ESMA guidance on the implementation of MiFID II/R

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MiFID II/R entered into force on 3 January 2018. In the last quarter of 2017, the European Securities and Markets Authority (ESMA) provided further guidance on a number of key issues for fixed income markets.

The following briefing is designed to provide a non-exhaustive summary of selected guidance impacting market structure and fixed income trading, notably: (i) Legal Entity Identifier requirements; (ii) other new ESMA Q&As released on 18 December 2017; (iii) an overview of MiFID II deferral regimes in EU Member States; (iv) liquidity assessments of individual bonds for trade reporting; (v) a revised ESMA opinion providing guidance related to third-country trading venues for post-trade transparency; (vi) trade reporting and third-country scenarios; (vii) transparency requirements for partial execution and post-trade deferrals for OTC trades; and (viii) transparency questions related to hedging newly issued bonds.

In addition, ICMA has been sending monthly briefings to members: the most recent example is the MiFID II/R Members Update December 2017.

(i) Legal Entity Identifier (LEI) requirements

The Legal Entity Identifier (LEI) is a mandatory requirement under MiFID II/R for meeting reporting obligations. It is a 20-digit, alpha-numeric code that enables clear and unique identification of legal entities participating in financial transactions. An LEI can be obtained from LEI issuers, also known as Local Operating Units (LOUs). A list of LEI issuers is available on the Global LEI Foundation (GLEIF) website.

On 20 December, ESMA published new guidance on LEIs:

LEIs for clients that are legal persons

- ESMA's original "validation test" (before the ESMA announcement on 20 December) for LEIs was: if there is

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Overview of selected ESMA guidance in the fourth quarter of 2017:

22 December: Updated liquidity assessments for individual bonds by ISIN

20 December: New ESMA guidance on Legal Entity Identifiers (LEIs)

18 December: Q&As on MiFID II/R transparency topics

18 December: Q&As on MiFID II/R market structure topics

18 December: Q&As on MiFIR data reporting

18 December: Q&As on MiFID II/R investor protection and intermediaries topics

15 December: Revised opinion in relation to third-country trading venues for post-trade transparency

15 December: Overview of MiFID II deferral regimes in EU Member States

14 December: Q&As on post-trading topics

6 December: Liquidity assessments for individual bonds by ISIN

15 November: Q&As on transparency topics

15 November: Q&As on market structure topics

14 November: Q&As on MiFIR data reporting

10 November: Q&As on investor protection topics

9 October: Briefing on Legal Entity Identifiers (LEIs)

3 October: Q&As on transparency topics

3 October: Q&As on investor protection topics

Note: ESMA Q&As and guidance are continuously updated, as dates reflect.

a missing LEI or the LEI issue date post-dates the trade date, the transaction report is rejected.

- Under the new regime, ESMA provides for a temporary period of six months whereby investment firms may provide a service triggering the obligation to submit a transaction report to the client, from which it did not previously obtain an LEI code, under the condition that before providing such service the investment firm obtains the necessary documentation from this client to apply for an LEI code on his behalf. The investment firm will need to apply immediately for the issuance of the LEI on behalf of the client. Once the relevant LEI has been obtained, the investment firm should submit its transaction report (as outlined in Article 26 of MiFIR).
- This will also require NCAs temporarily to amend a validation rule in their transaction reporting systems to allow for the acceptance of transaction reports where the LEI issuance date is after the transaction execution date. Investment firms are invited to contact directly their NCA for the specific details regarding these amendments.
- To streamline the issuance of LEIs, the GLEIF has introduced the concept of the Registration Agent. A Registration Agent helps legal entities to access the network of LEI issuing organisations responsible for performing LEI issuance and related services.
- ESMA and NCAs reiterate that investment firms are expected to ensure full compliance with the MiFIR requirement for the identification of clients that are legal persons using LEIs, given the relevance and importance of these data for regulatory supervision purposes.

LEIs for issuers

- ESMA previously stated that, starting from 3 January 2018, trading venues are expected to use the LEI codes pertaining to a given issuer when submitting reference data on financial instruments issued by EU issuers to support market abuse monitoring and market transparency through Financial Instruments Reference Data Systems (FIRDS). The correct LEI of an EU issuer is also required to determine the appropriate NCA for reporting purposes. Failure to submit an LEI of the EU issuer will be considered a breach of reporting requirements by the trading venue.
- ESMA equally expects trading venues to ensure that all non-EU issuers are identified through their respective LEI codes. However, understanding the additional difficulties in this case and to facilitate the introduction of the new reporting requirements, trading venues will be allowed on a temporary basis of six months to report their own LEI codes instead of LEI codes of the non-EU issuers while reaching out to the non-EU issuers.
- ESMA and NCAs will closely monitor the accuracy and completeness of the submitted reference data and pay particular attention to the frequency and the number of trading venues' own LEIs used instead of non-EU issuers' LEIs.

Previously, ESMA published on 9 October 2017 a Briefing on the LEI, reiterating to whom the requirements apply and how to obtain an LEI.

As highlighted in the ICMA MiFID II/R September Members Update, non-EU firms that do not have an LEI may find that EU counterparties are unable to transact with them, or that they are unable to transact on EU trading venues. Similarly, issuers of securities that are traded on EU venues (Regulated Markets, Multilateral Trading Facilities, Organised Trading Facilities, and Systematic Internalisers) need to provide an LEI.

(ii) Other new ESMA Q&As released on 18 December 2017

ESMA issued further Q&As on 18 December 2017 on the following topics:

- MiFID II/R investor protection and intermediaries. Key areas discussed include best execution, inducements, provision of investment services and activities by third-country firms and late transposition of MiFID II.
- MiFIR data reporting. Q&A updates encompass transaction reporting obligations for non-EU branches of EU investment firms, and the concept of underlying instruments.
- MiFID II/R market structure. Key areas discussed include the application of MiFID II after 3 January 2018, including issues of late transposition, in relation to authorisations of regulated markets and reporting services providers.
- MiFID II/R transparency. Updates include Q&As on non-equity transparency, and pre-trade transparency waivers.

(iii) Overview of MiFID II/R deferral regimes in EU Member States

On 15 December, ESMA published a table compiling the supplementary deferral regimes applicable in different Member States for trading in non-equity instruments under MiFIR.

Under Article 11 of MiFIR, national competent authorities (NCAs) are empowered to grant operators of trading venues a publication deferral of the details of transactions that meet either of the following characteristics: Large in Scale (LIS), deemed illiquid, or above the Size-Specific-To-Instrument (SSTI) threshold. In conjunction with a publication deferral, NCAs may grant a "supplementary deferral" which means that the level of granularity may vary, ie by:

(a) requiring the publication of additional information during the standard time period of deferral;

(b) allowing the omission of the publication of the volume of transactions for a time period of four weeks;

(c) allowing the aggregation of transactions for a time period of four weeks (non-equity instruments other than sovereign debt);

(d) allowing the aggregation of transactions for an indefinite period of time (sovereign debt instruments);

(e) allowing the combination of (b) and (d) for sovereign debt instruments.

Based on voluntary contributions by NCAs, the list provides an overview of the current status of implementation of the applicable MiFIR deferred publication regime per type of instruments in Belgium, Denmark, France, Germany, Italy, Malta, the Netherlands, Portugal, Spain, Sweden and the UK.

(iv) Liquidity assessments of individual bonds for trade reporting

On 6 December, ESMA published the transitional transparency calculations (TTC) for equity and bond instruments. ESMA subsequently updated the TTCs on 22 December. According to ESMA: "This updated version mainly reflects changes in the classification of the instruments and the related parameters and resubmission of data by some trading venues." However, the changes in the TTCs for bonds are relatively minor.

In total, 561 bonds or 0.9% out of 61,656 fixed income instruments have been classed as liquid according to the MiFIR criteria (excluding Exchange Traded Commodities and Exchange Traded Notes).

Corporate bonds constitute the largest category with almost 39,000 (out of 61,656) instruments, of which 0.4% are deemed liquid. In other words, 99.6% of corporate bonds are eligible for pre-trade transparency waivers and post-trade publication deferrals due to their illiquid trading status.

The calculations are subject to future amendments by ESMA if deemed necessary and are applicable from 3 January 2018 until 15 May 2018. The next version of the liquidity assessments for bonds will be published on 1 May 2018, applicable from 16 May 2018 to 15 August 2018. Subsequently, the liquidity assessments will be revised on a quarterly basis.

Latest updates of the FAQ document issued by ESMA in relation to the TTCs can be found here.

(v) Third-country trading venues for post-trade transparency

On 15 December, ESMA issued a revised opinion on post-trade transparency requirements in relation to third-country trading venues. It stated that "in order to contribute to the smooth implementation of MiFID II/ MiFIR as of 3 January 2018 and to maintain a level playing field between third-country trading venues, transactions [executed by EU investment firms] on third-country trading venues should *not* be required to be made post-trade transparent under Articles 20 and 21 of MiFIR", pending the publication of ESMA's assessment of third-country trading venues.

In a previous opinion published on 31 May, ESMA specified that, subject to third-country trading venues meeting a set of criteria, EU investment firms trading on those trading venues were not required to make transactions public in the EU via an Approved Publication Arrangement (APA). ESMA has since been asked to conduct assessments of more than 200 third-country trading venues. The results are expected to be published in the course of 2018 according to ESMA.

(vi) Trade reporting and third-country scenarios

ESMA provided on 15 November further guidance on trade reporting requirements for transactions executed by EU investment firms outside the EU, and trades by branches or subsidiaries of non-EU firms within the EU. The Q&A addresses 13 different scenarios including the implications for trade reporting and Systematic Internaliser (SI) calculations, and provides a number of clarifications and "general principles" [Section 9, Q&A 2]:

- The transparency requirements always apply to transactions concluded on EU trading venues.
- Transactions executed on third-country trading venues should be treated as OTC transactions and reported through an APA, unless these trading venues are deemed "comparable".

Note: According to the aforementioned ESMA opinion, this does not apply until ESMA has published the assessments of third-country trading venues.

- If one of the parties of an OTC-transaction is an investment firm authorised in the EU, the transaction is considered as executed within the EU.
- Subsidiaries are independent legal entities and subject to the regulatory regime of the third country in which they are established.
- Transactions by non-EU branches of EU investment firms are treated as transactions of the EU parent company and, therefore, have to be made transparent under the MiFIR rules.

(vii) Pre-trade waivers for partial execution and post-trade deferrals for OTC trades

ESMA provided further clarifications on pre-trade waivers, partial execution in order books, RFQ and voice trading systems (15 November), and post-trade deferrals for OTC trades (3 October).

For equities and similar instruments, but importantly also for non-equity instruments, ESMA stated that "the Large in Scale (LIS) waiver continues to apply in respect of an order that is LIS when entered into an order book but that, following partial execution, falls below the threshold applicable for that financial instrument, unless the price or other relevant conditions for the execution of an order are amended" [Section 5, Q&A 6]. In other words, a partially executed LIS order in bonds is subject to the same LIS waiver.

However, in RFQ and voice-trading systems, ESMA clarified that "each actionable indication of interest (A-IOI) must be above the relevant Size-Specific-To-Instrument (SSTI) threshold to be eligible for a pre-trade waiver. The waiver is not available for trading protocols other than request-for-quote and voice-trading systems, which exclude order books. If an A-IOI above the SSTI is partially executed, the remaining amount of the A-IOI should be considered a new A-IOI and so the relevant waiver checks should be carried out again for the SSTI waiver to apply" [Section 5, Q&A 6].

With respect to post-trade deferrals, ESMA clarified that "the deferral regime applicable to OTC trades is determined by the deferral regime applicable in the Member State where the investment firm […] is established. The [EU] location of the APA through which a transaction is made public is not relevant. Where it is for an EU branch to make a transaction public, the deferral regime applicable in the Member State where that branch is located should apply" [Section 4, Q&A 2].

(viii) Transparency questions related to hedging newly issued bonds

Furthermore, ESMA addressed on 15 November transparency requirements for transactions involving the purchase of a newly issued bonds and the simultaneous sale of another bond.

Question: "Where an investment firm buys a newly issued bond in the primary market as the result of an allocation and funds its investment by selling another bond to the lead manager of the issuance, simultaneously with and contingent upon the investment in the new issue, would this qualify as a package order for the purpose of pre-trade transparency?"

ESMA's answer: "No. Since primary transactions are not subject to transparency (see General Q&A 4 on transparency issues), they should not be considered when assessing whether components executed together qualify as a package order" [Section 4, Q&A 4 i)].

Note: The wording of the above-mentioned question is nearly identical to the question ICMA submitted on behalf of its MiFID II Working Group except that it refers to pre-trade transparency and does not address the question related to hedging. Nonetheless, ESMA's reply seems to suggest that a newly issued bond and the hedge do not qualify as a package transaction and are thus not eligible for deferred publication.

Further briefings with more granular information on the above-mentioned ESMA Q&A updates can be found on ICMA's dedicated MiFID II landing page.

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