Key issues in the MiFID/MiFIR Proposals

Comments from the IRSG

The International Regulatory Strategy Group (IRSG) of the City of London is a practitioner-led body comprising leading UK-based figures from the financial and professional services industry. It aims to contribute to the shaping of the international regulatory regime, at global, regional and national levels, so that it promotes open, competitive and fair capital markets globally, supporting sustainable economic growth. Its role includes identifying strategic level issues where a cross-sectoral position can add value to existing industry views. It is an advisory body both to the City of London Corporation, and to TheCityUK, a practitioner-led body which has been established to coordinate the promotion of the UK-based financial services industry.

TRANSPARENCY

Introduction

Transparency is an important characteristic of a well-functioning market. However, creating the appropriate level of transparency that is both meaningful and affordable is not easy:

- Significant differences exist between equity and non-equity products and markets. A useful transparency regime for non-equity markets therefore cannot simply mirror the equity regime but must be tailored to reflect the characteristics of these diverse asset classes.
- As experience in the European equity markets has shown, pre- and post-trade transparency requirements alone can provide only the ingredients for transparency. The successful consolidation of transactional information is needed to provide market participants with access to affordable and meaningful transparency.
- The registration of all organized trading venues that are exposed to similar same pre- and post-trade requirements, and the derivatives trading requirement, are often described as a means to increase transparency. In reality, however, the proposals could significantly change market structure and might harm market functioning and liquidity, if the regime is not appropriately calibrated.

a) Transparency in Non-Equity Markets

Background:

MiFID established mandatory pre- and post-trade transparency requirements in the European cash equity markets. However, such requirements do not currently apply to "non-equity" products such as bonds, asset backed securities, or OTC derivatives. In the United States, TRACE post-trade reporting has been in place for several years to publicly display information for transactions concluded in corporate bonds and, more recently, also structured finance instruments. Also, following the Pittsburgh commitments, the Dodd Frank Act requires "real-time reporting" of transaction information for all OTC derivatives. The MiFID legislative proposals would extend pre-and post-transparency requirements beyond cash equities to instruments such as fixed income and derivatives.

Issue:

Non-equity markets are quite different from equity markets, causing the cost/benefit relationship for pre- and post-trade transparency to differ. The universe of non-equity products is very diverse, products are numerous and most of them trade only infrequently, with trading velocity a fraction of that in the equities markets. Many of these markets are entirely professional, and indeed inappropriate for retail investors. Liquidity is mostly provided by intermediaries and the average transaction size is quite high. Any transparency regime for non-equity markets needs to be flexible enough to handle a spectrum from liquid futures and options (which are generally exchange-traded) through moderately liquid government and corporate bonds (which in some member states are commonly held by retail investors) to customized OTC derivatives, which may only ever trade once. A transparency regime that simply mirrors the one that is used in the equity markets is likely to damage liquidity and limit end user choice.

Pre-trade: institutional market participants typically have access to a wide range of pre-trade data for non-equity products already. Also, to provide competitive pricing to their customers, market makers need to retain discretion over which orders they are prepared to take on, reflecting their market risk appetite, their capital constraints and, not least, their ability to access the instruments in question. Any requirement to quote is therefore likely to cause market makers to withdraw liquidity, it would increase the overall costs of trading non-equity products which could, in turn, force smaller participants out of the market and will increase hedging costs for end users. CESR only welcomed any future pre-trade transparency regime that allowed Member States to introduce local requirements if deemed necessary.

Post-trade: given the multitude of products and their low trade frequency, post-trade transparency may have rather limited value for illiquid products. There does not seem to be any conclusive evidence on the benefits of TRACE. Further, a post-trade transparency regime that was not properly calibrated is likely to reduce the willingness of market makers to provide liquidity, as they will be exposed to market movements. CESR therefore recommended a liquidity calibration of the post-trade transparency regime for European non-equity markets, with the use of thresholds and delays for various asset classes based on transaction size. Notably, TRACE require trade reports in corporate bonds to mask the specific volume traded, requiring only an acknowledgement that the volume falls in one of three categories: less than 1m USD, between 1 and 5m USD and above 5m USD. This helps to ensure that market makers are not penalized by market prices changing as a result of the size of their position becoming known in the market.

Proposals:

- Pre-trade transparency: creates an obligation for investment firms to make a quote that they provide to a client also available to other clients "in an objective non-discriminatory way on the basis of their commercial policy", and to the public in a manner which is easily accessible on a reasonable commercial basis. Investment firms must also be prepared to enter into transactions with other clients up to a certain size.
- Post-trade transparency: requires the publication of transaction details "as close to real-time as is technically possible". Deferred publication could be authorized by competent authorities based on the type or size of the transactions, in particular for "large in scale" transactions.

IRSG Position:

- We agree that an increase in pre- and/or post-trade transparency in segments of the non-equity markets could deliver benefits to market participants and the public. However, as non-equity markets are very different from equity markets in key aspects, any transparency requirements should be designed and calibrated carefully to ensure that their costs do not outweigh their benefits.
- By obliging firms that have provided a quote to a client, to transact with any other client on the same basis, the proposals effectively go beyond transparency requirements and establish a market making requirement. Introducing a general quoting obligation for investment firms could unintentionally reduce market liquidity while providing little benefit. It should therefore be avoided. Trading on organized platforms might be a preferable means to increase the level of pre-trade transparency for these products.
- Any post-trade transparency regime for non-equity markets needs to be carefully calibrated based on product liquidity and characteristics to ensure the continued proper market functioning, as was reflected in CESR's technical advice. A properly calibrated regime with the use of thresholds and delays is preferable to the proposed real-time dissemination across asset classes and products with the potential for deferred publication being authorized by competent authorities.

b) Data Consolidation

Background:
MiFID requires information on executed trades in equities to be made available "as close to real time as possible" and "in any case within three minutes". This applies to exchanges, MTFs, Systematic Internalisers and to investment firms trading OTC. The means of publication can be provided by the trading venues, by third parties, or by the investment firms executing the trades (as an SI or OTC). These arrangements "must include all reasonable steps" to ensure the quality of the information published; they "must facilitate the consolidation of the data with similar data from other sources"; and "must make the information available to the public on a non-discriminatory commercial basis at a reasonable cost". Post trade data is particularly important to investors in assessing whether they have achieved best execution.

Issue:
Prior to MiFID, intermediaries and investors could generally rely on a single exchange source for all post trade data on a specific stock (at least for on-exchange trading – some markets did not publish OTC data at all). MiFID increased competition between execution venues so that some stocks are now traded in over 20 venues and the main exchanges now typically account for less than half of trading in the most liquid stocks. But this competition in execution has fragmented the data market so that users now have to buy data from multiple sources, including OTC publication sources. There are now some 84 data sources in the EU. The current situation raises three main concerns from users: <u>data quality</u>, particularly of OTC data; <u>data consistency</u>, between the different venues; and the <u>cost of data</u>. Some have therefore called for a standardised European Consolidated Tape ("***ECT***").

Proposals:
Introduce a number of measures to ensure that one (or several) ECTs will "emerge". They are

- Introduction of the APA (Approved Publication Arrangement) regime for data publication
- Tasks ESMA with setting standards for data formatting and standards
- Requires trading venues to make pre- and post-trade data available separately and at reasonable commercial terms, and free of charge 15 minutes after publication
- Introduces the concept of Consolidated Tape Providers ("CTPs") as regulated entities. CTPs are required to consolidate data from several sources and make it available in real-time and at reasonable commercial terms

IRSG Position:

- We agree that the provision of consolidated data of a high quality and at a reasonable cost is important for investors but has yet to be achieved for European equities.
- We support the proposals to enhance data quality, granularity and consistency, including the introduction of the APA regime. This should build on the work undertaken by the CESR Technical Working Group and the Market Model Typology (MMT) developed through the collaborative efforts of exchanges, MTF's, market data vendors and trade reporting venues.
- We are not sure whether it should be the EC's or ESMA's task to set pricing. Any such determination certainly cannot be a one-size-fits-all, it should take a number of relevant factors into account in order to establish pricing principles.
- In principle, the introduction of the CTP concept seems a good idea. However, given the existence of competing data sources and uncertainty about demand, it is unclear whether a CTP is commercially viable, and hence whether an ECT will actually "emerge" on that basis.

- Given the diversity and complexity of non-equity products the introduction of a consolidated post-trade tape for these asset classes represents an even bigger challenge, and it cannot simply be a wholesale extension of the data regime designed for equities. We welcome the intention to phase the implementation of a non-equities product by 2 years to take advantage of the experience gained from the introduction of an ECT for equities.

c) Trading Venues and the derivatives trading requirement

Proposals
The Commission's proposals aim at establishing a level playing field between all organized trading venues. They create the new category of Organized Trading Facility ("***OTF***") that would capture organized trading venues that are not RMs or MTFs. The OTF category would also be used to satisfy the G20 commitment related to derivatives trading.

IRSG Position
We see a significant risk that the prescriptive nature of the proposals in relation to execution will harm the functioning of the non-equity markets. This is because

- Organised trading venues and OTC execution meet different kinds of needs, they can be considered complementary trading models and therefore often co-exist for the same product.
- Market participants need flexibility and choice where and how to best execute their trades, depending on, for example, the nature of the product and the size of the transaction. As pricing may not always be available on other venues, for example in stressed market conditions, the availability of various forms of execution, including request-for-quote and voice mechanisms, is crucially important to ensure market functioning.
- The prohibition on the operator of an OTF from using his or her own capital to supply liquidity into his or her OTF seems unduly restrictive. Since the OTF operator has a best execution duty it is imperative that it has discretion over how to handle client orders in order to achieve best execution in practice. Arbitrarily denying access to a source of liquidity undermines this objective and is likely to result in sub-optimal outcomes for clients. Effective monitoring of best execution and transparent order handling rules are likely to be more effective and proportionate means of achieving the Commission's objective in this regard.
- Investment firms are often committed to providing liquidity to clients with whom they have relationships. Such liquidity provision is unlikely to be available in the context of a transaction carried out on a "neutral" trading platform.

ACCESS OF THIRD COUNTRY FIRMS TO EU MARKETS & ACCESS OF EU FIRMS TO THIRD COUNTRY MARKETS

Background

Neither MIFID nor its predecessor the ISD contains provisions which address the cross border provision of services in the EU by third country firms. Member States have adopted a variety of regimes under which such business may be undertaken without requiring a local license to be obtained. For example, most Member States allow cross-border business by third country firms with local clients/counterparties, including with retail investors, where the business is not undertaken as a result of active marketing (although the definition of active marketing differs in Member States) and many Member States recognise that local investors/counterparties (including retail investors) will deal indirectly with third country firms when the transaction is arranged by an EU authorised firm acting as intermediary (e.g. in an agency capacity), without the third country firm being subject to authorisation requirements.

Issue

EU firms need access to services provided by third country firms for a variety of reasons. Corporates may need underwriters in order to access global funding opportunities. Asset managers need access to research, execution services and safe keeping of foreign assets in order to allow them to invest internationally. Requiring all third country firms providing those services to have an EU licence or to be found subject to an equivalent regime could risk **severely restricting** cross border financial services business between the EU and the rest of the world. An appropriate exemptive regime, however, could bring **significant benefits** to investors, issuers and firms in a number of EU countries by facilitating their access to a wider range of providers of products and services.

Proposals

MIFIR (Article 36) proposes a regime of conditional registration by ESMA for third country firms wishing to provide certain services cross-border (execution of orders on behalf of clients, dealing for own account and reception and transmission of orders) to eligible counterparties only. Registration would be conditional on a prior adoption by the European Commission of a decision that requires determination of both equivalence of third country regulation to MIFID and CAD and reciprocal recognition of the EU prudential framework, as well as cooperation arrangements established by ESMA with the third country authorities. The proposed regime would appear to be a **full harmonisation** regime which would require the abolition of existing Member State regimes. It appears that the only exception to the new conditional registration regime would be for cross border business which is wholly unsolicited (no active marketing). Retail business could only be undertaken through an EU authorised branch (proposed MIFID Article 41). This too would be conditional on a determination of equivalence and reciprocity and would similarly represent full harmonisation, requiring abolition of existing member state regimes for branch authorisation. Also, EU venue execution requirements for non OTC derivatives would extend to transactions with non-EU counterparties.

IRSG Position

- A harmonised regime should only apply to third country branches that deal with retail customers or that require a full passport. MiFID/MiFIR should otherwise **leave in place existing Member State regimes** for third country branches.
- Cross border business should be allowed to continue under a licensing exemptions for third country firms with regard to business that does not involve solicitation (active marketing)
- Business with eligible counterparties, business intermediated by MIFID authorised firms and business regarded as taking place extraterritorially should be exempted for the conditional registration regime.The proposed EU regime risks **severely restricting** cross border financial services business between the EU and the rest of the world, both in terms of constraints on market liquidity - potentially with implications for systemic stability - and possible reaction to perceived protectionism. If professional EU market participants' interactions with non-EU firms are restricted, they will lose their existing access to non-EU capital, investment opportunities, risk diversification and market information, including from less developed jurisdictions.
- An appropriate exemptive regime could bring **significant benefits** to EU investors, issuers and firms by facilitating their access to a wider range of providers of products and services. It should not seek to exhaustively define the circumstances in which clients and investors in the EU can deal with third country firms, but instead take effect as a form of **minimum harmonisation** incorporating a uniform exemption allowing third country firms that meet certain minimum standards to deal with EU investors and counterparties – at least eligible counterparties and professional clients.
- Third country firms **would not be required to meet an equivalence or reciprocity standard** but would be required to be authorised by their home country regulator. If the business they seek to undertake in the EU is subject to additional authorisation in their home country, they should be required to have attained this authorisation. Further conditions should include that their home country should be on neither the Financial Action Task Force nor on any anti money laundering and terrorist financing blacklists and a memorandum of understanding should exist with local regulators. Furthermore, the EU should not automatically apply all its

transaction-specific requirement to transactions with non-EU counterparties, as such requirements might be inconsistent with non-EU regulatory regimes and market structures.

- Such a regime would be consistent with EU GATS commitments and provide a further platform for further harmonisation if warranted.

SME MARKETS

Background:

The development and growth of smaller and medium sized enterprises is key to how effectively EU economies recover from the recession. With the cuts in public expenditure, the best prospect for creation of jobs and new businesses rests with these growth businesses, which are typically innovative and entrepreneurial in nature. These businesses need finance at all stages of their development, from the initial start-up, R&D and product development, scaling up and through to major production or delivery of services. This finance will come from a variety of sources along what is called the funding ladder, including from the creators of the business, other entrepreneurs (business angels), banks, venture capital investors, private equity investors, institutional and other investors. Whilst bank/debt finance may not involve the business providing equity (shares) in the company, most other forms of investment will.

Issue:

With the downturn, sources of funding for SMEs have become harder to find and this is having an adverse effect on their ability to grow. Ways need to be found to re-energise this key activity. This involves all parts of the funding ladder.

Proposals:

The MiFID directive proposes the creation of a sub-category of SME growth markets within the MTF category. These markets have been recognised in the Directive as markets that facilitate the needs of SME issuers. The aim of this carve-out for SMEs is to raise their visibility and profile and to aid the development of a common pan-European regulatory standard.

IRSG Position:

- We welcome the proposals in the draft MiFID for the creation within the MTF category of a new sub-category of SME Growth Market. We agree with the Commission that the registration of these markets should raise their visibility and profile and develop a capital-raising environment for Europe's entrepreneurs and growth companies.
- On the issue of definition, the SME sector is a complex mix of different types of issuers, investors and advisers and all aspects must be addressed to have any prospect of delivering a successful outcome. With this in mind, we support the definition of an SME company for the purposes of the MiFID, which means a company with an average market capitalisation of €100,000,000 on the basis of year-end quotes for the past 3 calendar years.
- However, we would caution against lowering the thresholds for market capitalisation and for the percentage of "growth companies" below what is currently proposed in the Directive. We believe that if either or both of these thresholds were to be lowered, this would have serious consequences for SMEs outside the scope of the market, as they would then be trapped between the resulting smaller cap market and main listing, with no suitable market to support their development and growth.
- We also welcome the proposal in the Directive to reclassify ordinary shares on SME markets as "non-complex". This will facilitate retail and professional investor involvement in these markets. It is important not to confuse complexity with risk.
- We would also encourage the Commission to ensure that in the future, changes to EU financial services regulations do not have an adverse impact on these markets and to develop additional regulatory and non-regulatory EU policies to attract investors to them.
- We suggest the Commission, together with ESMA, establish an industry EU Growth Market Working Group, comprised of all exchanges that currently operate growth markets or who would be interested in doing so, together with representatives of investors, issuers and advisers to draw out common principles and guidelines for SMEs, including the admission to trading aspects, the cultural, financial, economic and educational requirements.

HIGH FREQUENCY TRADING (HFT)

Background:
MiFID introduced competition in the equities exchange trading space and new venues (MTFs) emerged including Chi-x, Turquoise, BATS and NYSE Arca. The emergence of these new trading platforms facilitated a dramatic reduction in exchange trading costs, making new types of trading strategies profitable. High frequency trading (HFT) is a broad term describing a variety of high-speed trading strategies, which generally involve the execution of large volumes of orders, trigged by a computer algorithm in response to market conditions. It is generally accepted that there are five different strategy types: 1) Electronic Liquidity Provision - spread capture and rebate driven strategies, 2) Statistical/Cross asset and market arbitrage: 3) Liquidity detection, 4) Short term momentum strategies, 5) Latency arbitrage. According to Tabb research, HFT accounts for 40% of the European equities market.

Issue:
The European Commission is concerned about the potential threat to the "orderly functioning of markets" posed, in certain circumstances, by high frequency trading. Examples of potential sources of risk cited by the Commission include "rogue algorithms", an "overreaction" by an algorithm to a market event and the risk of a large volume of orders overburdening a trading venue. There are also concerns that certain HFT traders are not currently required to be authorised and supervised under the current MiFID framework.

Proposals:

- HFT firms and automated traders who are direct members/participants of RMs or MTFs will need to be authorized.
- Firms providing "direct electronic access" will need to be authorised and have adequate systems and controls.
- All algorithmic trading strategies to operate during all trading hours and provide firm two-way quotes (this is a requirement to act as a 'market maker' by agreeing to buy or sell shares at certain prices and volumes throughout the trading day).
- Trading venues will need to adopt appropriate risk controls to mitigate disorderly trading and ensure the resiliency of their platforms. They must also have systems in place to limit the ratio of orders to executions should it be necessary (as defined at Level 2).
- The definition of algorithmic trading is very broad, covering any automated trading strategy except for order routing.
- Provide details on algorithmic strategies to competent authorities.

IRSG Position:

- We support moves to ensure that all firms with direct access to order books are regulated appropriately. We do not, however, believe that it would be appropriate to seek to regulate all firms conducting HFT strategies where these firms are accessing the order book via an intermediate broker (i.e. "sponsored access"). We support rules to introduce and harmonise requirements for sponsored access, including adequate risk controls. Sponsored access providers should be authorised and supervised according to harmonised rules.
- Introducing market making obligations on HFT firms would not be beneficial in our view and would lead to a number of firms ceasing to undertake HFT, leading to a (potentially very large) drop in liquidity. This is because firms will not wish to be obliged to provide liquidity in times of market volatility. Traditional market makers in stock exchanges are, notably, permitted to widen spreads in certain cases, for example where *force majeure* pertains.
- If policymakers wish to incentivise liquidity provision, we would suggest that it may be more effective to have regulated markets and MTFs operate a liquidity incentive scheme with rights and obligations similar to traditional market makers. In any case, the current wording should be more tightly defined. As it is currently written, for example, an execution algorithm designed to buy France Telecom according to a VWAP (volume weighted average price) benchmark over the day would be obliged to generate sell orders as well as buy orders, which, we believe, cannot be the true intention.
- We fully support the ability of regulators to interrogate algorithmic trading strategies and infrastructure. We believe it is important to get the clarity on the level of granularity required by regulators. If the level of detail is too granular, we are concerned that pre-notification of all algorithms to regulators would be unduly burdensome and of limited value given that the potential risks deemed to be posed by a single algorithm are unlikely to be identifiable by analysing that algorithm in abstraction. Rather, it is the interaction of that algorithm in the market that is important.
- We urge caution over any plans to introduce rules that are specific to HFT strategies. Given the fluid and evolutionary nature of technological and market changes, it is unlikely that a single definition could be drafted that captures all HFT activities, while being precise enough to provide legal certainty. Indeed, as a broad principle, we believe that regulations should be general in application to all market participants, so as to limit scope for regulatory arbitrage. Any strategy that constitutes market abuse should be covered by the existing Market Abuse Directive or its subsequent revision – no special treatment should be given to HFT activities.

EXECUTION ONLY BROKING

Background:
Execution only broking is the service offered by an investment firm, or broker, of buying and selling non-complex financial instruments on the instructions of clients without offering advice. It provides quick and cost-effective market access to investors, and is used by those who wish to make their own decisions and retain their own decision-making power over their investments. Consumer use of this service is widespread: in one EU member state in 2010, 72.5% of the total number of retail trades were on an execution only basis, four-fifths of which were online. The vast majority of deals were in plain vanilla equities.

Issue:
There has been no evidence of consumer detriment, complaints or other consumer-related problems in connection with execution only broking in non-complex products. In the absence of indications that the approach has not worked effectively, but on the contrary has served well the interests of retail investors, it is important to ensure retention and improvement to its key features, not their obstruction or abolition. Failure to achieve this would make it more difficult for retail investors to exercise their right to invest their own money on the basis of their own perceptions of appropriate action in suitable circumstances. Decreasing the attractiveness of the execution only approach by, for example, making all rather than some products complex, or by excessively narrowing the non-complex field, could reduce retail demand, lower retail participation in the market, create higher costs which would be passed on to consumers, and eliminate from the market those who can least afford access.

Proposal:
- The EC's Proposal for a recast of the MiFID sets out in article 25 the terms of a future regime for execution only broking in the EU. In essence this will allow it to continue on the same basis as now provided the financial instruments offered are shares and bonds traded on a regulated market or MTF, money market instruments without complex structures or embedded derivatives, shares or units in UCITS excluding structured UCITS, and other non-complex financial instruments. Although one implication is that non-UCITS ETFs may automatically be caught in the complex instruments category and require an appropriateness test before initial order execution, most EU ETFs are UCITS-compliant so this is a relatively small sector.

Position:
- Overall, this proposal meets the requirement not to tamper with a mechanism that functions well; it is therefore to the advantage of the retail financial consumer and is broadly supported within the execution-only business community. The addition of the catch-all "other non-complex financial instruments" is particularly welcome.
- As work on the recast MiFID Proposal goes forward and both the European Parliament and the Council examine it and prepare their own versions, it will be important to continue not to fix that which is not broken, and if possible to retain the existing text as it is.