European Securities and Markets Authority

Reply form for the Consultation Paper on the RTS 2 Annual Review

12 May 2021

European Securities and Markets Authority

Date: 12 May 2021

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 11 June 2021.

All contributions should be submitted online at 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 under the headings 'Legal notice' and 'Data protection'.

General information about respondent

Name of the company / organisation	International Capital Market Association
Activity	Other Financial service providers
Are you representing an association?	☒
Country/Region	Europe

Introduction

Please make your introductory comments below, if any:

<ESMA_COMMENT_CP_MIFID_NQT_1>
On behalf of the International Capital Market Association (ICMA), we are pleased to provide feedback regarding "ESMA's consultation paper on the RTS 2 Annual Review". ICMA's transparency taskforce (Taskforce) is grateful for the opportunity to respond to ESMA's consultation paper. The ICMA transparency taskforce member response is based on consensus view from a varied group of buy-side and sell-side investment firm bond trading participants and trading venues, representing Germany, France, Austria, Netherlands, Switzerland, Spain, Italy, UK, and the United States. There is a unique value in conveying broad view from across the industry and we hope this response is informative and useful. Taskforce members welcome the efforts of ESMA to seek out stakeholder views concerning the appropriateness of moving to stage 3 liquidity assessment, as set out in Article 17 of RTS 2.

In particular, the Taskforce welcomes the opportunity to provide ESMA with industry-based clarification and feedback regarding liquidity assessment stage advancement. This response is solely in relation to cash bonds.

ICMA would like to reconfirm its position on liquidity stage progression. As mentioned in its response to last year's ESMA consultation paper on 'MiFID II/ MiFIR review report on the transparency regime for non-equity and the trading obligations for derivatives'; "[ICMA taskforce members] believe no liquidity stage advancement should be considered before the liquid bond data universe, data set and liquidity output are verified as accurate by the 'DAG'". The 'Data Advisory Group' (DAG) members independently verifies bond liquidity and threshold data output together with ESMA.

Definition of 'Data Advisory Group' (DAG) as set out in ICMA's response to ESMA consultation paper on MiFID II/ MiFIR review report on the transparency regime for non-equity and the trading obligations for derivatives: The 'DAG', which was announced by ESMA on 6 August 2019 (never launched), has industry 'operational level' experts, including trading venues, APAs, data providers, sell-side banks (global and EU headquartered), Institutional Investors (global and EU headquartered) and intermediaries. ICMA suggests if ESMA sets up the DAG, they should ensure 'DAG' APA representatives are from the top APA providers as listed on ESMA's website, as those data repositories will likely have the most accurate datasets. The DAG "informs the DSC* on matters of practical implementation of reporting requirements which require clarifications or adaptations", according to ESMA. ICMA's Taskforce believes the 'DAG' should work alongside Data Standing Committee (DSC) in an interactive actionable manner to collectively produce good quality liquid bond and transparency data.

The Taskforce also believes no liquidity stage advancement should be considered before the liquid bond data universe, data set and liquidity output are verified as accurate by the 'DAG'.

Actions the DAG, working alongside the DSC could take:

- i. Detect outliers / data quality errors.
    - a. for example, by comparing data output with third party market data.
- ii. Take action against those outliers.
    - b. = not taking them into account in calculations.
    - c. + follow up with outlier data providers (supervision).

iii. Analyse data to detect missing data.

d. For example, compare with third party market data, they could find the top 100 most traded bonds on the data provider with the most bond data.

e. If not, investigate / challenge TV, APAs, Investment firms.

ESMA would proactively work alongside the DAG, including taking all necessary actions to resolve data quality issues including using ‘outlier advanced analytics to improve bond data quality and liquidity assessments.

Important to note, if the ‘DAG’ reviewed the liquidity data output and worked with ESMA to dynamically rectify and correct the data and then verify the data was correct, the industry could rely more on the list of liquid bonds and the bond universe. This would lead industry to potentially feel more comfortable with simplifying transparency regime, including thresholds and deferral periods.

*Data Standing Committee: https://www.esma.europa.eu/about-esma/working-methods/standing-committees.
<ESMA_COMMENT_CP_MIFID_NQT_1>

Q1. Do you agree with ESMA’s proposal to move to stage 3 for the determination of the liquidity assessment of bonds? Please explain.

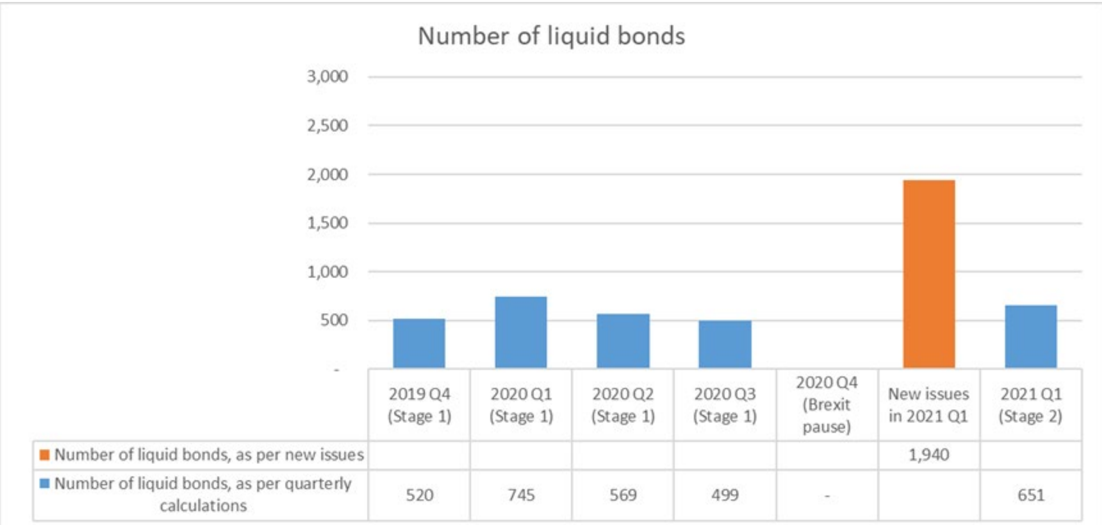
<ESMA_QUESTION_CP_MIFID_NQT_1>
ICMA does not agree with the proposal to move to stage 3 liquidity determination of assessment for bonds. However, ICMA does support transparency in bond markets, as long as the transparency regime balances risk and exposure for investors and liquidity providers.

ICMA notes RTS 2 does not dictate specifically the bond dataset should be analysed annually before moving to the next stage. However, the regulation does indicate that the assessment should be conducted on the 30th of July each year. Making Taskforce members believe it is important for, quality control purposes, to analyse the calculation data annually and not during a short window of time as proposed in this consultation e.g., moving from the very recent (approx. 6 weeks ago) stage 2 to stage 3.

Transparency taskforce members are concerned that any move to stage 3 liquidity assessment so soon after moving to stage 2 (15 April 2021), sets an unwelcome precedent. The concern for taskforce members is by ESMA setting the precedent of moving to the next stage of liquidity assessment, without an annual ‘lookback’, creates the conditions for ESMA to move to stage 4 without a thorough ‘lookback’ and/or industry verification and acknowledgement. Stage 4 liquidity assessment of 2 trades per day is worrying for ICMA taskforce members who are bond market participants, as this could result in negative consequences such as, wider bid offer spreads.

The Taskforce would like to point out ‘lookback’ analysis could have been carried out by the ‘DAG’, as mentioned in the introduction. Had ESMA launched the ‘DAG’, this industry expert group could have analysed and verified the bond transparency data alongside ESMA. The DAG could have helped ESMA with calibrating the data using stage 2 liquidity assessment parameters.

The DAG could have also assisted ESMA with identifying liquid bonds such as, new issue bonds and verifying the accuracy of the bond data universe. The graph below highlights in Q1 2021 there were 1940 liquid new issues bonds as of 6 May 2021. May 6th represents on any given day there were additional liquid new issue bonds. However, none of the additional new issue bonds were included in ESMA’s analysis. Only 651 bonds were declared liquid in Q1 2021.



Source: ICMA analysis using ESMA data

Furthermore, the bond universe that ESMA often refers to in official communications in the last few years has changed quite significantly. In ESMA’s March 2020 consultation paper, ESMA declared for Q3 2019, the bond universe was 320,696 bonds. While in November 2020 in ESMA’s statistical report, ESMA declared the bond universe for the full year of 2019 to be 173,656 bonds. Finally, in this consultation paper published on 10 March 2021, ESMA announced the bond universe for Q4 2020 to be 38,076 bonds, including UK data (excluding UK bond data, the universe of bonds is 28,126). ICMA taskforce members are confused as to the radical change in bond universe numbers. ICMA is however pleased the bond universe is moving towards a potentially more accurate reflection of the bond universe. Even so, ICMA would welcome the opportunity to understand better ESMA's parameters and process for determining the bond universe.

ICMA understands it is unlikely ESMA will create the DAG. Therefore, the industry does not have confidence that the universe of bond data is correct, or the number of liquid bonds is accurately portrayed. ICMA suggests ESMA should not progress any liquidity stage advancement until either the DAG is launched (as described above) and operational or an industry accepted bond consolidated tape (industry acknowledged prototype or final version consolidated tape) is producing good quality post-trade bond data, which can be used for analysis by both ESMA and industry participants.

<ESMA_QUESTION_CP_MIFID_NQT_1>

Q2. Do you agree with ESMA's 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_2>
N/A
<ESMA_QUESTION_CP_MIFID_NQT_2>

Q3. Do you agree with ESMA's proposal to move to stage 3 for the determination of the pre-trade SSTI thresholds for bonds (except ETCs and ETNs)? Please explain.

<ESMA_QUESTION_CP_MIFID_NQT_3>
ICMA does not support the move to stage 3 for the determination of pre-trade SSTI thresholds for bonds.

Firstly, ICMA would like to address the inaccuracies in paragraph 40 regarding the perception of market making activity in bond markets. ESMA states: "over the last years a reduction in market making activity in fixed income markets could be observed. This development appears to be largely driven by an increased reluctance of market makers to be exposed to market risks…" ICMA politely disagrees and points out market makers do expose themselves to risk for clients, even in stressed market conditions. This is evidenced in ICMA's European investment grade corporate bond secondary market & the COVID-19 study, where it states regarding trading in a crisis: "[ICMA] "Respondents confirm that during the peak of the crisis, for the most part, electronic trading in the European corporate bond markets broke down as participants resorted to voice trading. This was not so much due to technological challenges with firms relocating from their trading floors, but rather the consequence of market conditions. Essentially the market became too volatile and too illiquid for dealers and other liquidity providers to risk providing pricing across electronic platforms…. [The] observation of buy-sides seems to be the value of strong relationships with their dealer banks, and also in knowing who will be there when most needed and when the screens go blank. Whether the screens are switched on or off, it is the dealer-client relationship that ultimately holds the market together".

One of the key lessons, regarding liquidity provision and market making, learned from stressed conditions such as the Covid crisis, is to be reminded how corporate bond secondary markets function and how liquidity is created. "The structure of corporate bond markets is fundamentally different to that of the [exchange based] equity market, and while over a decade of technological innovation has provided significant efficiencies as well as facilitating [very welcome] new ways in which to access liquidity, this simple reality has not changed. Market-makers remain at the core of credit markets, and it is their capacity and willingness to assume and recycle risk (both long and short) that allows the secondary market to function."

The May 2020 ICMA Covid study "covered liquidity in the European IG credit market which became severely impaired during the period of late February and early to-mid March, and by March 18 2020, considered to be the nadir of the 'liquidity crisis, with some reporting the market had become dysfunctional". Therefore, this ICMA Covid impact study is a good reflection of modern bond market liquidity provision practice in stressed market conditions and the role of market markers.

Furthermore, ICMA would like to additionally comment on ESMA's statement in paragraph 40: … "development of new trading protocols, such as all-to-all trading platforms, can be observed compensating for the reduced contribution of market makers." ICMA would like to point out an orderly functioning bond market has a combination of healthy market making and e-trading protocols (such as all-to-all) working together in a symbiotic relationship. Taskforce participants observe all-to-all trading does not substitute for market-maker based trading for large in scale or illiquid trades.

"Buy-sides noted [in ICMA's Covid impact study], that any prices that could be found on platforms [trading venues] were unlikely to be executable, while in many cases electronic RFQs did not return quotes. As one buy-side participant explains, everything effectively became 'high touch', involving direct messaging or a phone call with a salesperson. Meanwhile, to the extent that buy-sides were able to continue to rely on their OMS/EMS functionality, this required far greater flexibility in their price tolerance parameters."

However, the ICMA study into stressed Covid related markets also found "volumes on venues remained high, registering record volumes at certain points... A number of respondents reported that as it became more difficult to find the three or more quotes that are often required as part of firm's best execution policy, they turned to all-to-all RFQ functionality to reach a broader base of potential liquidity providers. Similarly, anonymous trading venues (sometimes referred to as 'dark pools') also found traction….Perhaps unsurprisingly, the most utilised venue protocol during this period appears to have been 'move to venue' (also referred to as 'processed trades'), whereby trades are negotiated over the phone or via messaging, and then, once agreed, 'consummated' through a platform [trading venue] in order for the parties to benefit from automated post-trade processes, such as reporting and settlement."

The study proved that during stressed market conditions, market makers contributed liquidity to bond market participants and electronic trading protocols did not replace market-makers but complemented them. Taskforce members observe the universal truth, while trading moves to all-to-all trading venues because the trading is liquid, trading does not become liquid because the trading is on all-to-all venues.

ICMA believes ESMA should consider these facts when formulating opinions regarding the state of bond market trading and appearing to suggest that all-to-all trading could eventually replace market makers.

Therefore, ICMA disagrees with ESMA's statement in paragraph 40; "the role of SSTI waiver aiming at protecting market makers and liquidity providers from undue risk has become somewhat less important." As a result, ICMA disagrees with ESMA's suggestion to move to stage 3 for the determination of the SSTI threshold as proposed in paragraph 44, for the market structure reasons set out above and the data quality reasons set out in the response to question 1.

<ESMA_QUESTION_CP_MIFID_NQT_3>