MiFID II

Derivatives: trade execution

December 2016

Key Points

- MiFID II requires certain standardised derivative contracts to be traded through a trading venue.
- This obligation only applies to those classes of derivatives that are cleared through a central counterparty ("**CCP**") and that also are sufficiently liquid.
- After MiFID II becomes effective, ESMA will be responsible for assessing whether classes of derivatives should be subject to the trading obligation.
- Technical standards will set out how ESMA will determine whether a derivative is "sufficiently liquid".
- The trading obligation gives rise to several major cross-border issues, including a requirement for some derivatives with non-EU elements to be traded on EU trading venues.

In this briefing note, we set out some of the general provisions relating to derivatives (principally the requirement for certain derivatives to be traded on-exchange). For details of other derivatives reforms, please see our separate briefing notes on Pre- and Post-Trade Transparency and on Commodity Derivatives.

The trading obligation under MiFID II

MiFID II implements commitments given by the G20 group of major economies in 2009, by requiring certain standardised derivatives which have sufficient liquidity to be traded on exchanges or electronic trading platforms.

This is intended to encourage derivatives trading to move from over-the-counter ("**OTC**") trades to trading on exchanges. This will aid transparency in the derivatives market. MiFID II recognises that a role remains for bespoke contracts for which it would be difficult to mandate exchange-trading, so the reform is aimed only at standardised contracts.

The MiFID II framework for derivatives trading is interrelated with the derivatives regime under the European Market Infrastructure Regulation ("**EMIR**").[1]

Article 28(1) of the Markets in Financial Instruments Regulation ("**MiFIR**") requires relevant counterparties to execute certain derivatives transactions only on:

- regulated markets ("**RMs**");
- multilateral trading facilities ("**MTFs**");
- organised trading facilities ("**OTFs**"); or
- certain third country (i.e. non-EU) trading venues.

The trading obligation will only apply to derivatives trades between relevant counterparties

This trading obligation will only apply to derivatives contracts concluded between:

- financial counterparties ("**FCs**"): generally speaking, FCs are investment firms, credit institutions, certain pension schemes established in the EU, alternative investment funds ("**AIFs**") and UCITS funds;[2] and
- certain non-financial counterparties ("**NFC+s**").[3]

Intragroup transactions and transactions with certain pension scheme arrangements which currently benefit from an exemption under EMIR are not subject to the trading obligation.[4]

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[1] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

[2] Article 2(8), EMIR.

[3] i.e. non-financial counterparties which meet the conditions in Article 10(1)(b), EMIR.

[4] Article 28(1), MiFIR; Article 89, EMIR.

The trading obligation will only apply to derivatives that must be cleared under EMIR

The trading obligation will only apply to those classes of derivatives that have been declared to be subject to the clearing obligation under EMIR.[5] EMIR requires certain OTC derivatives to be cleared through a CCP.

After a class of derivatives has been declared to be subject to the clearing obligation under EMIR, the European Securities and Markets Authority ("**ESMA**") then has six months to decide whether that class of derivatives should also be required to be traded on a trading venue when traded by relevant counterparties.

The trading obligation will only apply to derivatives that satisfy the "venue test" and the "liquidity test"

In order to be subject to this trading obligation, the class of derivatives (or relevant interest) must satisfy both of the following conditions:

- the "venue test": the particular class of derivatives contract must be admitted to trading or traded on at least one trading venue; and
- the "liquidity test": there must be sufficient buying and selling interest in the particular class of derivatives for it to be characterised as “sufficiently liquid” to trade on trading venues.[6]

Taken together, these tests determine which of those classes of derivatives subject to the clearing obligation under EMIR should also be subject to the MiFID II trading obligation. This means that not all derivatives required to be cleared under EMIR will be required to be traded on a trading venue under MiFID II.

[5] Regulation 648/2012.
[6] Article 32(2), MiFIR.

If ESMA decides that a particular class of derivatives should be subject to the trading obligation, it must present a draft regulatory technical standard ("**RTS**") to the European Commission stating this, and confirming the date when the trading obligation will apply.[7]

ESMA's calculation of the liquidity test

ESMA will assess the liquidity test based on criteria set out in a Commission Delegated Regulation, RTS 4.[8] This test will determine whether a derivative has sufficient buying and selling interest to be considered "sufficiently liquid" to trade on a trading venue.

RTS 4 sets out the following criteria that ESMA will take into account when calculating the liquidity test:

- *Average frequency of trades*: This calculation will be based on the number of days on which trading took place and the number of trades. ESMA will assess these criteria over a specified period of time to assess whether the liquidity varies according to seasonal or structural factors.
- *Average size of trades*: This will be calculated based on the average daily turnover (i.e. the notional size of all trades divided by the number of trading days) and the average value of trades (i.e. the notional size of all trades divided by the number of trades) during a specified period of time.
- *Number and type of market participants*: ESMA will take into consideration the following factors: the number of market participants trading in the class of derivatives is not lower than two; the

[7] Article 32(1), MiFIR.
[8] Commission Delegated Regulation (EU) of 26 May 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on criteria for determining whether derivatives subject to the clearing obligation should be subject to the trading obligation ("**RTS 4**").

number of trading venues on which the class of derivatives is traded; and the number of market makers or other market participants who have a contractual arrangement to provide liquidity.

- *Average size of spreads*: ESMA will take into consideration the size of weighted spreads over different periods of time, together with spreads at different points in time of trading sessions.[9]

Non-EU issues

Certain derivatives may be traded on non-EU trading venues

Certain derivatives contracts may be subject to the requirement to trade on third country (non-EU) trading venues, provided that:

- the European Commission has determined that the legal and supervisory framework of the third country ensures that the trading venues in that country are subject to rules equivalent to those imposed on trading venues by MiFIR; and
- the third country provides for an effective equivalent system for the recognition of trading venues under MiFID II to admit to trading or trade derivatives declared subject to a trading obligation in that third country on a non-exclusive basis.[10]

Some derivatives executed with non-EU counterparties will be subject to the trading obligation

The trading obligation will apply to FCs and NFC+s which enter into derivative transactions that have been declared subject to the trading obligation with non-EU financial institutions or other third-country entities that would be subject to the clearing obligation if they were established in the EU.[11]

The trading obligation will even apply to some derivatives where neither of the parties is based in the EU

The trading obligation will also apply to non-EU entities that would be subject to the clearing obligation if they were established in the EU, which enter into derivatives transactions that have been declared subject to the trading obligation, provided that the contract has a "direct, substantial and foreseeable effect" within the EU or where such obligation is necessary or appropriate to prevent the evasion of any provision of MiFIR.[12]

A Commission Delegated Regulation, RTS 5, clarifies that an OTC derivative contract shall be considered as having a "direct, substantial and foreseeable effect" within the EU if it is a contract entered into by at least one third country entity which has a guarantee from an EU FC which covers all or part of its liability, and which meets both of the following conditions:

- the guarantee covers all of the liability of the non-EU entity for its OTC derivatives for an aggregated notional amount of more than €8 billion; and
- the guarantee is equal to at least 5 per cent of the total exposures to OTC derivatives

9 Articles 2-5, RTS 4. For an earlier draft, see RTS 4 in ESMA, Regulatory Technical and Implementing Standards – Annex I, 28 September 2015. See also ESMA, Final Report: Draft Regulatory and Implementing Technical Standards MiFID II/MiFIR (the "**Final Report**"), 28 September 2015, Chapter 2.4; and ESMA, Consultation Paper, 19 December 2014, Chapter 3.11. RTS 11 in ESMA, Consultation Paper – Annex B, 19 December 2014.

10 Articles 28(1) and 28(2), MiFIR.

11 Article 28(2), MiFIR.

12 Article 28(3), MiFIR.

contracts for the EU financial counterparty.[13]

RTS 5 also contains anti-avoidance provisions to prevent OTC derivatives transactions from being structured for the primary purpose of avoiding the provisions of MiFIR.

In its commentary on this RTS, ESMA noted that despite broad support for its approach, approximately half of the respondents to its consultation expressed concern that derivatives transactions carried on by non-EU counterparties and which were not subject to the EMIR clearing obligation, will nevertheless be required to trade on an EU trading venue. ESMA acknowledged these concerns but concluded that, in accordance with Article 13 of MiFIR, such derivatives must be subject to the trading obligation where they have a direct, substantial and foreseeable effect in the EU.[14]

ESMA derivatives register

MiFID II requires ESMA to publish on its website a register of:

- derivatives subject to the trading obligation;
- the venues on which they are admitted to trade or are trading; and
- the date from which the trading obligation takes effect.[15]

ESMA will maintain on its website a register specifying "in an exhaustive and unequivocal manner" the derivatives subject to the trading obligation and the venues where they are admitted to trade.

Timescales for implementation

The MiFID II Directive and MiFIR came into force on 3 July 2014, and most of their provisions will come into effect in member states from 3 January 2018. Member states have until 3 July 2017 to transpose the MiFID II Directive and the Delegated Directive into national law.

The RTS will become effective from 3 January 2018. RTS are EU Regulations having direct effect in EU law and so do not need to be transposed into the national law of member states.

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13 Commission Delegated Regulation (EU) of 13 June 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on the direct, substantial and foreseeable effect of derivative contracts within the Union and the prevention of the evasion of rules and obligations ("**RTS 5**"). For earlier drafts, see RTS 5 in ESMA, Regulatory Technical and Implementing Standards: Annex I, 28 September 2015; and RTS 12 in ESMA, Consultation Paper – Annex B, 19 December 2014.

14 ESMA, Final Report, 28 September 2015, Chapter 2.5.

15 Article 34, MiFID II Directive.

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