THE INVESTMENT ASSOCIATION

Dear Commissioner Hill, H.E. de Gooijer, Mr Ferber, Mr Maijoor

RE: Treatment of newly issued corporate bonds in the liquidity calibration for the purposes of RTS 2

We are writing this letter with reference to the European Commission's (the "Commission") letter to ESMA dated 14 March 2016 and its revised proposal for the liquidity calibration for the purposes of transparency in RTS 2.

Whilst fully cognisant of the challenge ESMA face to calibrate liquidity for the purposes of transparency in RTS 2, we are supportive of the European Commission's decision to request that ESMA amends their calibration for outstanding bonds.

While we think that there are still multiple open issues with transparency and liquidity definitions, and our members reserve the right to make additional comments, in this letter, the co-signatories are restricting their comments to reflect the Commission's revised proposals in their letter dated 14 March 2016.

We remain concerned about the treatment of newly issued corporate bonds for the purposes of the liquidity calibration and note that the Commission's request does not extend to the treatment of newly issued corporate bonds. This is worrying as the ability to find the right instrument at the right price, at the right time, with the right maturity is of paramount importance for end-investors who all have different investment objectives.

In this context, we agree with and acknowledge the European Parliament's letter dated 15 November 2015, where they raise their concerns around the treatment of newly issued bonds.

As we have previously discussed with DG FISMA, the ESMA Secretariat and National Competent Authorities, the original ESMA proposal for newly issued corporate bonds results in a high rate of mis-classification of newly issued instruments for the purposes of transparency.

Whilst therefore, we agree with the Commission's proposals to phase-in the liquidity calibration for bonds, to do so without having regard to newly issued instruments exaggerates the difference between the calibration of a bond upon issuance vis-à-vis the IBIA regime, and will be counterproductive to the laudable intention of the Commission.

Analysis based on Trax® data illustrates that a significant proportion of the newly issued corporate bonds classified as liquid upon issuance are mis-classified and will inappropriately have transparency requirements applied upon them (according to the relevant IBIA calibration for that year) as illustrated in the table below:

Year 1	Year 2	Year 3	Year 4 and beyond
97%	97%	90%	83%

In other words, even from Year 4 and beyond (the end of the proposed phased-in period), for every 5 newly issued corporate bonds classified as liquid upon issuance, over 4 of those bonds are actually mis-classified and will inappropriately have pre-trade transparency applied upon them.

The Level-1 text introduces transparency requirements only for those bonds that are determined to be liquid. In our view, given the high rate of false positives, this condition will not be met.

Whilst we recognise that newly issued instruments will only be subject to the high rate of mis-classification for up to 5.5 months since issuance, this immediate post-issue period is where corporate bonds have the highest trading activity throughout their issuance. This is significant because the mis-classification will impact corporate bonds precisely at the time that they are most actively traded.

The cleanest and easiest way to reduce the proportion of mis-classification is to **increase the issuance size threshold of corporate bonds to € 1 billion** in order for them to be classified as liquid and therefore subject to pre-trade transparency.

Analysis based on Trax® data shows that this will result in a drop of false positives down to 10% against the target IBIA calibration parameters for Year 4. Whilst still not perfect, it is our view that this will produce a better outcome for Europe’s corporate bond market.

On the Size Specific To the Instrument (the “SSTI”) and Large In Scale (the “LiS”) waivers, we agree with the Commission’s proposed phased-in approach. We do however, agree with the European Parliament’s letter dated 15 November 2015 to include sub-€100,000 trades in the calibration for both waivers. We acknowledge ESMA’s concern that for some markets, this may push the waivers to a lower than acceptable threshold and, as such, are supportive of a threshold floor of €100,000 being put in place.

Finally, whilst acknowledging that the deferral regime for post-trade transparency is left to the national competent authorities, we are concerned that this will detract from the principle of supervisory convergence. There needs to, at the very minimum, be co-ordination through ESMA to ensure that the national deferral regimes do not create a bottleneck in Europe.

To deliver sustainable economic growth in the EU, the starting point for MiFID II/MiFIR, like the CMU, needs to be the interests of Europe’s saving and investing citizens and companies. Roughly half of all investable assets in Europe are sitting in cash in the bank rather than being invested at a time when many sectors of the European economy are in need of capital. MiFID II is the means to deliver this mechanism more efficiently.

As agents for Europe’s end-investors, the organisations signing this letter are prepared to work with the Institutions in any way we can to ensure we get to an outcome that delivers the MiFID Level 1 objectives without negatively impacting market liquidity, which will be to the detriment of European companies, pensioners and savers.[1]

Yours sincerely,

Guy Sears
Interim Chief Executive
The Investment Association

[1] This letter focuses on the above issues, but concerns remain about other aspects of MiFID transparency and liquidity definitions and some of the organisations signing this letter may also comment separately.

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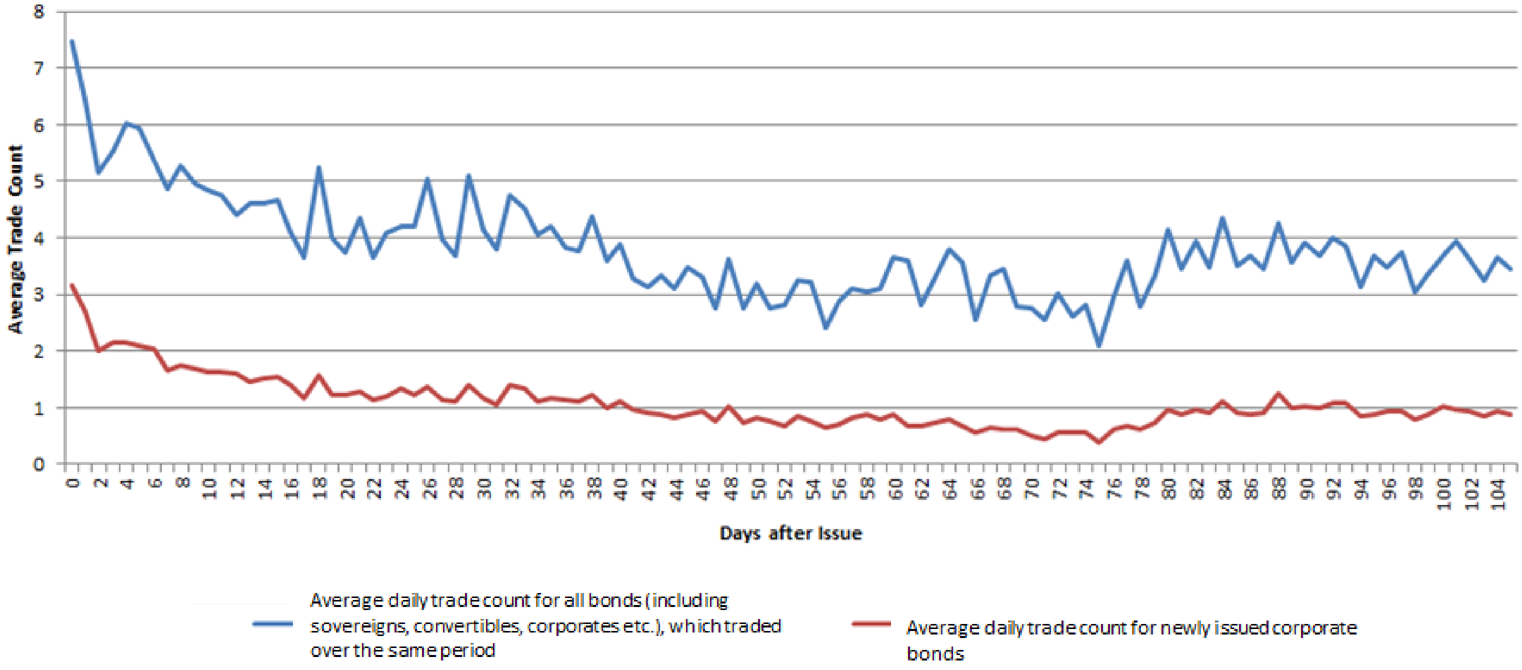
Liquidity calibration for newly issued bonds

Average daily volume in corporate bonds peaks meaningfully in the immediate days following issuance. Following this period, the issuance trading is characterised by unpredictable spikes of activity typical of the fixed income markets.

As illustrated in the graph below, the average trade count for corporate bonds issued in September 2014 peaks immediately following issuance after which there is a meaningful drop in activity. This trading activity explains the high rate of mis-classification of newly issued corporate bonds.

Sample: Newly issued corporate bonds in September 2014.
56,008 Trades from 489 Bonds over 105 Days since Issue



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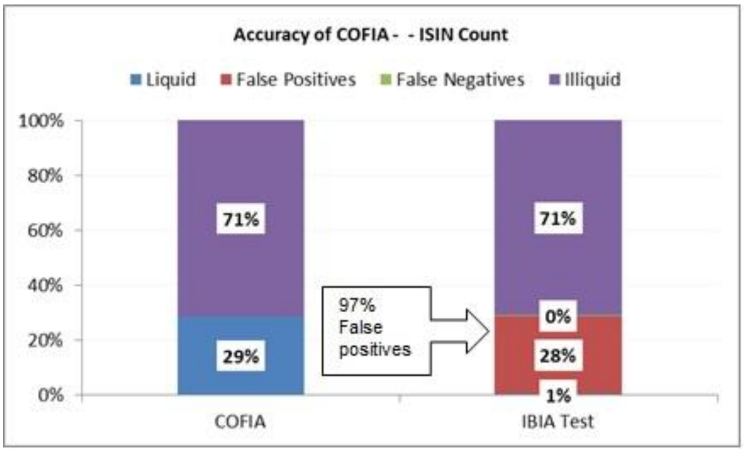
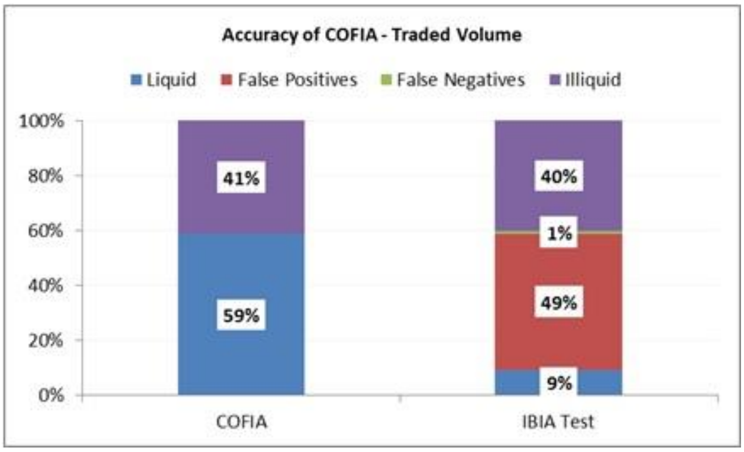
As illustrated in the graphs below, using newly issued corporate bonds from March-May 2014 that traded during the COFIA period until 15 August 2014, when tested against the newly proposed IBIA calibration for Years 1 – 4 as drafted by the European Commission, the rate of mis-classification by ISIN count and traded volume are illustrated below:

Year 1: Corporate New Issuances using an issuance size threshold of € 500 million, when tested against Year 1 IBIA calibration drafted by the European Commission





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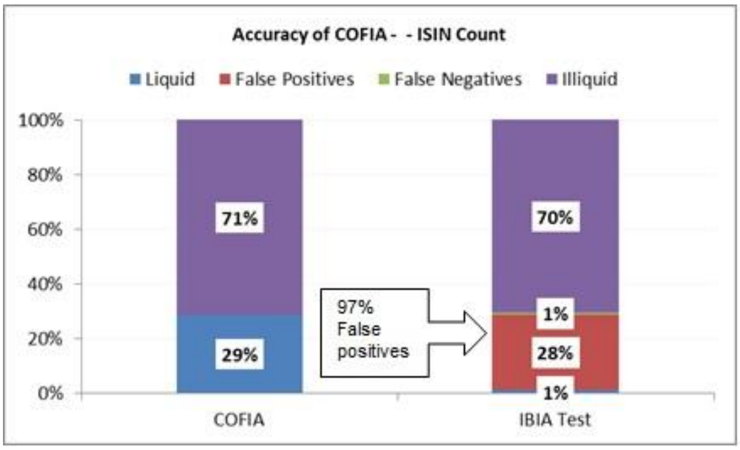
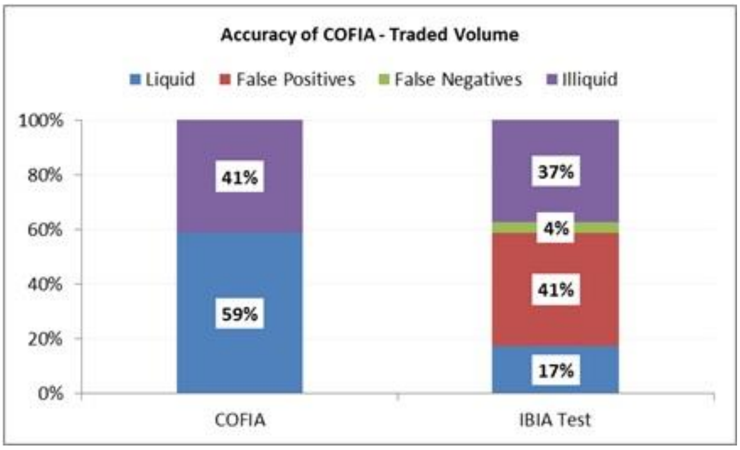
Year 2: Corporate new issuances using an issuance size threshold of € 500 million, tested against Year 2 IBIA calibration drafted by the European Commission





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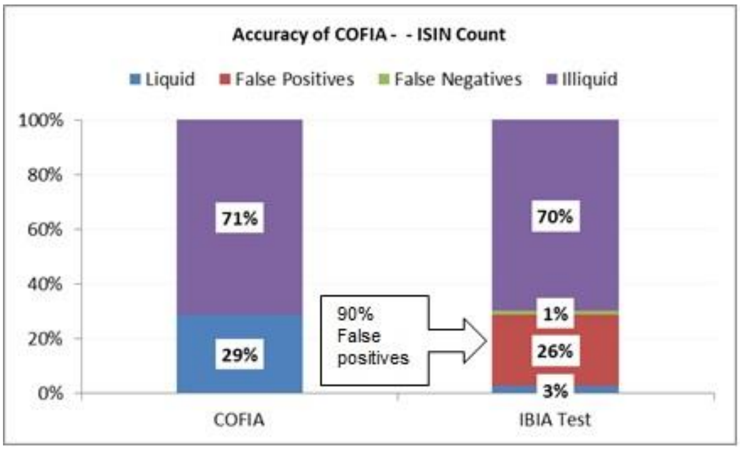
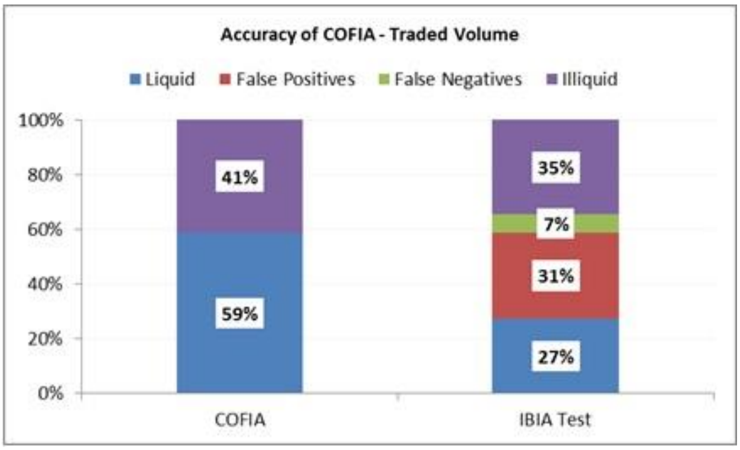
Year 3: Corporate new issuances using an issuance size thresholds of € 500 million, when tested against Year 3 IBIA calibration drafted by the European Commission





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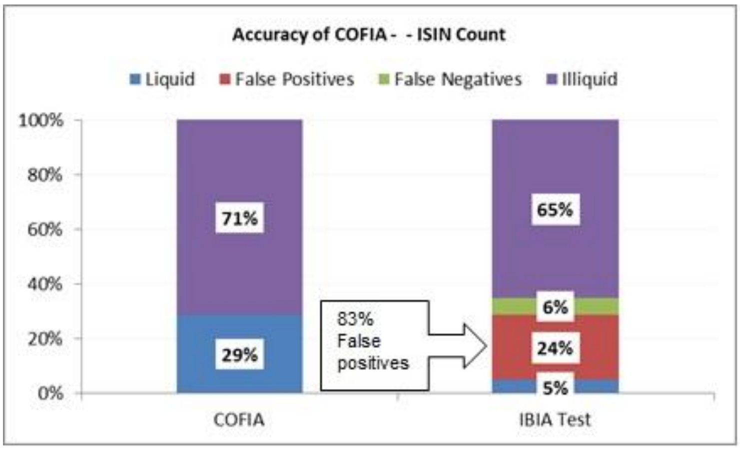
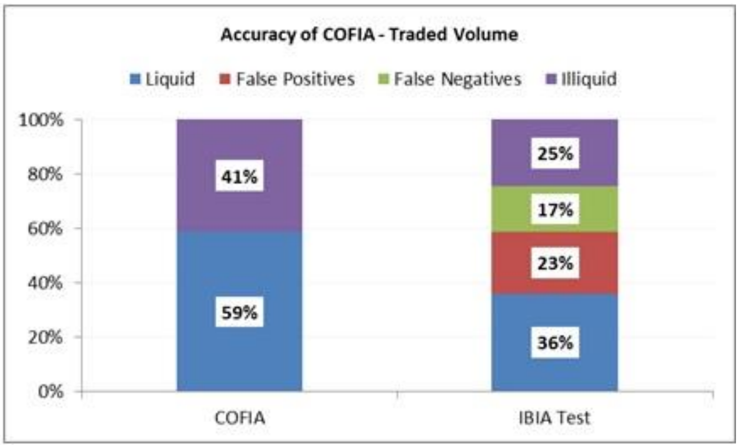
Year 4 and beyond: Corporate new issuances using an issuance size thresholds of € 500 million, when tested against Year 4 IBIA calibration drafted by the European Commission





Data provided by Trax®

As such, from Year 4 and beyond, for every 5 newly issued corporate bonds classified as liquid upon issuance, over 4 of these corporate bonds will actually be mis-classified.

By increasing the issuance size of newly issued corporate bonds to €1 billion, the rate of false positives drops dramatically to 10% of the total sample when measured against the IBIA calibration parameters for Year 4**.** Whilst still not perfect, it is our view that this will result in a better outcome for Europe's corporate bond market.

Waivers

Whilst we agree with the Commission's proposal to phase-in the waivers over a period of 4-years, we agree with the European Parliament that that sub-€100,000 trades need to be included in the calibration of the waivers.

As the Trax® data below illustrates, for corporate bonds, the majority of trading activity happens at or below €100,000 and by excluding these trades, the calibration will be exposing market makers to undue market risk.

Data Provided by Trax®

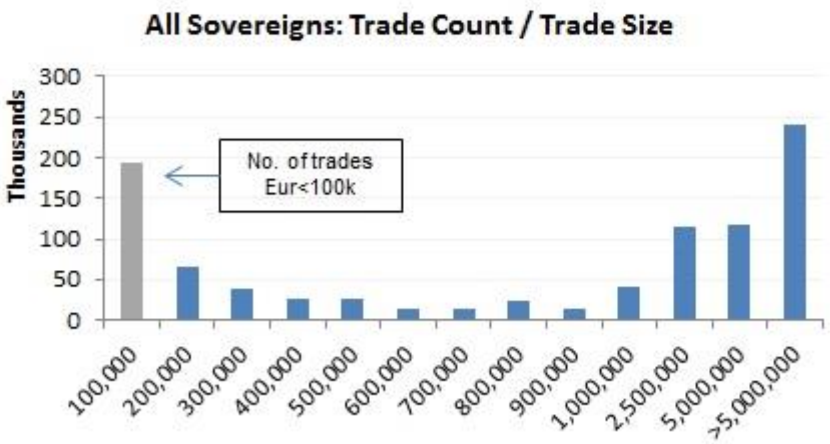
By including trades executed below €100,000 and instituting a floor of €100,000, the waiver thresholds will result in the below when applied to all trades within the period of September to November 2014:

Per cent of trade count	Ticket size excluding sub €100k	Ticket size excluding sub €100k but including trades at €100k	Ticket size including all trades
30%	€253,480	€200,000	€100,000 (floor)
40%	€365,029	€270,002	€100,000
50%	€500,000	€400,000	€165,627
60%	€722,000	€553,610	€280,000
70%	€1,000,000	€900,000	€500,000
80%	€1,500,000	€1,279,500	€900,000
90%	€2,710,000	€2,433,000	€1,800,000

Data provided by Trax®

The delta between the waivers is due to the inclusion/exclusions of the "=100k" trades, as they represents 9% of all trades in the period of the analysis

For sovereign bonds, the data illustrates a similar scenario as expressed for corporate bonds above. Trades executed under €100,000 make up a significant proportion of trades in the sovereign market as illustrated below:



Data provided by Trax®

Therefore, by excluding sub €100,000 trades, the waiver calibration will be excluding a significant proportion of the sovereign market. As illustrated below, by including all trades when calibrating the waiver thresholds for sovereign bonds will result in the following thresholds when applied to all trades within the period of September to November 2014:

Per cent of trade count	**Ticket size excluding sub €100k**	**Ticket size excluding sub €100k but including trades at €100k**	**Ticket size including all trades**
30%	€900,000	€801,336	€250,000
40%	€1,500,000	€1,303,080	€642,000
50%	€2,500,000	€2,359,019	€1,136,790
60%	€5,000,000	€4,500,000	€2,408,320
70%	€6,281,500	€6,003,000	€5,000,000
80%	€10,000,000	€10,000,000	€8,000,000
90%	€20,000,000	€20,000,000	€15,179,520

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