see merit in the proposed ESMA opinions on new trading systems as a complementary solution, where they cover system types which are in no way variations of the definitions listed in Annex 1 and instead completely innovative. This way, ESMA resources would only be used in exceptional cases where there is indeed a distinct need for analysis and requirements suitable for the respective market conditions. To not obstruct market innovation, trading venues should be allowed to operate these new systems under provisional requirements agreed with their respective regulators while the opinion is pending. However, we would like to stress that such opinions must be issued as soon as practically possible and within less than six weeks.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_6>

1. Do you agree with the proposal for the definition of hybrid system? Are there in your view trading systems currently not or not appropriately covered in RTS 2 on which ESMA should provide further guidance? Please explain.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_7>

We agree with the reasoning outlined by ESMA. Europex considers hybrid systems as those formed of more than one component. Our proposal in our answer to Q6 would bring its definition back to its originally intended use-case of only covering combinations, instead leaving variations to be covered by extended definitions and complete innovations by ESMA opinions, respectively.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_7>

1. Do you agree with ESMA’s proposal to require SIs to make available data free of charge 15 minutes after publication? Please explain.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_8>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_8>

1. Would you see value in further standardising the pre-trade transparency information to increase the usability and comparability of the information? Please explain.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_9>

No, Europex does not see value in further standardising pre-trade transparency infomation.

The reasons for this are as follows:

1. The vast quantity of data that needs to be published. It should be noted that the file formats are restricted in the quantity of data that can be displayed. Furthermore, applications that are available to non-professional users will have their own built-in features that restrict the display of millions of data entries.
2. The high number of publication sites since each venue must publish data in the public domain. This is a very costly source for users to collect data. Professional users will have to connect to multiple sites to collate all data they require, restructuring multiple formats and filtering the required content. This requires a lot of time and effort.
3. The lack of demand for such information.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_9>

1. Do you agree with ESMA’s assessment of the level of post-trade transparency and with the need of a more streamlined and uniform post-trade regime which does not include options at the discretion of the different jurisdictions? If not, please explain why and, where available, support your assessment with data.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_10>

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<ESMA\_QUESTION\_CP\_MIFID\_NQT\_10>

1. Do you agree with this proposal? What would be the appropriate level of such a revised LIS-threshold in your view?

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_11>

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<ESMA\_QUESTION\_CP\_MIFID\_NQT\_11>

1. In your view, should the real time publication of volume masking transactions apply to transactions in illiquid instruments and above LIS waiver (Option 1) or to transactions above LIS only (Option 2 and Option 3). Please elaborate. If you support another alternative, please explain which one and why.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_12>

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<ESMA\_QUESTION\_CP\_MIFID\_NQT\_12>

1. Do you agree with the publication of the price and volume of all transactions after a certain period of time, such as two calendar weeks (Option 1 and 2) or do you support the two-steps approach for LIS transactions (Option 3)? Please explain why and provide any alternative you would support. Which is the optimal option in case a consolidated tape would emerge in the future?

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_13>

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<ESMA\_QUESTION\_CP\_MIFID\_NQT\_13>

1. Do you agree with ESMA’s proposed way forward to issue further guidance and put a stronger focus on enforcement to improve the quality of post-trade data? Are there any other measures necessary at the legislative level to improve the quality of post-trade data? What changes to the transparency regime in Level 1 could lead to a substantial improvement of data quality?

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_14>

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<ESMA\_QUESTION\_CP\_MIFID\_NQT\_14>

1. What would be the optimal transparency regime to help with the potential creation of a CTP?

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_15>

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<ESMA\_QUESTION\_CP\_MIFID\_NQT\_15>

1. Do you agree with ESMA’s above assessment? If not, please explain.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_16>

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<ESMA\_QUESTION\_CP\_MIFID\_NQT\_16>

1. Are you of the view that the interpretation of TOTV should remained aligned for both transparency and transaction reporting? If not, please explain why.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_17>

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<ESMA\_QUESTION\_CP\_MIFID\_NQT\_17>

1. Which of the three options proposed, would you recommend (Option 1, Option 2 or Option 3)? In case you recommend an alternative way forward, please explain.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_18>

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<ESMA\_QUESTION\_CP\_MIFID\_NQT\_18>

1. What is your view on the proposal to delete the possibility for temporarily suspending the transparency provisions? Please explain.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_19>

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<ESMA\_QUESTION\_CP\_MIFID\_NQT\_19>

1. Do you have any remarks on the assessment of Article 28 of MiFIR? Please explain.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_20>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_20>

1. Do you have any views on the above-mentioned criteria and whether the criteria are sufficient and appropriate for assessing the liquidity of derivatives? Do you consider it necessary to include further criteria (e.g. currency)? Do you consider that ESMA should make use of the provision in Article 32(4) for asset classes currently not subject to the trading obligations? Please explain.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_21>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_21>

1. Do you agree that a procedure for the swift suspension of the trading obligation for derivatives is needed? Do you agree with the proposed procedure? Please explain.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_22>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_22>

1. Do you have a view on this or any other issues related to the application of the DTO?

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_23>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_23>

1. Do you have any views on the functioning of the register? Please explain.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_24>

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<ESMA\_QUESTION\_CP\_MIFID\_NQT\_24>

1. Do you agree that the current quarterly liquidity calculation for bonds is appropriate or would you be of the view that the liquidity determination of bonds should be simplified and provide for more stable results? Please explain.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_25>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_25>

1. Do you agree with ESMA proposal to move to stage 2 for the determination of the liquidity assessment of bonds? Please explain.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_26>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_26>

1. Do you agree with ESMA proposal not to move to stage 2 for the determination of the pre-trade SSTI thresholds for all non-equity instruments except bonds? Please explain.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_27>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_27>

1. Do you agree with ESMA proposal to move to stage 2 for the determination of the pre-trade SSTI thresholds for bonds (except ETCs and ETNs)? Please explain.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_28>

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<ESMA\_QUESTION\_CP\_MIFID\_NQT\_28>

1. What is your view on the current calibration of the ADNA and ADNT for commodity derivatives? Are there specific sub-asset classes for which the current calibration is problematic? Please justify your views and proposals with quantitative elements where available.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_29>

RTS 2 sets out the methodology for determining illiquid instruments. The IL waiver thresholds are determined on the basis of the average traded daily notional amount (ADNA) (or average daily amount in the case of emission markets) and the average daily number of trades (ADNT) as specified by the RTS for a given sub-asset class.

However, this methodology has proven unworkable in practice, particularly with respect to energy commodity derivatives. Calculations based on insufficiently granular sub-asset classes, besides arbitrarily selected and inappropriately calibrated parameters, result in a significant number of niche and nascent products being incorrectly classified as liquid based on the two liquidity criteria in Table 7.1, Annex III, RTS 2. These products are then subject to significantly broader transparency requirements, which were previously reserved for developed markets.

The latter has the effect of preventing nascent commodity derivatives markets from developing, pushing small and medium sized members towards more bilateral (OTC) trading. This ultimately results in more direct trading with the large(r) producers, often referred to as origination business.

Consequently, Europex proposes to replace the current RTS 2 methodology for calculating LIS and IL waiver thresholds for commodity derivatives with a product-specific approach based on well-established practices of trading venues. Please see our response to Question 31 for our full proposal.

A key principle underpinning this approach is the exclusion of price from the calculation of IL and LIS threshold. The inclusion of price in the calculation of the ILQ and LIS threshold values can lead to misinterpretations and confusion when measuring liquidity in instruments that are not natively defined in notional value. This can result in situations like the following:

1. Price movements occurring in the same direction as changes in liquidity exaggerate the liquidity changes;
2. Price movements which occur in the opposite direction mute the change in liquidity;
3. Price movements without a change in liquidity make liquidity appear more volatile than it actually is.

Liquidity should therefore not be measured by the notional value of transactions. For example, applying notional value as per the ADNA across all asset classes is likely to introduce a significant amount of ‘noise’ to an analysis of market liquidity. Moreover, market players typically hedge their production and consumption in trading in lots and not in notional value.

Thus, we recommend that any liquidity analysis is normalised to a base quantity unit that is native to the asset class. For commodities this will typically be a specific unit of measure (e.g. barrels, tons, MW, etc.).

Given the urgent need to find a workable solution that avoids the negative impacts outlined above, we propose a recalibration of the LIS and IL waiver thresholds for energy derivatives as a ‘quick-fix’ solution. This will allow exchanges to implement appropriate LIS thresholds for liquid contracts as soon as possible and reduce the detrimental impact of RTS 2 on the ability of energy market participants to use regulated platforms to hedge their risk exposures.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_29>

1. In relation to the segmentation criteria used for commodity derivatives: what is your view on the segmentation criteria currently used? Do you have suggestions to amend them? What is your view on ESMA’s proposals SC1 to SC3? In your view, for which sub-asset classes the “delivery/cash settlement location” parameter is relevant.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_30>

Europex supports proposals SC1 and SC2 for the added benefit they would provide in making data for different commodity classes more comparable. Therefore, we strongly recommend setting a generous timeline and work solely in a forward-looking way.

Europex considers the current segmentation criteria for commodity derivatives to be insufficiently granular. This leads to certain commodity derivatives contracts being wrongly classified as liquid or subject to excessive Large In Scale thresholds. This insufficient granularity is in particular an issue for oil markets where important aspects, such as delivery points, are currently not taken into account and contracts with the same physical underlying but delivered to different locations are subject to the same requirements. In consequence, this causes discriminatory treatment for oil contracts at less liquid delivery points.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_30>

1. What is your view on the analysis and proposals related to the pre-trade LIS thresholds for commodity derivatives? Which proposal to mitigate the counterintuitive effect of the current percentile approach do you prefer (i.e. keep the current methodology but modify its parameters, or change the methodology e.g. using a different metric for the liquidity criteria)? Please justify your views and proposals with quantitative elements where available.

<ESMA\_QUESTION\_CP\_MIFID\_NQT\_31>

RTS 2 sets out the methodology for calculating LIS thresholds. The LIS calculation is based on a threshold floor expressed as notional trade value in a given sub-asset class and the trade size which lies below the percentage of transactions corresponding to the trade percentile specified in the RTS for this sub-asset class.

However, this methodology has proven unworkable in practice, particularly with respect to energy commodity derivatives. Calculations based on insufficiently granular sub-asset classes, besides arbitrarily selected and inappropriately calibrated parameters, result in disproportionately low LIS thresholds for highly liquid products and overly high thresholds for developing markets. This could lead market participants to revert to more bilateral trading outside transparent and supervised venues and outside CCP clearing. To avoid this and allow for a more natural move to on venue trading, the current methodology for setting the LIS thresholds should be replaced by a more appropriately tailored and market-based approach.

Trading venues and market participants are also challenged by the fact that the LIS thresholds are set in Euros instead of lots. Using lots has been the market standard for similar threshold calculations pre-MiFIR. The current LIS thresholds based on historical Euro trade values and not the number of traded lots in a particular sub-asset class can create unintended and disproportionate LIS thresholds that ignore the actual underlying trading behaviour.

For example, the LIS threshold for highly liquid ICE Futures Europe Gasoil Futures calculated under the current RTS 2 methodology is equal to 10 lots compared to the 100 lots minimum block threshold previously applied before the introduction of MiFIR. In contrast, in far less liquid products such as Rotterdam Coal Options, only trades above 50 lots would be considered LIS as compared to the 5 lots block threshold pre-MiFIR.

Europex proposes the following solution:

**Replace the current RTS 2 methodology with a product-specific approach for calculating LIS and IL waiver thresholds**

Europex first proposes replacing the current methodology for calculating LIS and IL waiver thresholds for commodity derivatives with a product-specific approach based on well-established practices of trading venues. Below we emphasize several key principles as a basis for developing a workable method:

1. **Exclusion of price from the calculation of LIS thresholds**

Importantly, the inclusion of price in the calculation of the ILQ and LIS threshold values can lead to misinterpretations and confusion when measuring liquidity in instruments that are not natively defined in notional value. This can result in situations like the following:

1. Price movements occurring in the same direction as changes in liquidity exaggerate the liquidity changes;
2. Price movements which occur in the opposite direction mute the change in liquidity; and
3. Price movements without a change in liquidity make liquidity appear more volatile than it actually is.

**Liquidity should therefore not be measured by the notional value of transactions.** Applying notional value as per the ADNA (Average Daily Notional Amount) across all asset classes is likely to introduce a significant amount of ‘noise’ to an analysis of market liquidity. Moreover, market players typically hedge their production and consumption in trading in lots and not in notional value.

Thus, we recommend that any liquidity analysis is normalised to a base quantity unit that is native to the asset class. For commodities this will typically be a specific unit of measure (e.g. barrels, tons, MW, etc.).

1. **Sufficiently high daily number of trades for a market to be liquid**

In order for a market to be considered liquid, a sufficiently high number of trades should be executed on each trading day. **We recommend that the threshold be set at the median of 100 transactions per day instead of the current average of 10.** Considering the fact that liquidity is the ability to find a counterparty in a relatively short period of time within a given trading day, a threshold of 100 trades per day implies that it represents an average of approximately 1 trade every 5 minutes on an 8-hour trading day. In contrast, a threshold of 10 trades represents just 1.25 trades per hour. Given that trading is rarely uniformly distributed throughout the day, the higher threshold is a better basis for determining liquidity.

For the same reason, **a median is proposed as the minimum instead of a mean**. The mean can simply be an alternate view of the sum count of trades per year.

1. **Trade frequency and standard size rather than volume as liquidity indicators**

Consider two instruments: Instrument 1 is traded on average once per day for 100,000 units and Instrument 2 is traded on average 10,000 times per day for 10 units. In both cases, the average volume will be 100,000 units per day. However, it would be very difficult to categorise Instrument 1 as liquid, whereas Instrument 2 can be considered very liquid for trade volumes of approximately 10 units. **We therefore recommend that trade frequency and standard size, excluding unrelated vectors such as price and currency, are both measured in order to determine liquidity.**

1. **Counterintuitive effects of a percentile-based approach**

A percentile-based approach can lead to significant counterintuitive effects, which is important to keep in mind when setting LIS thresholds. We would like to illustrate this in the following:

Figure 1 represents the distribution of trade quantities in a highly liquid instrument.

A screenshot of a cell phone

Description automatically generated

Figure 2 is a similar chart for an instrument that exceeds 100 trades per day but has significantly lower liquidity.

A screenshot of a cell phone

Description automatically generated

Explanation: The low-liquidity instrument in Figure 2 is beginning to develop liquidity in lower trade sizes as evidenced by the local spike at a quantity of 1. However, some metric specific to this instrument is st

ill driving the trade sizes in increments of 5 unit multiples with specific drivers around the 50 level. Such drivers are no longer the main determinant of trade size in the high liquidity market in Figure 1.

Table 1 shows the basic statistics of the two instruments described above:

*Table 1: Basic statistics of a high liquidity instrument and a low liquidity instrument*

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Liquidity | Mean | Median | Mode | Standard Deviation | Mode Trade Size as a percentage of Total Trades |
| High | 2.59 | 1 | 1 | 12.01 | 77.66% |
| Low | 39.61 | 40 | 50 | 36.12 | 36.02% |

Any approach similar to the existing one using a central or percentile-based measure applied equally to these two examples will result in:

a)  A low standard size for the high liquidity instrument;

b)  A high standard size for the low liquidity instrument;

c)  A low LIS for the high liquidity instrument (the 70th percentile is still 1 unit);

d)  A high LIS for the low liquidity instrument (the 70th percentile is 50 units by trade and 72 units by volume).

The above results are counterintuitive and imply that the instrument with lower liquidity can support higher LIS levels than the high-liquidity instrument – when in fact the opposite is true. While the low liquidity instrument does typically trade in a higher size, the overall size of this market and trade frequency is dwarfed by the higher liquidity of the market. Therefore, setting a low LIS for high liquidity markets and a high LIS for low liquidity markets based on the standard trade size in either mean, median or mode terms is detrimental for the development of low liquidity markets.

There is a clear need for multiple approaches or a scaled approach based on variations in distribution.

1. **Decreased LIS threshold floor**

For many commodity markets in Europe, the minimum threshold of 500,000 EUR is too high and should be decreased significantly.

As an example, in the Nordic electricity derivatives space, the off-order book volumes are essential to the generation of on-order book volumes. In the off-order book volume the market consists of a substantial amount of stakeholders that are non-financial counterparties, such as utilities, generators of electricity and wholesale distributors. The market is supplemented with financial counterparties, essential for the efficiency of the market. The market is, for this reason, heavily dependent on the

broker community to bring off-order book volumes to the exchange. Off-order book

participants often have larger volumes to hedge in one go, across various maturities, which would (with high likelihood) skew the market price if placed in the regular order book of the exchange.

We support the introduction of LIS thresholds that have been in place at exchanges for decades to promote transparent order book trading versus less transparent off-order book trading. The problem with the current regime is that the LIS thresholds become disproportionate and restrict the market from functioning in an efficient manner. The disproportionate LIS thresholds are due to a number of factors such as the ill-calibrated parameters for ADNA and ADNT.

The biggest problem, however, is the pre-trade LIS threshold floor, currently set at 500,000 EUR, and the ill-calibrated trade percentile of 70%.

In addition, the use of a euro-denominated minimum floor value is inefficient when applying this to commodity derivatives as the nominal value is of little importance for commodity traders. The price of the given commodity fluctuates constantly, and the underlying quantity/volume is the actual concern when concluding a trade or placing a bid in the order book.

When looking at the size of each trade, disregarding the notional value of the trade itself, our analysis showed the following when comparing the LIS threshold in lots vs the mode (most frequently traded size):

*Table 2: LIS threshold in lots vs the mode*

|  |  |  |  |
| --- | --- | --- | --- |
| **Contract Type** | **LIS in Lots** | **Mode** | **Average** |
| Day | 726 | 50 | 60 |
| Week | 104 | 25 | 24 |
| Month | 24 | 5 | 10 |
| Quarter | 8 | 3 | 5 |
| Year | 2 | 1 | 2 |

This shows that the LIS thresholds are largely disproportionate, especially when the inherent size (number of MWh) is low in the given contract (i.e. a day contract covers 24 hours, while a year contract typically covers 8760 hours). The LIS thresholds in this case eliminates more or less all off-order book trading and, when eliminating the majority, the rest will follow the vicious circle.

Moreover, the methodology has considered a number of segmentation criteria, but is lacking a clear segmentation of inherent volume of a contract. As an example, a week contract can fall within the same liquid time to maturity bucket as a monthly or a quarterly contract. When applying a minimum LIS floor in euros (e.g. for month 1-12), the effect on a weekly contract and a quarterly contract is extremely disproportionate.

**Recalibrating the LIS and IL waiver thresholds for energy derivatives**

Europex appreciates that while working on a revised methodology for calculating pre-trade transparency thresholds in line with the key principles set out above, ESMA may choose to introduce an interim ‘quick-fix’ solution. Such a solution would allow exchanges to implement RTS 2 requirements as soon as possible. In this context, we would like to propose the below revised thresholds that should reduce the detrimental impact of RTS 2 on the ability of energy market participants to use regulated platforms to hedge their risk exposures.

Please note that the below proposals for the revised thresholds are based on the assumption that, for the bucket grouping according to time to delivery, each financial instrument (e.g. Phelix Monthly Futures) is considered individually for the purpose of the calculation. For example, the July 18 expiry in the Phelix Monthly Futures would not be placed in one maturity bucket with other futures products with the same underlying, e.g. the Second Week July 18 Phelix Weekly Futures. Any other way of conducting these calculations would inevitably produce inaccurate outcomes in terms of liquidity profiles of the instruments in question.

Furthermore, **the proposal should be adopted in its entirety**. It should be understood as a combination of thresholds that cannot be detached from one another.

*Table 3: Proposed revised threshold values for energy commodity derivatives*

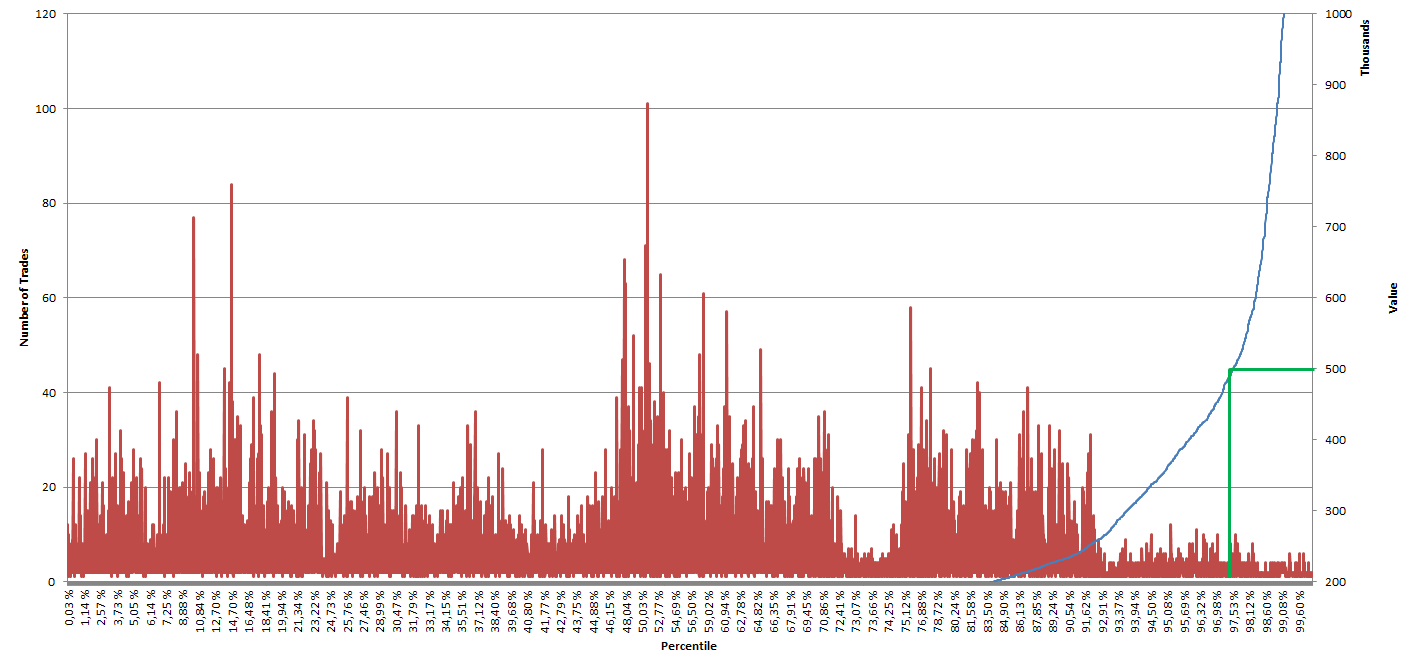
|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **IL waiver (Table 7.1, Annex III, RTS 2)** | | **LIS waiver (Table 7.2, Annex III RTS 2)** | |
| **Average daily number of trades** | **Average daily notional amount (ADNA)** | **LIS percentile** | **LIS, notional value of a trade** |
| **Current value** | 10 | 10,000,000 | 70 | 500,000 |
| **Proposal** | **100** | **100,000,000** | **30** | **50,000** |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **IL waiver (Table 13.1, Annex III, RTS 2)** | | **LIS (Table 13.2, Annex III RTS 2)** | |
| **Average daily number of trades** | **Average daily notional amount (ADNA)** | **LIS percentile** | **LIS, notional value of a trade** |
| **Current value** | 5 | **150,000** tons of equivalent | 70 | EUA as underlying **50,000** tons / other underlying: **25,000** tons |
| **Proposal** | **100** | **150,000** | **30** | **50,000/25,000** |

For example, the Nasdaq Nordic Electricity Monthly Futures Bucket 2 would be deemed liquid under both the current threshold of 10 trades and 10,000,000 EUR as well as the proposed threshold of 100 trades and 100,000,000 EUR depending on the development of prices. A threshold floor of 500,000 EUR would fall at the 97th percentile, thereby jeopardising the ability of market participants to hedge their exposures. This clearly indicates that the LIS threshold floor is set far too high when a product becomes liquid.

To illustrate this, please see the chart below where the green line marks the current LIS floor:

*Figure 3: Determining the LIS floor[[1]](#footnote-2)*



Explanation: the red columns show the number of trades (left Y-axis) at each percentile. The blue line shows the trade value in thousands (right Y-axis) at each percentile. The green line marks the current LIS floor of 500,000 EUR (right Y-axis) and marks the current LIS floor percentile. This value stipulates 97.5% on the X-axis. The percentile is measured by sorting all trades in the period by trade value.

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1. \*Note: the number of trades and the notional values are measured over a defined interval, in this case from 1.1.2017 to 31.12.2017. The monthly contracts are compiled in maturity bucket 2, representing 1 month < time to maturity ≤ 1 year. [↑](#footnote-ref-2)