THE MIFID REVIEW: A BRIEFING FOR THE EUROPEAN COMMISSION
AND CESR ON KEY THEMES IN PREPARATION FOR CONSULTATIONS
ON THE MIFID REVIEW

23rd March 2010

Introduction

As the European Commission (EC) and CESR prepare for their consultations on the MIFID review, we would like to suggest some key themes and guiding principles for the review, and set out our preliminary thoughts on particular issues that have recently been discussed.

Key themes and guiding principles

In all aspects of the MIFID review process, we stress the importance of:

- staying true to the original objectives of MIFID — a fully effective passport, more investor and issuer choice, consistent investor protection, more competition and innovation, and reducing the costs of trading, investment, and capital;
- protecting the improvements MIFID has made, while continuing to improve the business environment for all market users, including SMEs and their investors;
- recognising the extent of recent reform, and not placing undue burdens on intermediaries (particularly smaller firms) that may limit investors and issuers’ ability to fulfil their economic needs;
- thoroughly applying disciplines of impact analysis (including the aggregate impact of different measures), proportionality, and public consultation;
- appropriately reflecting the differences between markets, avoiding ‘one size fits all’ and maintaining market, product, and service diversity through the cycle of regulatory reform;
- focusing further regulatory action on key problems that have emerged;
- making use of the full range of policy tools available, and reopening the legislation only if other tools would not work so well.

MIFID has brought significant overall benefits to users of wholesale markets and consumers, and to larger firms operating internationally, by facilitating cross-border investment business in the EU, and increasing competition and innovation while reducing trading costs. It is important to maintain these economic and investor benefits, and bear in mind that firms have already incurred significant cost in implementing MIFID requirements. For investment firms with a retail client base and minimal cross border involvement, however, the costs of adjusting to MIFID requirements have not generally been balanced by commercial benefits: it is particularly important to guard against change for change’s sake in this field.

EC must not lose sight of the original objectives of MIFID, and the extent to which they have been achieved. These objectives were: (1) The protection of investors and market integrity by establishing harmonised requirements governing the activities of authorised
intermediaries; (2) The promotion of fair, transparent, efficient and integrated financial markets, in particular by the development of ground-rules governing the negotiation and execution of transactions in financial instruments on organised trading systems and marketplaces, and by investment firms.

The financial crisis has not altered these objectives, and the focus of the MIFID review must be on how they can be better achieved. In order that the real progress made is not compromised, EC should base its assessment of whether legislative change is needed on whether MIFID has benefited all users of the market (investors and issuers) by greater efficiency and reduced cost, and where it has not, whether the failure is attributable to MIFID or to other causes which should be addressed by other means than revising the legislation. Particular achievements of MIFID include:

- facilitating increased competition and choice across markets, products, and services, with reduced spreads and lower costs in some areas (though continued work on some costs is still needed: see (g) below);
- single market based on an enlarged passport, home State licensing, consistent rules and mutual recognition;
- removal of obstacles to market access;
- better transparency (though continued work is needed to improve transparency further: see (d) below);
- better adjusted and consistently differentiated protection across the EU as a whole for retail clients, professional clients, and eligible counterparties;
- better cooperation, and better allocation of tasks, between competent authorities.

**Key areas of focus for the MIFID review**

Given the extent of regulatory change elsewhere in the wake of the financial crisis, it is important for the MIFID Review to stay focused on core issues where MIFID has not worked as well as hoped. Even where difficulties have arisen with MIFID, legislative change is not necessarily needed or wise: it can lead to unintended consequences and may force further system changes or additional administrative and operational burdens on firms which would lead to additional costs for investors without corresponding benefits. A targeted approach addressing the specific issues that have arisen and using the full range of policy tools already available to EC, CESR/ESMA, and national Competent Authorities (e.g. enforcement, intervention, Level 3 guidance, as well as ESMA technical standards and legislative change) will work better. In some areas, technical work by stakeholders with the involvement of the EU authorities could enable more rapid delivery of benefits, at modest cost, than could be achieved by changes to the primary legislation. We suggest that EC’s strategy for approaching the MIFID review in a coordinated and comprehensive fashion should, broadly, take the following approach:

(a) **Consistent national implementation of MIFID:** Where Member States have not fully implemented MIFID, resulting in continuing non-MIFID-compliant barriers to the Single Market, it is important to tackle the relevant local requirements and consequent practical obstacles to cross-border business. Concerns persist about MIFID implementation in a number of Member States. Targeted enforcement of correct implementation of MIFID must be a priority for EC and, in due course, the new ESAs, using consistent measures of the effectiveness of implementation.

(b) **Quality and ease of consolidation of equity trading data:** CESR, national competent authorities, investment firms, trading venues, and data vendors, are seeking to co-
operate in making post-trade data more consistent and more capable of consolidation. In most respects MIFID continues to provide an appropriate legislative template for what is needed, by specifying that data should be capable of consolidation, and a number of constraints on the information it must contain and how it is published. Most of the detail of technological standards (e.g. standardised coding, formats, field sizes, quality control of data, identifying venues in post-trade reporting in a way that protects client confidentiality) is better dealt with in a market-centred way through Level 3 guidelines or agreed market protocols, a process which CESR/ESMA should support, and if necessary be empowered to enforce, but which should not go through legislation (except where targeted legislative or regulatory change may ultimately be needed to achieve European harmonisation). This approach would enhance the ease of use, transparency, and reliability of data, while promoting confidence in alternative venues and reducing the negative impact of data fragmentation. Some aspects may need to be addressed through changes to MIFID: e.g. delays and thresholds for delayed reporting. Other aspects (e.g. reporting through obscure, non-consolidatable media) may need to be addressed through enforcement by CAs, where necessary coordinated by CESR/ESMA. The end user costs of obtaining post trade data should be reviewed and initiatives aimed at reducing such costs should be encouraged.

(c) **Systematic internalisation (SI):** There are concerns, such as those set out in CESR's June 2009 report on the Impact of MIFID on secondary market functioning, that the systematic internaliser provisions may not have been working as well as hoped. For example, it was intimated that firms are, in some cases, operating as SIs without complying with quoting and other obligations. We consider that this issue is best addressed by effective enforcement of existing MIFID requirements, not by reopening the carefully negotiated legislation.

(d) **Transparency of non-equity markets:** EC, and the UK FSA, have recognised that in some non-equity OTC markets there are adequate levels of transparency, and that the appropriate shape of transparency will vary from market to market. Pre-trade transparency in order to ensure price discovery is already offered in these markets, either through voice, electronic platforms (Bloomberg, Market Axess, Tradeweb, TLX, etc) or quotes/runs/axes in electronic format. A number of initiatives by trading venues and investment firms have already improved the infrastructure for and transparency of non-equity markets. Market participants, particular investors have concerns that full post-trade data would impair dealers’ ability to bear principal risk, and thus investors’ ability to trade large, illiquid or esoteric bonds. Any legislative proposals that would increase transparency of non-equity markets must take account of these initiatives, to get the balance right between users’ demand for increased transparency, and dealers’ ability to continue to provide liquidity. It will be important to bear in mind the importance of liquidity provision in OTC markets; the three-way trade-off between end-user transparency, market liquidity, and confidentiality of trading positions; and the fact that in bond and derivative markets, for different reasons, other factors than transparency drive the pricing mechanism. By focusing non-equity reporting on the most liquid products traded on electronic platforms within certain size thresholds, transparency can be provided to the market on liquid trades, whilst managing the confidentiality required for the less liquid positions.

(e) **Listed equity derivatives:** this topic has not appeared as a major concern for EC in the preliminary discussions about the MIFID review. However, it appears that a
higher level of competition and transparency could be achieved as regards the use of financial indices and benchmarks for listed equity derivatives, by guaranteeing equal access to indices and other market benchmarks.

(f) **Best execution and comparison of execution venues:** Concerns have been raised, particularly by smaller firms, that the poor quality and comparability of data about quality of execution on different venues has made it hard for firms to assess and compare different venues. We consider that the improvements in quality and consolidation of post-trade data discussed at (b) above, together with continuing improvements in application and enforcement, should provide the improvements that are needed. Market sensitivity, and flexibility in the best execution factors that firms apply, must be retained. The flexibility of the factors as cast in MIFID means that best execution works across a range of markets: concerns that have been raised about the quality and consolidation of data need to take account of that fact. It is important to maintain the EC interpretation under which best execution is owed where a firm acts on behalf of a client. Concern remains that best execution rules are not well adapted to portfolio managers: taking account of CESR’s statements on this matter, it may be worth exploring whether it is necessary to distinguish between the best execution that applies when a portfolio manager deals directly in the market, and the broker selection that such firms undertake when they rely on brokers to act on their behalf.

(g) **Trading costs:** Trading costs have decreased, but the corresponding reduction in order sizes, costs of access to multiple venues, and continuing high data and post-trade clearing and settlement costs (see (h) below) mean that, overall, there are still cost reductions that could be obtained by targeted action. Continuing efforts are needed to enable such improvements (see also comments at (b) above on the need for improvements to post-trade data). Regarding post-trading infrastructure, it will be important to assess the how the MIFID provisions might be affected by any other legislative initiatives.

(h) **Clearing and settlement:** The unreformed clearing landscape affects choice of venues under best execution requirements, and the right to choose where to clear and settle is embodied in MIFID. We support a high-level approach, based on guidance from national authorities, to introduce interoperability for CCPs. Since the ability to choose a CCP should reduce overall trading costs and enable better risk management, robust guidance should be an important structural change that will reduce overall costs and lead to widespread pan-EEA trading benefits.

**Areas requiring thorough evidence-based review**

In some areas there have been concerns that MIFID has not worked well or not fulfilled expectations. In considering such cases it is important for EC to proceed on the basis of factual analysis, and to be aware of the effect of legislation in promoting or stifling competition between different groups of market infrastructure and service providers. Examples include:

(i) **OTC trading in cash equities:** It has been asserted that OTC trading in equities is unregulated, untransparent, and increasing. In fact OTC trading continues to play an important, and broadly steady, role in markets, though published Thomson Reuters data suggest that its share of European cash equity trading has declined recently. Investment firms are thoroughly regulated under MIFID in both their
business and market conduct. Post-trade transparency provides (subject to the necessary improvements noted at (b) above) sufficient information to meet market needs.

(ii) **Automated Crossing activities:** It has been asserted that broker crossing systems (BCSs) represent a substantial, growing, unregulated, and untransparent sector of the market. In fact, BCSs are an example of the benefits that technology has brought to market participants. Simply an automation of previous more manual processes, they enable firms to find liquidity (an important element: certainty of execution) to execute clients' large trades which are not appropriate for pre-trade transparency. The investment firms which do this business are thoroughly regulated, in particular by best execution and conflict management rules, and the trades assist broader market price formation, as they are promptly reported post-trade. While BCSs represent a small percentage (low single figures at most) of total volume, it is nonetheless essential not to impede the capacity to execute large size orders.

(iii) **High frequency trading:** We consider that high-frequency trading is a legitimate trading strategy which contributes liquidity to the market. Any policy focus should be on the objectives of high frequency trading and how it operates, in particular whether there is discriminatory access to published pre-trade transparency information (‘flash quotes’), or whether there are inadequate controls, not on high frequency trading per se.

(iv) **Client categorisation:** Following the financial crisis, there have been comments that MIFID categorisation does not adequately protect certain customers. It has been suggested, for example, that more clients should be treated as retail when trading in complex products. It is important for investor protection to be well calibrated to investor needs. Less differentiated client protection would make trading more costly for clients, limit investor choice, and could result in regulatory focus shifting away from protecting vulnerable clients who need it most. The retail sector already includes a significant number of high-net-worth individuals, small corporates, trusts, and charities, who nevertheless have experience and expertise in using these markets. Certain clients that fall into the retail category receive maximum regulatory protection even though they have significant expertise: this applies in particular to specialist expert entities that are constituent parts of large groups which qualify as professional clients, but where the specialist entity itself, because the size tests are based on the company rather than the group, cannot be automatically classified as professional. MIFID already provides for clients to seek a higher level of protection if they need it, and many do so. There is no consensus on the meaning of the term ‘complex products’ More importantly, there is no obvious connection between the risk profile of a product and its complexity, which could lead to complex, risk-reducing products being replaced by riskier, less complex products.

We look forward to a constructive dialogue with EC and CESR on these issues as the consultation proceeds.