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## **AFME Position Paper on MiFID/R Key Council Proposals**

### **April 2013**

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### **Equity Market Transparency**

#### ***Reference Price Waiver (MiFIR Article 4.1a)***

We strongly believe the RPW plays an important role in ensuring better returns for ordinary investors. Indeed, end investors have expressed support for the RPW and its general importance for different trading strategies. The RPW protects wholesale trades against market impact, providing efficiency and accessibility for investors in the execution of their orders. It favours long term investors over short term trading strategies enabling long term investors to access and match liquidity avoiding the often unnecessary risk-premium demanded in the open market.

After at least five years of usage of the RPW since MiFID I, recent data for European markets suggests that dark MTFs (the majority of which use the RPW) traded just 4.46 % of overall turnover in European equities in February 2013<sup>1</sup>. In future, it is clear that trading under the Waiver will be even lower than it is today. With the EUR6000 size threshold in place, and with the reduction of available price points from four to two, it is estimated that trading under the waiver will reduce by 25-30% from the already low levels stated above. We would also stress that there is no evidence of the RPW damaging price formation. We consider that the further restrictions proposed by the new IE Presidency Non-Paper would be unjustified and dangerously premature without further impact assessment.

Two times SMS (EUR15K for most stocks) amounts to more than four times average trade sizes, and we regard this as a draconian measure. Such a far-reaching restriction of the RPW is unlikely to cause a shift in liquidity from such trading practices to the lit markets. Instead it would reduce the willingness of investors to trade, increase transaction costs, and materially reduce aggregate volumes of trading thus limiting liquidity.

We fully support the importance of striking an optimal balance between lit and dark markets, but have not seen any evidence that the usage of the RPW is detrimental to price discovery. Rather than introducing an arbitrary volume threshold limit, we urge regulators to continue carefully monitor the market and develop market-specific benchmarks (based on e.g. spreads and/or volumes trades) to better assess the health of price formation and make decisions on any limit to pre-trade dark trading on the basis of the methodologies developed. A single Consolidated Tape Provider, avoiding issues of data inconsistency which will inevitably arise when aggregation is done by multiple providers, would provide the appropriate mechanism to assess the volume of trading that will flow through the waiver across EU trading. To have the calculation performed by each national authority, rather than doing it once centrally, would be a huge duplication of effort and create potential for divergence of approach.

### **Non-Equity Transparency**

We fully support the recent letter from the Sub Committee on EU Sovereign Debt Markets to the EU Economic and Financial Committee, which sets out the need to protect liquidity providers, indefinite volume omission and allow for a properly calibrated post-trade transparency regime.

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<sup>1</sup> Source: Thomson Reuters

**Approach to Calibration (MiFIR Article 20b (new))** Currently, MiFIR does not stipulate that the non-equity transparency requirements should be calibrated in a dynamic way by a central entity. We believe that these are essential features of a properly configured transparency regime that is a consistent, predictable and harmonized across Europe.

We are concerned by the introduction of the new Article 20b in MiFIR, which allows national Competent Authorities (CAs) to require trade data for the purpose of carrying out the calibration of the transparency requirements at the national level. This insertion indicates a preference for a fragmented approach, where each CA performs the calibration for instruments issued/traded (“issued approach” and “traded approach”) within in their jurisdictions. We strongly advise against such an approach. The infrastructure needed to support multiple CAs identifying the securities in scope and collecting trade data and producing a dynamic calibration would need to be very complex, would produce poor data quality, and could create confusion and asymmetry of information in the markets.

First, if each of the 27 CAs had to identify a list of securities in scope, it would mean that every market participant will need to cross check 27 evolving in-scope lists against the securities they have traded (for either the issued or traded based approach). This would cause confusion as to whether an instrument is in scope or not. Also, since non-European securities traded in Europe are in scope, it is unclear by which CAs those instruments would be calibrated.

Second, having each of the 27 CAs producing the calibrations would create the following problems: (i) the calculation of calibrations will not be undertaken and based off a single European wide audited data source; (ii) having to send data to 27 different member CAs that produce different calibrations and then to apply those different calibrations to trades would be difficult to cross-check, apply, comply with and understand (e.g. one bond could have different calibration requirements in different jurisdictions creating information asymmetry and an un-level playing field); (iii) non-standardised and harmonised data collection and calibration would be to the detriment of data quality (e.g. a high level of duplications); (iv) every CA would need to produce their calibration at exactly the same time as the other 27 CAs; and (v) it would require a static calibration (e.g. annual) which conflicts with the dynamic approach needed to reflect changes in liquidity.

We believe that a centralised approach is necessary to appropriately implement and maintain the transparency regime. Such an approach would enable CAs to operationalise the calibration requirements based on an assessment that takes into account the entire EU market, in a reliable and dynamic way and in a timely fashion. Also, it makes the calibration requirements for each instrument available to all market participants (including investors) across the EU, ensuring that there is no asymmetry of information. Further, it ensures optimum data quality (e.g. preventing duplicative reporting). Lastly, it guarantees that the process for identifying and maintaining the list of securities within scope of the requirements is robust. This is important as the publication requirements will apply to hundreds of thousands of different securities.

AFME has, as part of its cross-industry transparency initiative, defined an optimal set of features for the central calibrating entity: its role, business model, governance, costs and technology. A single European entity should perform the following functions: (i) produce and maintain a list of the instruments that are within scope; (ii) collect trade data to produce the results of the transparency calibrations; and (iii) produce the calibration of those instruments using the trade data.

These functions do not have to be undertaken by ESMA; they could be outsourced to an independent entity subject to ESMA oversight. For example, the US has a single calibrator (FINRA), which outsources its technology functions to the commercial provider (NASDAQ). At level 1, we recommend legislators to grant sufficient powers to the EC and ESMA to set up the appropriate pan-European infrastructure to enable an efficient implementation and ongoing operation of the MiFID II non-equities transparency requirements.

## **Market Structure**

### ***Trading Obligation for Equities (MiFIR Article 20c(new))***

We are very concerned by the insertion of a trading obligation for equities, which is not consistent with the G20 derivatives mandate, has not been subject to impact assessment and would be anomalous internationally. It would further reintroduce a de facto concentration rule undermining significant gains in competition and investor choice delivered by MiFID I. In addition, the proposed extension to all shares, including illiquid instruments is particularly troubling since these are precisely the types of instruments that are less suited to venue or Systematic Internaliser trading<sup>2</sup>. Indeed, the inclusion of illiquid equities is inconsistent with the approach to equity market pre and post trade transparency (in MiFIR Articles 4 and 6) where the granting of the large in scale waivers or authorisation of deferred publication is based on the relative liquidity of the order or transaction in question.

A trading obligation will mean that clients and end users will be unable to exercise their choice as to where they execute their share trading, based on their overall investment objectives. This curtailment of investor ability to execute OTC trading would have a detrimental impact on their willingness to trade and thus the availability and cost of liquidity. Indeed, trade execution is not a zero sum game: the insertion of a trading obligation and consequent curtailment of OTC will not translate to a direct shift of liquidity from OTC to the lit markets. In addition, and as reflected in the recent Presidency text there are a number of types of trading that are technical and non-price forming in nature that could not feasibly be executed on a venue but that would also not fit within the SI regime. Examples of such trades include broker to broker give-up/in trades and trades in equities not traded on a sufficiently organised, frequent and systematic basis.

We believe that the current regulatory framework where OTC equates to all activity which is not executed on a venue or though an SI is appropriate.

### ***OTF for Equities (MiFIR Article 2(7))***

We welcome the reversion to the Commission's original proposal to permit equity trading on OTFs but note that the usability of this measure is fundamentally undermined by the continued ban on the execution of investor orders against the own capital of the OTF operator (see comments immediately below re MiFID Article 20).

The reintroduction of the equity OTF category recognises that brokers have an important role in expediting and matching investor' trades in circumstances where investors do not wish to face market risk, for example where the trades are large in scale or illiquid, or where the ultimate counterparty is anonymous. Since a broker would operate the OTF facility in order to execute trades for its clients, the broker needs to be able to exercise a degree of discretion over how orders are matched and to permit access to the OTF exclusively for its clients. An OTF is not a public market and should not be treated as such by regulation.

### ***Own Capital and Matched Principal (MiFID Article 20)***

We are concerned by the continued ban on OTF operator deployment of own capital in relation to all financial instruments and by the proposed limitation of matched principal trading to non-equity OTFs.

The distinction between equity and non-equity products erroneously assumes that all equities share the same liquidity characteristics and trade in the same fashion. In fact, the deployment of own capital and

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<sup>2</sup> The need for venue trading obligation to apply to only liquid instruments is acknowledged in the MiFIR Article 26 requirement for ESMA to consider the liquidity profile of a class of OTC derivatives before subjecting it to the trading obligation proposed in MiFIR)

the ability to conduct matched principal trading in an OTF is critical for the facilitation of investor-initiated liquidity across a variety of equity, fixed income and derivative markets. The key purpose is to enhance available liquidity and to ensure efficient client order execution by consolidating all trades with a single counterparty.

When there is no simultaneous, equal and opposing trade to match a client order, the investment firm will need to take on his client's position against his own risk book until either an opposing client order is found or the position can be unwound against multiple other orders within the OTF or other trading venue. In other instances, an investment firm may need to transact in the market principally (for example when hedging a client derivative).

Prohibiting the investment firm from interacting with existing client orders in its own OTF will result in a poorer quality execution for the investor than if permitted to interact with the firm's order. Indeed, given deployment of own capital is of particular importance for less liquid instruments, the client may be unable to execute its order at all. We are of the view that the deployment of the operator's own capital should be allowed where the client has expressly consented to it, thereby supporting client choice and fulfilment of the G20 agenda. Any potential conflicts of interest can and should be addressed by stringent order handling and conflicts of interest rules.

## **Safekeeping and Administration Services (MiFID Annex I)**

We welcome the move of safekeeping and administration services from Section A (Investment services and activities) to Section B (Ancillary services). We support the harmonisation of custody services regulation in the EU. However, AFME members believe that MiFID and MiFIR are not appropriate legislative vehicles for the creation of a harmonised regime as both texts deal primarily with the execution of financial instruments and related market structures.

## **Access between Venues and CCPs (MiFIR Articles 28, 29 and 30)**

The latest Irish Presidency text reverts to the last Cypriot Presidency draft compromise text and adds protection from competition for trading venues, CCPs with close links to venues and existing benchmark indices.

Trading venues can use CCPs provided there is no liquidity fragmentation or adverse affects to systemic risk. These elements should not be used for protectionist reasons and we await ESMA's Level 2 guidance. Interoperability for derivatives can only be achieved if the relevant parties agree. Given that only one incumbent exchange has to date provided interoperability arrangements for cash securities, we believe that a voluntary approach is unlikely to succeed.

For new trading venues, provided their turnover remains below €100bn pa for transferable securities and money market instruments and €500bn pa, for derivatives, trading venues can refuse to accept the conditions for non discriminatory access for three years from the application of MiFIR, followed by another three years if values still not reached. Further conditions will be required by ESMA if the above three year 'protection' period is allowed to proceed.

Article 30, access to benchmarks, now states that any request for access may be rejected for three years from the first request, with no basis how this timeframe was arrived at, or why. Existing products may obtain a three year exemption after entry into force of MiFIR.

In summary, we call for a review of the timeframe during which an entity receiving a request for access can be protected from competition. Similarly, there is no clear rationale why a benchmark, which may have been in existence for many years, should still be afforded an additional three years of protection from competition. If fair, reasonable and non-discriminatory terms can be

agreed, we would suggest that the license originator would be compensated for any loss of income for all benchmarks. Each of the above measures only serves to reinforce and protect a vertical silo model and decreases the opportunity of further competition in the EU, contrary to the spirit of the Regulation.