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Trade transparency and possible waivers and deferrals for non-equity instruments

The EU aims to promote trade transparency in the financial markets in Europe. With greater transparency, investors can better and more easily assess the prices they are being offered in the market. This will help to bring lower transaction costs and more effective pricing, which may attract more investors and increase revenue, see FSA discussion paper on trade transparency and the Danish mortgage bond market¹

Against this background, the EU is introducing new pan-European requirements for both pre- and post-trade transparency for bonds, structured finance products, emission allowances and derivatives traded on organised exchanges. This is done through the EU Regulation on markets in financial instruments (MiFIR), which will enter into force on 3 January 2018.²

At the same time, the EU is aware that high transparency can have adverse effects in some markets, particularly because it can reduce liquidity.

MiFIR therefore provides for the national competent authorities (in Denmark, the Financial Supervisory Authority) to allow market operators and investment firms in various financial instruments certain waivers from the requirements for trade transparency on the pre-trade side, i.e. for orders. On the post-trade side, the FSA can allow the publication of trade information to be deferred.

The FSA has decided to use some of the options in MiFIR for waivers and deferrals. These are shown in Table 1 for bonds and derivatives. At the same time, the FSA notes that these decisions can be changed if the conditions change. The decisions may also be disregarded if the FSA considers that there are special circumstances in an application that justify this.

¹ For a more detailed description of the implications of trade transparency for the Danish mortgage market, see FSA (2017), 'Discussion paper on transparency and liquidity on the mortgage-credit-bond market'.

² Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments (MiFIR). The Regulation includes requirements for an operator of a trading venue to publish current bid and ask prices as well as information on market depth (pre-trade transparency). When a transaction is agreed, the price, volume and time of the transaction must be disclosed (post-trade transparency). This should be done as soon as technically possible and not more than five minutes after the trade is effected (for a transitional period until January 2020, the upper limit is 15 minutes).

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For structured finance products and emission allowances, the Danish FSA will assess potential applications and grant waivers and deferrals based on the same principles used for decisions on bonds and derivatives, see below.

Table 1: Options to waive from and defer disclosure

	Bonds		Derivatives	
	<i>Pre-trade</i>	<i>Post-trade</i>	<i>Pre-trade</i>	<i>Post-trade</i>
<i>Order management facility waiver</i>	✓	N/a	✓	N/a
<i>Illiquidity</i>	÷	÷	✓	✓ (T+2 days)
<i>Size specific to instrument (SSTI)*</i>	✓	÷/✓ (T+2 days)	✓	✓ (T+4 weeks)
<i>Large in scale (LIS)</i>	✓	✓ (T+2 days)	✓	✓ (T+4 weeks)

Note: * For sovereign bonds, deferral is allowed on grounds of SSTI, while SSTI deferral is not granted for all other bonds. Order management facility waivers are marked 'N/a' on the post-trade side, as they are only relevant to orders (pre-trade side). Asset classes follow the definitions in Commission Delegated Regulation (EU) 2017/583 of 14 July 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 transparency requirements for trading venues and investment firms in respect of bonds, structured finance products, emission allowances and derivatives. In this document, bonds do not include exchange-traded certificates (ETCs) and exchange-traded notes (ETNs).

Publication of the FSA's decisions on waivers and deferrals marks the end of the debate which the FSA began in earnest in the spring of 2017. It took place at a seminar on trade transparency and its implications for the Danish mortgage bond market. Prior to the seminar, the FSA also published a discussion paper in which it invited all stakeholders to give their assessment of trade transparency and its effect on the markets, including the various options for waivers from disclosure.

The debate, and the assessments of trade transparency received, have enhanced the background material for the FSA to assess the options for waivers and deferrals to be granted.

Possible waivers and deferrals granted by the FSA

1. All financial instruments

Order management facility waiver

Orders stored in an order management system in the trading venue may be waived from disclosure obligations.

The FSA grants this waiver to all financial instruments³, as it ensures that the trading systems can still automatically handle e.g. stop and iceberg orders in a storage system.

In this way, the trading venue can facilitate and organise the handling of orders in a consistent and cost-effective manner. Otherwise, investors themselves would have to raise a new order every time the previous order was executed, or when the price reached a certain level.

2. Bonds

Illiquidity

The FSA does not allow waiver from or deferral of publication due to illiquidity.

Fixed quantitative criteria in MiFIR define whether an instrument is illiquid.⁴ These criteria are expressed as thresholds for:

- the average daily turnover in euros
- the average daily number of trades
- the percentage of days traded over the period considered.

The FSA assesses that transparency of orders and trades in bonds defined as illiquid according to MiFIR will not have an adverse impact on the market, including liquidity.⁵

The assessment reflects the fact that the FSA considers MiFIR definition of illiquidity to be too broad. For example, it would include virtually all corporate bonds and the vast majority of mortgage bonds – even those generally perceived as liquid.

³ I.e. bonds, structured finance products, emission allowances and derivatives.

⁴ See thresholds in Annex III to Commission Delegated Regulation (EU) 2017/583 of 14 July 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 transparency requirements for trading venues and investment firms in respect of bonds, structured finance products, emission allowances and derivatives.

⁵ In this document, bonds do not include exchange-traded certificates (ETCs) and exchange-traded notes (ETNs).

The FSA therefore finds that, if illiquidity constitutes grounds for waiver or deferral, trading could proceed without any transparency for the vast majority of Danish corporate and mortgage bond series, and these series cover a significant portion of the total exposure.

At the same time, the FSA has noted that people are pleased with the current transparency regime on the post-trade side. The regime means that transaction data for all corporate and mortgage bond series (and hence also series covered by the definition of illiquidity in MiFIR) is published within three minutes of the transaction. For trades worth at least DKK 20 million for corporate bonds and at least DKK 100 million for mortgage bonds, publication may be deferred until the end of the trading day.

Size specific to instrument (SSTI)

On the pre-trade side the FSA grants waiver for orders that meet the criteria for SSTI.

Among the criteria for SSTI waiver are that the order must be of a size specific to the financial instrument and that the order must be in a request-for-quote or a voice trading system.

The possibility of SSTI waiver must be viewed in conjunction with the fact that, in MiFIR, it is automatically given to systematic internalisers.⁶ To ensure fair competition between trading venues and systematic internalisers, the FSA also provides for SSTI waiver for market operators and investment firms running a trading venue.

On the post-trade side the FSA provides for the publication of trade data to be deferred on grounds of SSTI for sovereign bonds, but not for other bonds.⁷

The FSA's decision affects market operators and investment firms running a trading venue, and systematic internalisers. The latter do not enjoy automatic deferral in MiFIR on grounds of SSTI, as is the case with SSTI waiver on the pre-trade side.

The FSA provides for deferral on grounds of SSTI for trading in sovereign bonds. This is because the expected values of the SSTI and LIS thresholds will be very high – and considerably higher than for other types of bonds.

⁶ A systematic internaliser is an investment firm which, on an organised, frequent, systematic and substantial basis, deals on own account when executing client orders outside a regulated market; see definition in Directive 2014/65/EU of the European Parliament and of the Council on markets in financial instruments (MiFID II).

⁷ It should be noted that, in MiFIR, deferred publication of trade information on the post-trade side does not require trading to take place in specific trading systems.

The FSA does not grant deferral for bonds other than sovereign bonds because it believes that transparency of trades in these bonds, when the trade is above the SSTI threshold but below the threshold for 'Large in scale' (LIS), see below, does not pose excessive risks to liquidity providers.

This should be viewed in light of the fact that, under the current rules, it is not possible to defer publication of trades worth less than DKK 20 million and DKK 100 million, respectively. This also includes trades between the expected SSTI and LIS thresholds. The FSA considers that this transparency is working well.

Large in scale (LIS)

LIS includes orders or transactions that are large compared with the normal market size for that financial instrument.

On the pre-trade side the FSA grants waiver for order data under the LIS criterion.

It should be noted that LIS automatically applies to orders that qualify for SSTI waiver. This is because the threshold for SSTI is always lower than for LIS.

However, some orders above the SSTI threshold are not covered by SSTI waiver. This is the case, for example, where the order is not in a request-for-quote system or a voice trading system.

On this basis, the FSA's decision allows for deferral on the post-trade side on grounds of LIS – see below. If a waiver is not granted, market participants can view order information, including size. They can also see if an order disappears. In these cases, they know that the order has been either changed, cancelled or traded. Market participants thus know, with a certain probability, that there has been a trade and how large this trade is. They can then use pre-trade information to obtain possible post-trade information, which reduces the value of granting deferral on grounds of LIS.

On the post-trade side the FSA provides for publication of trades over the LIS threshold to be deferred.

Several players in the industry have stated, both directly and indirectly through the Danish Securities Dealers Association and Finance Denmark, that they will seek to facilitate the conclusion of a civil-law agreement for the industry. The industry agreement will ensure that the current post-trade regime can continue. This means that information on all trades will be published as soon as possible (and no more than three minutes) after the trade is concluded. However, information on trades worth at least DKK 20 million for corporate bonds and at least DKK 100 million for mortgage bonds must be published no later than the end of the trading day.

If the industry agreement is implemented in the form outlined above, no market participants will have any less transparency than they have today.

The FSA believes that such an agreement will ensure a reasonable balance, retaining a certain amount of transparency which market participants can use to set prices, while not having any adverse effect on liquidity.

The assessment reflects the fact that details of the vast majority of trades will be disclosed as soon as possible after the transaction, as they are below the thresholds of DKK 20 and 100 million. Compared with shares, the frequency of trades in bonds is also low, and the prices are relatively stable. Information on large trades therefore contains details that are still relevant to market participants when the information is published at the end of the trading day.

In second half of 2017 these few large trades accounted for more than half of the turnover in both corporate and mortgage bonds. Few large trades result in a low probability of matching a buyer and a seller at a given time. Market makers here act as intermediaries by buying bonds and keeping them on their balance sheet until a buyer has been found.

For large purchases, it will often take a few hours for a market maker to sell the bonds. If the other market participants know that a large amount of bonds have just been sold, they can use this knowledge to immediately bring the price down. This makes it less attractive for the market maker to enter into large trades and carries the risk that the market makers will no longer want to operate in the market – or only to a limited extent. This could weaken liquidity, especially given that the market makers account for the vast bulk of the turnover in the bond markets.

If it becomes more difficult, and therefore more expensive, to effect large transactions, this will affect how well the markets function. One consequence will be that borrowers have to pay higher interest rates.

Against this background, the FSA wants to support the industry to reach an agreement that maintains the current transparency regime.

The FSA therefore grants a standard deferral, which implies that disclosure of all the transaction information may be deferred until no later than 19.00 on the second trading day after the transaction. This is the shortest deferral period that the FSA can grant.

The deferral is granted on the assumption that the industry enters into an agreement to retain the existing rules on transparency. If not, the FSA will reconsider its decision.

3. Derivatives

On the pre-trade side the FSA provides for all the possible waivers for derivatives; see Table 1.

On the post-trade side the FSA provides for deferral in all the possible cases, so that transaction information has to be disclosed no later than 19.00 on the second trading day after the transaction; see Table 1. For trades that meet the criteria for SSTI or LIS, however, it allows for extended deferral. This means that information on volumes has to be published no later than four weeks after the transaction has taken place.

Trading in derivatives differs from bond trading in several respects. These include the following:

- There is currently no transparency for derivatives. The point of origin for trade transparency is thus different than for bonds.
- In general there are very few players in the derivatives market. This makes it relatively easy to assess who has entered into a derivatives trade.
- Market participants report that it often takes a while for the risk to work its way through the accounts when they have bought derivatives. For large trades, the market participants say this can take several weeks. This could carry the risk of the market moving against the market maker. This makes it more expensive for market makers to work their way out of the position and the associated risks. In some cases, it may be less attractive for market makers to enter into derivatives transactions, and this can weaken liquidity.
- The FSA currently has less data on derivatives trading than for bonds. This makes it harder for the FSA to assess the possible consequences if there is a very high degree of transparency on pre- and post-trade side. In the longer term, the FSA expects the data quality to improve.⁸ This could prompt it to reconsider the present waivers and deferrals.

Given these differences, the FSA has chosen to provide for a lower degree of trade transparency for derivatives than for bonds.

⁸ Among other things, more derivatives are likely to be traded via a trading venue. In this case, the trades will be covered by the requirement for transaction reporting under MiFIR. Work is also in progress at the European level to improve the use of derivative data reported pursuant to 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 (EMIR).

Process for waivers and deferrals

Waivers from pre-trade transparency

An operator of a trading venue must submit a waiver application to the FSA if it wishes to be waived from the disclosure obligations on the pre-trade side. A template for applying for a waiver can be found on the FSA's website.

The FSA assesses the applications individually. If the FSA can grant an application, it has to notify the European Securities and Markets Authority (ESMA) and the other competent authorities in the EU of the intended use of each individual waiver and explain how it will apply. This must be done no later than four months before the waiver is intended to take effect.⁹

ESMA checks that the formal requirements are met in the FSA's statement. Within two months after receiving the notification, ESMA has to issue a non-binding opinion.

The competent authorities in the other EU countries have the opportunity to object to a waiver. In this case, the FSA can refer the matter to ESMA, which will assess the objection.

The FSA may withdraw a waiver, either on its own initiative or upon the request by other competent authorities. This may happen if the waiver is used in a way that differs from the original purpose or in order to circumvent the requirements for the waiver.¹⁰

Deferred publication of trade information

On the post-trade side, the FSA may allow operators of a trading venue to defer disclosure of trading information based on the size or type of trade. The same is true for systematic internalisers.¹¹

Operators of a trading venue must obtain prior approval (permission) from the FSA before they defer disclosure of trading information. Systematic internalisers have the same waivers as operators of a trading venue, but do not need prior approval.

On the post-trade side, ESMA is only required to monitor the application of FSA's prior approval. In other words, MiFIR does not regulate the process for the FSA's prior approval on the post-trade side. There is thus further scope for national regulation of the FSA's prior approval on the post-trade side. The general administrative law must, however, be observed at all times.

⁹ MiFIR Article 9(2).

¹⁰ MiFIR Article 9(3).

¹¹ MiFIR, Article 21(4).

On this basis, the FSA considers that operators of a trading venue or other investment firms should not have to apply for prior approval to defer publication of trading information when the arrangements meet the criteria for the possible deferrals which the FSA will allow; see above. The FSA can simply disclose the deferrals to be granted, and the criteria that must be met.

Operators of a trading venue and investment firms must, however, inform the FSA of the deferrals that they use. This allows the FSA to oversee how the players are using the deferrals. The FSA can then also provide ESMA with the information that ESMA is likely to request in connection with its monitoring of the FSA's prior approvals.¹²

¹² ESMA has to present an annual report to the Commission on the way in which the deferrals are being used in practice.