

MiFID II: Ambitious, But Appropriately Calibrated? | Juan Pablo Urrutia



At the intersection of markets and technology, Insights provides ITG's global perspectives on market structure, analytics and research, and liquidity.

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The much anticipated draft law amending the Markets and Financial Instruments Directive (MiFID) was recently issued by the European Commission. The Commission has split the legislative proposals into a new Markets in Financial Instruments Regulation (MiFIR) and a revised directive (MiFID). This reflects the Commission's view that there is a need to achieve a uniform set of rules (covered by the Regulation) in some areas (where countries will not be authorized to 'interpret' the European rules into national legislation), while allowing for differences in national markets, legal structures and investor profiles in other areas (covered by the Directive).

A review of MiFIR/MiFID shows that the EC left important technical detail to future secondary legislation. This allows for flexibility and means a greater understanding of the market can be achieved along with any further analysis which may be required prior to the introduction of any new rules. However, there are also a number of areas where the proposals raise significant concerns. In this article we cover three sections of the legislative proposals which will require significant attention from the asset management community to achieve an optimal outcome in both the final text and subsequent detailed rules.

Algorithmic Trading

At the 11th hour, a quasi market making obligation has been introduced into the draft law for all market participants who operate algorithmic strategies. We expect this proposal will cause much debate amongst asset managers. The proposed rule (Art 17 para 3 of MiFID) says (the relevant section of the text highlighted and underlined for emphasis only):

*"An algorithmic trading strategy shall be in continuous operation during the trading hours of the trading venue to which it sends orders or through the systems of which it executes transactions. The trading parameters or limits of an algorithmic trading strategy **shall ensure that the strategy posts firm quotes at competitive prices with the result of providing liquidity on a regular and ongoing basis to these trading venues at all times, regardless of prevailing market conditions.**"*

The algorithmic trading section is unquestionably targeted at the high frequency trading community and the difficulties that policymakers have had in defining high frequency trading are well known. However, some are likely to seriously question why the Commission did not consider adopting the European Securities and Markets Authority's (ESMA) definition of High Frequency Trading contained in their Call for Evidence on micro-structural issues in April 2010.

Just as we anticipate asset managers to lobby in Brussels for a more narrow application of the market making obligations, we also believe that there will be a substantive and independent level of negotiation on wider market making aspects of this provision at both the European Council and European Parliament level. That said, a successful lobbying outcome is not a foregone conclusion given that the Commission would not have introduced a rule with such wide impact without careful analysis. Some market structure experts reviewing the MiFIR proposals, however, may believe that the wider scope of the rule provides a good negotiation position for the Commission.

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Finally, the proposals also include a section that imposes an annual notification of an investment firm's algorithms to the relevant national regulator. Unfortunately, concerns with the level of granularity required in the notification process and delays in the processing of the relevant notifications have not been clarified by the Commission proposals but, we continue to believe that the rule is likely to stop short of requiring the disclosure of source codes.



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Pre-trade transparency

The two important questions on everyone's mind are how will the pre-trade transparency waivers rules for dark pools look and what effect will the new market structure landscape have on the investment bank's broker crossing systems? Both of these questions are interrelated at the market structure level.

The proposals do not give sufficient granularity on the Commission's thinking on the pre-trade transparency waivers. MiFIR simply says that the technical detail will be decided by way of delegated acts (without the European Parliament or the European Council being allowed to vote on the subsequent delegated acts). However, we can gain some insight from the whopping 390 page European Commission Impact Assessment used to draft the MiFIR and MiFID proposals.

The Commission's thinking is that "the exemptions to pre-trade transparency are kept to the absolute minimum necessary". However, the Impact Assessment does go on to say that the Commission considered various policy options and concluded that abolishing the pre-trade transparency waiver would cause "substantial damage to market liquidity". We may deduce from this that the existing pre-trade transparency waivers will remain firmly in place and that the Commission will be focused on the need to calibrate any change in the existing waivers, with eyes fixed on the impact to liquidity that any such calibration could cause.

The investment banks that operate broker crossing systems will also be cautiously looking at the detailed proposals on the pre-trade transparency waivers. Under the proposed Organised Trading Facility (OTF) regime (applicable to broker crossing systems), OTF operators will be prohibited from crossing client orders against their own proprietary flow. This may make investment banks consider the benefits of operating a Multi-lateral Trading Facility (MTF) and/ or a Systematic Internaliser (both of which allow proprietary trading flow to be crossed against client orders). In those circumstances, the decision to operate a Systematic Internaliser (SI) or an MTF is likely to be conditioned, at least in part, by the calibration of not just the pre-trade transparency waivers but, the 'standard market size' threshold above which SI operators will be exempted from making their two way quotes publicly available. How the Commission decides to define 'standard market size' is likely to impact an investment bank's decision about whether to operate an SI.

To assist with understanding the Commission's proposed trading landscape, the table below sets out the trading modalities, their transparency requirements and their trading obligations (e.g. discretionary or non-discretionary). Pre-trade transparency requirements will extend to regulated markets (RMs), MTFs, OTFs and SIs. Over the counter trading (OTC) will continue to be fully exempt from any pre-trade transparency requirement. However, the scope for OTC orders will be severely limited to non-systematic, ad-hoc and irregular trading.

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Table: Trading Landscape

	“Execution venue”	Categorised as OTC	Pre-trade transparency	Execution
RM	Yes	No	Identical for RM, MTF, OTF	<ul style="list-style-type: none"> • Non-discretionary • Multi-lateral third party interest interacting
MTF	Yes	No	Identical for RM, MTF, OTF	<ul style="list-style-type: none"> • Non-discretionary • Multi-lateral third party interest interacting
OTF	Yes	No	Identical for RM, MTF, OTF	<ul style="list-style-type: none"> • Discretionary + must provide best execution • Multi-lateral third party interest interacting • Cannot cross client orders against proprietary capital.
SI	No	Yes for all trading on own account	Orders above “standard market size” are not subject to pre-trade transparency requirements	<ul style="list-style-type: none"> • Discretionary + must provide best execution • Bilateral and cannot bring together third party buying and selling interests in functionally the same way as RM, MTF or OTF • Can cross client orders against proprietary capital.
OTC	No	Yes	No	<ul style="list-style-type: none"> • Discretionary, non systematic and irregular trading against own proprietary capital



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A missed opportunity: extension of non-discriminatory access to indices to also cover single name market data

The Commission has missed an opportunity to break the larger trading platforms’ inherent monopoly over the cash markets trading data (generated by the activity of trading members on the platform which they operate). This is all the more striking considering that the MiFIR proposal does address the same question but, only in relation to benchmarks and indices for derivatives trading. The proposed rule (Art 30 of MiFIR) says (the relevant section of the text highlighted and underlined for emphasis only):

*“...a person with proprietary rights to the benchmark shall ensure that CCPs **and trading venues** are permitted, **for the purposes of trading and clearing, non-discriminatory access to:** (a) relevant price and data feeds and information on the composition, methodology and pricing of that benchmark; and to (b) licences.”*

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It is well known that one of the highest trading costs in the cash markets are the pre-trade market data charges. Furthermore, some may suggest that it is fundamentally inconsistent that MiFIR will prohibit anti-competitive practices in respect of access to benchmarks/ indices (e.g. for trading in derivative instruments) but, will nevertheless allow the high pre-trade market data costs to continue for transactions in single name financial instruments. Without the buy-side vociferously making it known to policymakers that this omission has a fundamental impact on their business, it is unlikely that those policymakers will be willing to expend political capital in correcting this omission.

Next steps

We understand that certain member states met last week to begin discussing the proposals and that the European Parliament may produce its position paper as early as Spring 2012. After this, the European Parliament, European Council and Commission will meet in a “Trialogue” to hammer out an agreed position by the fourth quarter of 2012. However, judging by the time that it took to negotiate the Alternative Investment Funds Managers Directive, some believe that all of these timelines may prove to be overly optimistic.

Hence, the legislative process is likely to have a considerable way to go before the proverbial ‘ink is dry’ and will require a substantive amount of negotiation to achieve consensus in the Commission, European Parliament and European Council. Both a senior staffer at the European Securities and Markets Authority and key players in the European Parliament have emphasised that market participants need to reach out beyond their home country finance ministries, local Members of the European Parliament and national regulators. This comment reflects the majority voting process that exists both in the European Council and European Parliament which will make it impossible for any one country to veto the proposed rules. Hence, whilst there is still plenty of opportunity for asset managers to lobby, an effective (but, necessary) advocacy campaign will be both time consuming and arduous.



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