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Finance for Europe

Association for Financial Markets in Europe

Briefing Note

Review of the Markets in Financial Instruments (MiFID) – Extended Overview

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Introduction

Key principles of properly functioning markets that serve the real economy

Properly functioning financial markets serve the real economy. They help individuals, families, businesses and governments to save and invest. They are key to financing our society's needs for prosperity and employment through economic growth.

The financial crisis exposed a number of weaknesses in the financial system and highlighted the importance of well-judged regulation and effective supervision. To emerge fully from the crisis and avoid a repeat of another one of that scale, all participants must share in the responsibility and work together to design an appropriate and sustainable regulatory framework. This must embed, in equal measure, the four key principles around which properly functioning markets should be organised for the long term: Safety, Resilience, Liquidity and Efficiency.

MiFID Review – Key objectives to deliver on those principles

In the context of the Markets in Financial Instruments Directive (MiFID), AFME believes that the main objectives of increasing competition and strengthening investor protection have been largely achieved, bringing significant benefits to market participants. We recognise, however, that a number of weaknesses have emerged (e.g. data fragmentation, retail investor best execution) and that new objectives (e.g. financial stability) revealed by the financial crisis now need to be taken into account in securities markets regulation.

AFME therefore welcomes the MiFID review. We believe that meeting all of the following policy objectives through the MiFID revisions will be critical to the establishment of safer, more resilient, liquid and efficient securities markets that serve issuers and investors.

- Ensuring that markets are **sufficiently and appropriately transparent**
- Providing **appropriate levels of protection** for institutional and retail investors
- Promoting **financial stability** and preventing systemic risk
- Promoting **competition** and user participation
- **Global consistency** of regulatory regimes and supervisory cooperation

It is with these objectives in mind that we provide high level comments on the main issues that will likely arise during the MiFID review. In that context, AFME also calls on market participants to contribute constructively and with as much evidence-based input as possible to this review process – as AFME has sought to do for some of the issues addressed below. This is important given the tight timetable that policymakers are operating under and the lack, to date, of a comprehensive impact assessment.

Ensuring markets are sufficiently and appropriately transparent

The liquidity challenge

Liquidity lies at the heart of whether a person wants to participate in and can exit a market. Users need to find a counterparty and complete a trade without moving the price of the asset they are buying or selling. Where there are no natural buyers or sellers, or where buyers and sellers are not continuously accessing the market, as is often the case in bonds and derivatives markets, users will seek liquidity with a financial institution (directly or via its broker, or market maker) that is able to take on that risk[1]. There is a trade-off between transparency and liquidity, and the difficult challenge for both industry and policy makers is to achieve the optimal balance between where public transparency can support liquidity, and where it starts impairing it. Generally, the more participants in a market the more commoditised it is, and the smaller the trade the less any one user's actions affect prices. This is where public transparency can support liquidity. However, markets will always also have to serve users' needs for infrequent trading, trading in large size, and for non-commoditised products. This is where raising levels of transparency can impair liquidity. Beyond a certain point, publishing investors' trading intentions (pre-trade transparency) or actual trades (post-trade transparency) can actually harm their ability to buy and sell.

Equity markets

Waivers from **pre-trade** transparency on exchanges and Multilateral Trading Facilities (MTFs) enable investors' needs to be better served. We broadly support the Commission's proposal to review such waivers in order to reflect market evolution since MiFID was adopted four years ago. So called "dark pools", whether operated by an exchange, an MTF or a firm, strengthen market liquidity by enabling investors to execute trades that would otherwise be too large to execute in "lit" markets without damaging their interests. Research in this area finds no evidence that dark pool trading damages price discovery.

We fully support the establishment of a **European Consolidated Tape** (ECT) in response to the increased fragmentation of data sources since MiFID was introduced. We believe that the ECT should be run by a commercial provider and are actively involved in the cross-industry group tasked with its development.

In terms of finding the optimal balance between transparency and the market's ability to accommodate larger orders, we have significant concerns with the Commission's proposal to reduce delays for the publication of block trades. We recommend that, in the absence of a proposal with broad participant support, the task of reviewing the entire deferred reporting regime (not just numbers but underlying principles) be delegated to ESMA, together with an obligation to consult fully with equities product groups.

Non-equity markets

MiFID already provides for transparency **to regulators** in non-equity cash markets. The upcoming European Market Infrastructure Regulation (EMIR) will do the same for the over-the-counter (OTC) derivatives markets. Indeed, regulators should have unfettered access to all relevant transaction and position data across all asset classes, the resources to analyse such data, and the ability to share information between them.

Transparency is also important for investor protection: AFME is committed to supporting policies with that objective (as we have shown recently in developing 10 initiatives[2] to improve transparency in the securitisation market) as investor confidence is crucial to well functioning financial markets.

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[1] A bank risks its own capital when facilitating its customer's trade. This activity is fundamentally different from providing a non-discretionary public venue where buyers and sellers can meet to transact with one another, such as an exchange

[2] Industry initiatives to increase transparency

Most policy makers appreciate, however, that MIFID's current public transparency regime cannot be simply replicated for Fixed Income, Foreign Exchange (FX), Commodities and Derivatives markets. To do so, could drain the liquidity in a significant portion of these markets.

AFME recently published a Price Discovery Guide[3] showing that a large amount of **pre-trade** information is already available to investors in the fixed income markets. The International Swaps and Derivatives Association (ISDA) has also provided similar information relating to the derivatives market (**OTC derivatives and European Regulatory reform)[4]**. If market makers are forced to provide additional pre-trade information, investors may not receive any further value so market liquidity could be impaired. As explained above, generally bonds in the fixed income markets are larger and trade much less frequently than equities. Therefore, disseminating binding quotes in real-time would increase the risks for dealers and be practically difficult. To mitigate the risks of providing real-time binding quotes, dealers would need to either price the risk into their quotes (i.e. make it more expensive for investors to trade) or withdraw from quoting altogether, thereby depriving investors of valuable information.

Introducing mandatory **post-trade price transparency without the right calibration** would have similarly damaging effects. AFME acknowledges that constructing a well calibrated regime that protects liquidity is a difficult task for any regulator, as the fixed income market is complex with many different types of participants. Therefore, AFME considers it important that the industry itself attempts to develop and build a framework that balances the interest of transparency and liquidity for all participants. AFME is currently taking the initiative to develop such a regime. To that end, it is reaching out to key stakeholders to gather their input.

Providing appropriate levels of protection for institutional and retail investors

Investors are best protected by:

1) **appropriate information** relevant to their decisions and provided in a timely fashion; and
2) **fair treatment** by market intermediaries. The less expert the investor, the greater the protection needed.

As such, we believe that the **current client categories** of retail, professional and eligible counterparties have been shown to be **appropriate and flexible**, with scope for clients to seek to move between them. Similarly, the "execution only" and investment advice regimes both appear to have worked well. Finally, MiFID's best execution requirements are well calibrated and best in class.

The priority for regulators should be to ensure that these requirements are fully enforced. They should ensure, for example, that retail investors are consistently provided with best execution.

Promoting competition and user participation

Competition enhances social welfare by lowering costs, improving quality, widening choice and driving innovation. Europe's economic strength lies in this. MiFID has significantly opened up competition in trade execution which, notwithstanding the data fragmentation referred to above and with technology developments, has significantly reduced trading costs (as shown by a recent Oxera study) and improved investor choice.

The importance of choice and diversity

- ✓ Every economic decision involves a unique assessment of risks and opportunities: the better the markets can serve these specific needs, the better they can serve the economy.
- ✓ Competition encourages innovation and markets must be allowed to foster responsible innovation: users must be able to turn to alternative providers when incumbents do not meet their needs.

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[3] Price Discovery Guide

[4] See ISDA website

- ✓ Investors must be allowed to make free informed choices, including choosing the best means of trade execution and most appropriate venue. Available liquidity will often be the determining factor.
- ✓ It is therefore imperative that policy makers recognise the important different and complementary purposes of OTC and non-OTC, or "organised", execution systems and that they are not driven by inaccurate estimates of the size of OTC markets.

Therefore, we do not oppose in principle the introduction of a regime that captures organised trading outside the current range of existing MiFID venues, through the creation of an **Organised Trading Facility (OTF),** so long as this new category is clearly defined and respects the differences and therefore choice between the expanded range of venues. As such, we have significant concerns about the proposal requiring OTF sub-categories, such as Broker Crossing Networks (BCNs), to convert to MTFs upon reaching a certain volume threshold. This fails to recognise the different business model and purpose of BCNs[5] vs. MTFs, and acts arbitrarily to prevent investor choice.

As the new OTF definition also envisages capturing non-equity markets, it will be extremely important to ensure that it is further defined to take account of the liquidity issues discussed above. A historical analysis of market structure evolution shows that an asset generally trades on organised markets when it is sufficiently liquid. Hence in non-equity markets many systems provide only indicative prices or are aimed at facilitating investors' requests for quotes (RFQ). These systems would not be able to satisfy OTF requirements and therefore should not be caught by them. Only systems designed to match and execute trades should fall in the OTF definition.

OTC markets must be allowed to continue to exist in order to complement organised markets when trading does not lend itself to an exchange, MTF or OTF environment. This may be either because of the size or complexity of the trade, or another need of the customer, such as the ability to obtain certainty of execution in times of market stress. Appropriate transparency can be derived irrespective of the type of execution method.

Promoting financial stability and preventing systemic risk

The financial crisis has revealed the role markets play in economic stability. It is right, therefore, that securities regulators should be concerned with the systemic risk implications of market activities and work closely with prudential regulators to design a sustainable framework to mitigate and manage future shocks. Technological advances and financial innovation are often cited as some of the potential contributing factors to market instability. This is particularly evident in the MiFID Review discussions on high frequency trading (HFT) and bans on products and services.

High Frequency Trading

The US is currently debating the relevance of HFT to the 6 May 2010 "Flash Crash". While the evidence does not appear to find a link between the two, it is understandable that EU regulators should be concerned about the risks of such an event happening in Europe. The debate is also about the broader implications of technological developments on investor protection, market integrity and the social usefulness of HFT.

We believe that any HFT firm with direct exchange access as a member should be authorised and that operators of trading venues should have in place appropriately calibrated risk controls (such as circuit breakers) to mitigate errors generated by automated trading. We would encourage the Commission to consider making use of existing alert mechanisms as most trading venues already have circuit breaker type concepts in place. Pre-trade risk controls should be managed by brokers.

However, we disagree with a minimum order life, resting period, and any ratio of orders to transactions. This would severely limit dealers' ability to reflect new information coming into the market (in particular in volatile conditions) and may also force customers to remain in a market position that they wish to exit.

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[5] BCNs are nothing more than an automated way for firms acting on behalf of clients to match client orders when it is in their best interest to do so (notably for best execution purposes).

While HFT firms contribute important liquidity, they do not provide a market making function in normal markets, and should not need to do so in time of stress. Therefore, imposing ongoing market making requirements on them does not appear appropriate.

Ban on Products or Services

As the financial crisis has showed, there are multiple, complex and interacting causes of market instability that cannot be easily determined, let alone be attributed to one specific instrument or practice. Unilateral actions to ban certain products or practices can lead to confusion for both markets and authorities, as was experienced with the short-selling ban in 2008 (US, UK, Germany and France), and result in loss of market confidence.

Individual products in themselves cannot be considered high risk or "bad" per se, and there is often a false link made between "complex" products and the associated level of risk. Unfortunately, the MiFID definition of complex products relates to the ease with which the product can be understood by an investor, rather than its market risk. In reality, however, some "complex" products are less risky than some "simple" products, and vice-versa. We recognise that problems can occur in the manner in which certain products are *used,* which are better addressed through provisions to tackle market abuse than through banning products.

Securities regulation and systemic risk

In its February 2011 paper on "*Mitigating Systemic Risk – A Role for Securities Regulators*", IOSCO recommends the following measures as the basis of robust and effective systemic risk frameworks for securities regulators:

- ✓ Disclosure and transparency to arm regulators with the information needed to take action; and to allow market participants better to price risk.
- ✓ Robust regulatory supervision of business conduct to avoid the build-up of undesirable incentive structures within the financial system.
- ✓ Focus on financial innovation: encourage and facilitate innovation that can improve market efficiency or bring useful products and new participants to the market; carefully monitor innovation which involves opacity or improper risk management.
- ✓ Sharing market information and knowledge among authorities: key to improve understanding of securities markets, and to deliver a truly efficient regulatory response to systemic risk;
- ✓ Develop key risk measurements relevant to systemic risk arising within securities markets.

We fully support this approach, which does not propose banning products or services, as an effective systemic risk management tool for regulators. We note also that the recently agreed EU Supervisory Package already provides each supervisory authority (in this case ESMA) with the power to restrict or prohibit market activities when there is a serious threat to financial stability.

Global consistency of regulatory regimes

The financial crisis was a global crisis and it is imperative that the regulatory reforms that emerge around the world, under the impetus and guidance from the G20, are globally consistent.

We welcome the Commission's leadership in seeking to establish robust global standards of securities regulation. We strongly agree with FSB Chairman, Mario Draghi's recent call for the need to have an iterative process in the development of a globally coherent regulatory framework. In its absence, **3rd country operators should continue to operate freely in the EU subject to rules which ensure similar regulatory and prudential outcomes to those in the EU**.

Regulatory and prudential barriers to global capital markets (such as barriers that could emerge from regime based on strict equivalence) would likely:

- ✓ reduce investments into the EU
- ✓ make it more difficult for EU firms to access non-EU markets (encouraging retaliatory or similarly protectionist reactions)
- ✓ fragment instead of integrating global markets in situations where the EU and, e.g., the US divide on major topics
- ✓ tie up significant ESMA resources that could be better deployed on its new regulatory and supervisory day-to-day duties.

Conclusion

The MiFID review provides all stakeholders with an opportunity, and a responsibility, to work together towards developing well functioning markets that serve the real economy and can support Europe's Single Market Act agenda. The result of this review will also be a major factor in determining the international standing, effectiveness and success of the European market in the near future as a competitive place to trade securities globally.

Radical, uninformed changes to the current MiFID regime could threaten these ambitions and, thus, the benefits that MiFID has already brought must be preserved.

However, appropriate and evidence-based changes should be made where MiFID has fallen short of its objectives (e.g. retail best execution) or revealed certain weaknesses (e.g. post-trade transparency and data consolidation) and to take account of market structure developments since MiFID was introduced, as well as lessons from the crisis for securities regulation.

In designing the revised legislation it will be important, in particular, to strive to **avoid a "one size fits all" approach that reduces choice and diversity**: i.e. to recognise the diversity of asset classes as well as allowing investors to make free informed choices, including choosing the best means of trade execution. It must recognise the important different and complementary purposes of wholesale and retail markets and of OTC and non-OTC markets. The better markets can serve users' specific needs, the better they can serve the economy.

Further documents

MiFID is an extremely complex and comprehensive piece of regulation. AFME has considered the key points relating to specific markets in a series of individual briefing notes:

- BN-11-02 MiFID Review Briefing Note on Equities including market structure issues, venue definition, high frequency trading, etc.
- BN-11-03 MiFID Review Briefing Note on Fixed Income including price transparency
  - BN-11-03A MiFID Review Briefing Note on Rates (yet to be published)
  - BN-11-03B MiFID Review Briefing Note on Credit (yet to be published)
  - BN-11-03C MIFID Review Briefing Note on Securitisation (yet to be published)
- BN-11-04 MiFID Review Briefing Note on Foreign Exchange
- BN-11-05 MiFID Review Briefing Note on Corporate Finance
- BN-11-06 MiFID Review Briefing Note on Compliance including data consolidation, transaction reporting, investor protection, ESMA and Access of Third Party firms.

See also briefing notes covering AFME led initiatives:

- Post Trade Transparency Framework for Fixed Income
- OTC Equity Trading Report

AFME's response to the MiFID Review Consultation can be found here

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About AFME

AFME (Association for Financial Markets in Europe) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. For more information please visit the AFME website, www.afme.eu.

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