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MiFID Review
Objectives for MiFID II/MiFIR

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Market Structure

The 'Deal' in MiFID 1

- Before discussing the Commission's proposals on market structure, I will give a very quick overview of what type of market structure MiFID 1 has resulted in.

- There were two potentially conflicting objectives underlying the legislation:

  - *To create more investor choice and competition (equities markets would inevitably fragment)*
  - *To protect investors and to ensure markets remain efficient (in spite of fragmentation)*

- Obligations on transparency were imposed to reconcile these objectives, preserve price formation and protect the end investor. However, we do not believe that this 'transparency deal' has been respected.

- To understand why let us look at the *kind* of fragmentation that has resulted. This can be considered from two points of view: (i) within lit markets (i.e. fully transparent) and (ii) between lit and dark markets.

Fragmentation within lit markets

- MiFID 1 has had its greatest success in creating more competition: users have more choice and prices have come down. New entrants now account for over 1/3 of lit equity trading and Europe's largest platform is a Multilateral Trading Facility ("MTF"), Chi-X – this is all good

- **Who are these new players?**

- Entry has been exclusively user-sponsored, and among these user-shareholders, high frequency firms dominate – so now over 1/3 of lit volumes take place on user owned platforms. There is nothing wrong with this as such.

- These platforms operate business models that are structurally unprofitable as standalone corporate entities, but in fact they are ultimately profitable to their shareholders who earn indirect rents from them, notably in the form of (i) maker taker pricing (ii) control over market structure and (iii) fee reductions from incumbent markets.

- We call for a clear regime for managing conflicts of interest for investment firms that operate platforms; regulated markets are subject to substantial conflicts of interest regulation. The accumulation of roles in investment firms operating MTFs include: (i) operating a platform (ii) providing own account flow to that platform (iii) providing client flow to that platform (iv) operating automated routing arrangements between the platform and the firms own books and finally (v) being responsible for the market supervision and integrity of the platform.

- MTFs were given an explicit helping hand in MiFID 1 and in supervisory application with 'proportionate' regulation: lighter organisational requirements, market surveillance and systems resiliency.

- MiFID has been successful in creating MTFs that now have volumes larger than most exchanges. Accordingly, we call for identical rules between regulated markets ("RMs") and MTFs.

Fragmentation between lit and dark markets

- This is an even more important issue than fragmentation within lit markets. There is always a natural tension between the individual and collective interests in markets.

    - *The interests of the individual pull towards dark trading*
    - *The interests of the collective pull towards lit trading*

- There is nothing wrong with these interests, but it is the job of regulation to strike a balance between the two. This is because in any competition between lit and dark markets, the dark will always win. We do not believe the regulation is doing a good job of respecting the 'deal' in MiFID 1

- MiFID 1 manages the balance between lit and dark trading in two ways:

    - *A system of waivers to pre-trade transparency;*
    - *A recognition that business can take place OTC (over-the-counter) for large, occasional and professional business.*

- However, this system is not working; dark trading now makes up 40% of reported equities volumes. OTC in the cash equities space is the real issue – accounting for 38% of October 2011 reported equities volumes[1]. While a portion of this may be accounted for by technical and duplicative trades, a substantial part is addressable liquidity which should be part of the price formation process on lit markets.

[1] Thomson Reuters reported figures

- As long as there is no legally enforceable definition of OTC for equities, market innovations will naturally gravitate to what is dark and undefined. And this is what is happening.

- You can try to create all the new trading categories in the world, but if you leave the back door open, OTC trading will continue to grow – market players will find ways around the definitions.

- We know today that OTC contains things that it shouldn't: notably the activity of bank crossing networks and lots of small trades. In addition, there is a significant lack of clarity around the exact composition of OTC.

- We should therefore define what OTC trading should be by firstly, simply moving the existing definition from a recital in MiFIR into the main body of the text, thereby giving it legal force; and secondly, making concrete reference to a system of OTC flags defined by EMSA so we know what type of trades are contained in it. A simple change to fix much of what is wrong today.

- Let me touch on waivers, which accounted for 2% of Oct 2011 reported equities volumes. Waivers are not evenly applied across national regulators and we believe ESMA should have a stronger role. Waivers should be defined in the proposed regulation - at least by type - and not left to the Commission in delegated acts. This is a major future source of loopholes for future growth in dark trading.

Organised Trading Facilities ("OTFs")

- We welcome the fact that the Commission sees there is a problem with loopholes, but the real solution to loopholes is not to create more categories. You can't possibly think up a new category each time a new way of trading appears. This is because new types of platforms will simply find ways

around them and fall into the OTC category, which is currently undefined. A new 4th category should therefore be conditional upon a legally enforceable definition of OTC being contained in the text.

- So, if an OTC definition is made legally enforceable, we have nothing in principle against a fourth category of trading venue as long as it operates on a level playing field with other venues. We do not want a new 'light' touch category.

- The Commission has positioned the OTF in the same multilateral family as regulated markets and MTFs (neutral, pricing forming with the same transparency regime).

- If the OTF is to be a multilateral venue then it is wholly appropriate not to allow the operator to inject their own account flows, since MTFs and RMs are not allowed to do so. Trading on own account can take place under the SI regime.

- Links between OTFs and other infrastructures such as SIs, routing systems, subsidiaries of the same firm should be carefully studied since they may be used to circumvent the rule on own account flow.

- Prices published by OTFs (under the same transparency regime as RMs and MTFs) should be executable. The Commission is proposing that the OTF have discretion over prices, but if the prices are not binding then the contribution of a multilateral OTF to price formation is meaningless. Furthermore, in relation to the G20 trading obligation for OTC derivatives, if there is discretion over price matching this must raise a question mark over the quality of price formation in the OTF. This raises concerns for investor protection and the quality of the clearing process, since price information forms one of the main inputs to that clearing process.

Algorithmic trading

- It is important to recognize that algorithmic trading is not the same as high frequency trading ("HFT"). Algorithms are used by most markets participants and are valued by the end clients of investment banks who use them to break down larger orders. HFT is a smaller subset that implements traditional trading strategies, such as arbitrage, at a far greater speed.

- HFT firms should not be demonized. MiFID has fragmented markets and HFT firms have a role in ensuring the coherence of prices between platforms. They are rational economic agents acting within the market structure that MiFID has created for them. They have been one of the major drivers behind post MiFID competition.

- I would like to address three aspects of HFT which seem to be worrying policy makers:

  (i) Some commentators have been concerned about the weight of HFT on markets. This is simply because their relative weight has increased, as "long-only" institutional and retail business have withdrawn from the market given economic conditions.
  (ii) There is the perception that HFT can abruptly withdraw from the market, causing liquidity to suddenly disappear and prices to crash. The answer to this is in having effective market controls, and not more draconian obligations on presence obligations, which would simply cause HFT to withdraw from the market altogether.
  (iii) Finally, market abuse is not somehow unique to HFT: it can be both human and electronic and should be rooted out wherever it is.

SME markets

- Unlike the main MTFs, exchanges dedicate substantial resources to maintaining markets in SMEs.

- We welcome the Commission's proposals, but we should recognise that this is only part of the problem: the home bias in SME markets is particularly strong and a pan-European approach requires a stronger commitment in overcoming the information asymmetries between investors.

- Most importantly, we should be mindful of the liquidity issues around SMEs, by pushing the fragmentation of SME trading the liquidity could suffer. We therefore think the issuer should have some say in whether their stock is traded away from their home markets or not.

Commodity Derivatives

- NYSE Euronext's regulated markets in Paris and London provide a forum for the trading of a wide-range of futures and options contracts based on soft and agricultural commodities. These contracts have long been relied upon as trusted European and global benchmarks, facilitating price discovery and risk management.

- The European Commission's proposals for commodity derivatives markets sit within a broader context of policy development in the G20. This, in turn, has been influenced by concerns over price levels and price volatility, as well as broader issues such as productive capacity and food security.

- As the G20 has recognised, these issues are complex and addressing them will require complementary action and initiatives across many different sectors of society.

- One element of that action plan concerns the commodity derivatives markets. At the Cannes Summit in November 2011, the G20 reiterated its previous calls for enhancements to the operation of those markets. These are reflected in two key components of the Commission's MIFID proposals, namely:

    - **Greater transparency**.

    - **Enhanced position management**.

Transparency

- On transparency, the Commission has proposed that trading venues should publish a weekly report setting out aggregate positions held by different categories of market user.

- NYSE Euronext believes this will enhance market confidence by putting more information about the use of the commodity derivatives markets into the public domain.

- In October 2011, NYSE Euronext began publishing weekly position reports in respect of commodity futures contracts which are traded on its regulated market in London. These reports are similar to those proposed by the Commission under MIFID. They show the proportion of open interest held by producers, merchants and processors on the one hand and financial participants on the other. They have been introduced in response to requests for greater transparency from various market users.

- NYSE Euronext's only suggestion for improving the Commission's proposal would be to remove the requirement for position reporting by member firms to be done in **real time.** This is because reporting on a real time basis is not necessary to produce a **weekly position report**. It would also pose significant practical problems.

Enhanced Position Management

- Turning to the Commission's proposals on position management, NYSE Euronext believes that strong oversight of positions in commodity derivatives markets is an essential element in ensuring that markets remain fair and orderly and that the price formation and delivery processes operate smoothly.

- The Commission has proposed that trading venues should be required to implement position limits - or alternative arrangements with equivalent effect - in order to deliver three policy objectives:

    - To support liquidity.

- To prevent market abuse.
- To support orderly pricing and settlement conditions.

- NYSE Euronext supports those policy objectives. It also believes that the inclusion of "alternative arrangements with equivalent effect" is essential because market structures and physical commodities are extremely diverse and regulatory solutions need to be tailored accordingly.

- The position limits or alternative arrangements will, of course, need to operate within the context of wider position management processes. Position limits are not a panacea in themselves, but they can be a useful addition to a trading venue's regulatory tool kit.

- Their use does need to be carefully targeted because, by their very nature, position limits are intended to alter – and may well distort - demand and supply conditions in the market place. If applied inappropriately they could unduly inhibit legitimate activity.

- As the pressures which can cause technical or abusive market squeezes typically manifest themselves in the period immediately prior to the maturity of the relevant commodity futures contract, NYSE Euronext believes that spot month delivery limits would be a targeted way of helping to address such pressures.

- It is noteworthy, in this regard, that the IOSCO Report in September 2011 and the G20 Declaration at the Cannes Summit both stated that "market regulators should have, and use, formal position management powers, including the

power to set ex ante position limits, **particularly in the delivery month**"[2].

- Alongside these developments, NYSE Euronext has been undertaking its own review. As a result, NYSE Euronext is now actively working on the design of a more transparent and prescriptive policy for its London commodity contracts. Spot month position limits are already applied in the run up to delivery of NYSE Euronext's commodity derivatives which are traded on its regulated market in Paris.

- Returning to the Commission's proposals, NYSE Euronext strongly supports the fact that the primary role for setting and enforcing position limits is given to trading venues. That said, further clarification is needed on the way in which the reserve powers of other authorities, such as the Commission, would be used in practice.

[2] IOSCO Principles for the Regulation and Supervision of Commodity Derivatives Markets, Final Report, September 2011 (page 44); Cannes Summit, 4 November 2011, Final Declaration (paragraph 32).