

Review of the Markets in Financial Instruments Directive

Questionnaire on MiFID/MiFIR 2 by Markus Ferber MEP

Response by BATS Chi-X Europe

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The questionnaire takes as its starting point the Commission's proposals for MiFID/MiFIR 2 of 20 October 2011 (COM(2011)0652 and COM(2011)0656).

All interested stakeholders are invited to complete the questionnaire. You are invited to answer the following questions and to provide any detailed comments on specific Articles in the table below. Responses which are not provided in this format may not be reviewed.

Respondents to this questionnaire should be aware that responses may be published.

Please send your answers to econ-secretariat@europarl.europa.eu by 13 January 2012.

Theme	Question	Answers
Scope	1) Are the exemptions proposed in Directive Articles 2 and 3 appropriate? Are there ways in which more could be done to exempt corporate end users?	BATS Chi-X Europe (BCE) endorses the proposal that members or participants of regulated markets or MTFs should come within the scope of the Directive. In relation to the exemptions proposed, BCE thinks these are reasonable.
	2) Is it appropriate to include emission allowances and structured deposits and have they been included in an appropriate way?	No comment
	3) Are any further adjustments needed to reflect the inclusion of custody and safekeeping as a core service?	No comment

	4) Is it appropriate to regulate third country access to EU markets and, if so, what principles should be followed and what precedents should inform the approach and why?	It is appropriate to regulate third country access. However, clear criteria must be established and transparent and consistent decision making is crucial. Decisions on access must be speedily resolved and should not necessarily be based on exact reciprocity but should consider qualitatively the adequacy of the third country's regulatory and supervisory regimes, and the information sharing arrangements.
Corporate governance	5) What changes, if any, are needed to the new requirements on corporate governance for investment firms and trading venues in Directive Articles 9 and 48 and for data service providers in Directive Article 65 to ensure that they are proportionate and effective, and why?	Certain of the proposals appear to cut across the requirements of national company law and best practice codes of corporate governance. This could lead to uncertainty and confusion as to which takes precedence. Some of the proposals are prescriptive (e.g. number and type of directorships held, composition of nominations committee), whilst other elements are general. It might be better to leave the prescriptive rules to national bodies that can take account of particular local circumstances. In addition, the requirements of the proposed diversity policy seem very broad – for example, to include geographical diversity. There may be practical constraints to meeting prescriptive targets.
Organisation of markets and trading	6) Is the Organised Trading Facility category appropriately defined and differentiated from other trading venues and from systematic internalisers in the proposal? If not, what changes are needed and why?	It is not clear that the OTF classification will meet policy objectives or bring significant benefits to the trading of securities, such as listed shares, that are admitted to trading on a RM or MTF; and the new category may lead to greater fragmentation. There are potentially insufficient differences with the capabilities of an MTF. In addition, intermediaries that undertake activities that would be covered by the OTF classification are already required to be authorised and subject to regulation. There appears to be the potential for

		<p>overlap between the requirements for OTFs and the general requirements for investment firms. It might be clearer to make the distinction between public markets (RMs and MTFs) and OTC trading via brokers.</p>
	<p>7) How should OTC trading be defined? Will the proposals, including the new OTF category, lead to the channelling of trades which are currently OTC onto organised venues and, if so, which type of venue?</p>	<p>OTC should be defined as trading in Financial Instruments (as set out in Section C Annex 1) on a bilateral basis that is not carried out on a RM or MTF. The new OTF category, if introduced, would mean that more trades will occur on an organised venue. It is likely that a number of OTFs would register and would pick up a proportion of the previously OTC market. MTFs and RMs may also benefit from orders being routed to their venues and also as a result of some BCNs deciding not to register as OTFs.</p>
	<p>8) How appropriately do the specific requirements related to algorithmic trading, direct electronic access and co-location in Directive Articles 17, 19, 20 and 51 address the risks involved?</p>	<p>The requirements to have in place effective systems and risk controls, resilience and sufficient capacity seem reasonable. Nevertheless, it must be borne in mind that one cannot necessarily predict the outcome of technological advances and no system can be guaranteed to be bug free or never suffer outages. Therefore, whilst the principles are sensible, there needs to be pragmatism about the limits of what can actually be achieved.</p> <p>In relation to annual reports to competent authorities describing the firms algorithmic strategies, it is not obvious that this will be a productive use of the firm's or the competent authority's time (for example, competent authorities may not have the skills and resources to fully analyse and understand the algorithmic strategies without further explanation from firms). To avoid wasted time and effort, it would be better if</p>

		<p>the competent authority could engage with individual firms, as necessary, based on risk assessment and periodic reviews rather than a blanket requirement.</p> <p>In relation to requiring algorithmic trading firms to be in continuous operation throughout the day and acting as a liquidity provider, it seems that this confuses the aims and objectives of genuine market makers and firms whose strategies are based on reacting to price/market/external events. Just because the latter is done at speed by computer algorithms rather than by human intervention should not impose liquidity provider requirements on firms that are not organised to provide such a facility. Such obligations could increase costs and risks for these firms and could cause them to leave the market, so impacting liquidity and spreads. It should also be highlighted that algorithmic trading strategies may react to orders posted and may remove liquidity as well; and may be used to post client orders when used by brokers.</p> <p>The requirement on the need for MTFs to manage conflicts of interest with owners is equally applicable to RMs and OTFs. As this is a principle of general application, it is questionable whether a specific rule is required.</p> <p>In relation to Art 51:</p> <p>(1) BCE agrees with the requirements that regulated markets should have in place effective systems, procedures and arrangements, as outlined in the draft.</p>
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		<p>different across markets and asset classes – e.g. taking account of new products, liquidity in the market and whether the same security is traded on multiple venues. There may be alternative ways of managing message flow, such as disincentivising bad behaviour with higher fees for excessive data traffic. In relation to capacity, BCE does not currently use specific throttling technology but does limit the number of orders per participant at the port level.</p> <p>With regard to minimum tick sizes, these are defined by BCE's static data for each security and orders that are entered finer than the minimum tick size are rejected.</p> <p>(4) As regards direct electronic access, it is important to remember that the trading venue's relationship is with its participants and not with the participants' clients. There is therefore a limit to what the venue can do and it must rely on the participant's due diligence to a large extent. The responsibility is on the participant to vet and monitor clients who are sponsored by them, and the participant is best placed to apply appropriate risk and systems' controls. In relation to Direct Market Access (DMA) arrangements, the trading venue does not see or necessarily know if there is a DMA client behind an order. It is only possible for the venue to distinguish and potentially intervene where there is a dedicated client port (i.e. with sponsored access).</p> <p>(5) In relation to co-lo services, whilst it is reasonable to require a market's rules and fee structures to be transparent, it is</p>
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		(6) In relation to the requirement to give a competent authority access to the order book, BCE considers this reasonable and could meet the requirement.
	9) How appropriately do the requirements on resilience, contingency arrangements and business continuity arrangements in Directive Articles 18, 19, 20 and 51 address the risks involved?	The contingency arrangement requirement appears very high level. By simply requiring the arrangements to be “effective”, it could mean that any failure would potentially breach the requirement. The very nature of technology means that systems’ failures do happen and it is impossible to guarantee that there will be no disruption as a result. This should be taken into account and proportionate requirements applied.
	10) How appropriate are the requirements for investment firms to keep records of all trades on own account as well as for execution of client orders, and why?	No comment
	11) What is your view of the requirement in Title V of the Regulation for specified derivatives to be traded on organised venues and are there any adjustments needed to make the requirement practical to apply?	BCE is broadly supportive of the requirement to have standardised and liquid derivatives traded on organised venues. However, from a commercial and risk management point of view, organised venues and clearing houses should not be forced to admit to trading/clear such contracts. The practical impact of this is that some standardised derivatives may not have an organised venue to trade on. Therefore a default position needs to be established – for example, if an investment firm wishes to offer its clients the possibility of trading such a contract, it would potentially need to become an OTF and find a clearer who is willing to clear the trades.

	<p>12) Will SME gain a better access to capital market through the introduction of an MTF SME growth market as foreseen in Article 35 of the Directive?</p>	<p>Whilst BCE is supportive of efforts to help grow the SME market, it notes that RMs/MTFs already exist that offer primary listings for SMEs. Whilst it may be beneficial to harmonise certain standards, it is not evident that a new category of registration for SME growth MTFs is necessary or likely to lead to a significant growth in the market. Growth is more likely to come from tax incentives and easing the cost and legal/regulatory burden on SMEs.</p>
	<p>13) Are the provisions on non-discriminatory access to market infrastructure and to benchmarks in Title VI sufficient to provide for effective competition between providers? If not, what else is needed and why? Do the proposals fit appropriately with EMIR?</p>	<p>BCE fully supports the initiative to allow non-discriminatory clearing access to allow for greater competition amongst venues and lower costs to customers. To improve the likelihood of success, it is recommended that the time for a response from a competent authority or CCP under Art. 8 (2) and (3) be shortened as speed to market is critical to the successful launch of a new or competing product. In addition, the conditions under which access can be denied need to be carefully defined as factors creating undue risks can be subjective or open to interpretation. Likewise, conditions based on volume and numbers of users are unlikely to be useful benchmarks where a new product is being launched.</p>
	<p>14) What is your view of the powers to impose position limits, alternative arrangements with equivalent effect or manage positions in relation to commodity derivatives or the underlying commodity? Are there any changes which could make the requirements easier to apply or less onerous in practice? Are there alternative approaches to protecting producers and consumers which could be considered as well</p>	<p>No comment</p>

	or instead?	
Investor protection	15) Are the new requirements in Directive Article 24 on independent advice and on portfolio management sufficient to protect investors from conflicts of interest in the provision of such services?	No comment
	16) How appropriate is the proposal in Directive Article 25 on which products are complex and which are non-complex products, and why?	No comment
	17) What if any changes are needed to the scope of the best execution requirements in Directive Article 27 or to the supporting requirements on execution quality to ensure that best execution is achieved for clients without undue cost?	BCE supports the obligations on investment firms to take all reasonable steps to obtain best execution for their clients. BCE believes that execution venues make sufficient information available to allow investment firms to select appropriate venues. Prescriptive reporting requirements are unlikely to aid selection of venues, particularly in light of smart order routing technology. BCE supports the proposed requirement on investment firms to explain clearly to clients how orders will be executed and believes that regular reporting of the top execution venues used will be of benefit to clients.
	18) Are the protections available to eligible counterparties, professional clients and retail clients appropriately differentiated?	BCE believes that the protections are appropriate and supports the additional wording requiring investment firms to act honestly, fairly and professionally with eligible counterparties.
	19) Are any adjustments needed to the powers in the Regulation on product intervention to ensure appropriate protection of investors and market integrity without unduly damaging financial markets?	Whilst such powers will be a useful tool for ESMA in addressing threats to investor protection, careful use of such tools is necessary in order to avoid stifling innovation and economic growth. Without clear criteria on the use of these powers,

		decision making may be too subjective and based on perceived rather than actual threats.
Transparency	20) Are any adjustments needed to the pre-trade transparency requirements for shares, depositary receipts, ETFs, certificates and similar in Regulation Articles 3, 4 and 13 to make them workable in practice? If so what changes are needed and why?	A principles based approach with national competent authorities retaining discretion and monitored by ESMA appears the best solution. However, BCE is concerned that the mechanism for interaction between competent authorities and ESMA for approving waivers is too lengthy and cumbersome. In addition, the approval process could stall if competent authorities in different member states disagree, to the disadvantage of market participants and customers. We also question whether the Commission, rather than the competent authorities, should be adopting detailed delegated acts specifying the measures set out in paragraph 3 rather than giving discretion to competent authorities.
	21) Are any changes needed to the pre-trade transparency requirements in Regulation Articles 7, 8, 17 for all organised trading venues for bonds, structured products, emission allowances and derivatives to ensure they are appropriate to the different instruments? Which instruments are the highest priority for the introduction of pre-trade transparency requirements and why?	No comment
	22) Are the pre-trade transparency requirements in Regulation Articles 7, 8 and 17 for trading venues for bonds, structured products, emission allowances and derivatives appropriate? How can there be appropriate calibration for each	No comment

	instrument? Will these proposals ensure the correct level of transparency?	
	23) Are the envisaged waivers from pre-trade transparency requirements for trading venues appropriate and why?	<p>Please see answer to Q 20.</p> <p>BCE is against minimum order size thresholds for the use of reference price waivers as the size of the order does not, per se, have an impact on price formation (the systems being passive). In addition, the current LIS waiver thresholds are too high and broad, resulting in the waivers being rarely used. The waivers should be recalibrated in order to properly reflect the average order and trade size.</p>
	24) What is your view on the data service provider provisions (Articles 61 - 68 in MiFID), Consolidated Tape Provider (CTPs), Approved Reporting Mechanism (ARMs), Authorised Publication Authorities (APAs)?	BCE is broadly supportive of the provisions. However, we think that “reasonable commercial basis” should be more clearly defined allowing pricing rationale to be more easily monitored.
	25) What changes if any are needed to the post-trade transparency requirements by trading venues and investment firms to ensure that market participants can access timely, reliable information at reasonable cost, and that competent authorities receive the right data?	No comment
Horizontal issues	26) How could better use be made of the European Supervisory Authorities, including the Joint Committee, in developing and implementing MiFID/MiFIR 2?	No comment

	27) Are any changes needed to the proposal to ensure that competent authorities can supervise the requirements effectively, efficiently and proportionately?	No comment
	28) What are the key interactions with other EU financial services legislation that need to be considered in developing MiFID/MiFIR 2?	The main one that BCE would highlight is EMIR, due to its relevance to market infrastructure. It will be important to avoid overlap and confusion between the requirements of EMIR and MIFID/MIFIR, particularly with regard to OTC trading and clearing.
	29) Which, if any, interactions with similar requirements in major jurisdictions outside the EU need to be borne in mind and why?	The EU should be very aware of regulatory developments in all countries that have major financial centres in order to ensure consistency on an international basis, where possible. In particular, it should avoid the possibility of regulatory arbitrage or a flight of capital and business to lesser regulated countries. Specifically, the EU should be aware of significant regulatory developments, such as Dodd Frank in the USA; and the Swiss market.
	30) Is the sanctions regime foreseen in Articles 73-78 of the Directive effective, proportionate and dissuasive?	No comment
	31) Is there an appropriate balance between Level 1 and Level 2 measures within MIFID/MIFIR 2?	No comment
Detailed comments on specific articles of the draft Directive		
Additional comments on Q.8		

While firms that use algorithmic trading are important contributors of liquidity to the markets, BCE does not believe that attempting to compel the provision of liquidity on an ongoing basis via the imposition of designated market maker obligations such as continuous quoting requirements would be beneficial. Such requirements would significantly reduce the provision of liquidity to markets; increase the costs of trading, including for end investors; and not prevent market crashes. A detailed explanation of the difficulties and consequences of this approach is set out below.

i. Difficulties in defining Algorithmic Trading

It is difficult to achieve an adequate definition of algorithmic trading that would be appropriate. Many strategies which may use algorithmic trading are statistical arbitrage, ensuring that prices are aligned across markets. Attempting to impose continuous quoting obligations on these strategies would be impractical, result in the withdrawal of this liquidity and reduce price efficiency.

ii. Difference in the role of designated market makers in quote driven markets and the provision of liquidity in competing public limit order books

This proposal also confuses the role of a designated market maker or specialist in a dealership or quote driven market model with that of an order book driven market model. A dealership or quote driven market model of trading utilises designated market makers to make quotes at which other trading participants can choose to buy and sell with the designated market makers. In return for privileges, including obtaining all the flow, market makers are prepared to meet certain quoting obligations.

Most exchanges now operate public limit order books, particularly for blue chip securities. In a public order book all participants' orders compete against each other, and no participants have a guarantee that their orders will be successfully matched. To impose continuous quoting obligations on a sub set of participants without significant compensatory privileges would substantially reduce their willingness to participate or increase the return they require. This would reduce liquidity, widen bid-ask spreads and increase overall costs, including for end investors.

Public limit order books have many benefits and are considered more appropriate for more liquid stocks. Firms which employ algorithmic trading to voluntarily make two way prices are incentivised by the profit opportunities present, including where available rebates in exchange fees. A requirement to make prices when profit opportunities do not exist (or losses are likely) would destroy this balance and result in a withdrawal of liquidity including in normal market conditions. European equity markets have benefited significantly from the liquidity these firms have provided and the competition for order flow resulting in reduced bid-ask spreads.

iii. Disorderly markets and market crashes

The suggested purpose for the proposal to impose continuous quoting obligations on those utilising algorithmic trading is to provide an obligation to continue to provide liquidity to the market in the event of adverse market conditions. This is a misconception of the purpose of market maker obligations, which are not to compel those to stand in the way of falling or volatile markets but as an alternative model of displaying quotes in general market conditions to a public limit order book. Market makers are generally not required to quote for 100 per cent. of the time and obligations are typically relaxed or relieved in volatile market conditions. To do otherwise would risk the prudential position of these firms.

In BCE's experience firms pursuing these algorithmic trading strategies have remained providing liquidity even during periods of significant market volatility, for example during the financial crisis in 2008 and 2009. This is also supported by other accounts and academic research. The experience of the 6th May "flash crash" in the U.S. appears to be mixed but market maker obligations would be of no help in an extremely disorderly market and the solutions in the U.S. are to address inter-related flaws in the U.S. market structure.

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Detailed comments on specific articles of the draft Regulation	
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