Review of the Markets in Financial Instruments Directive

Response by Global FX Division of the Global Financial Markets Association (GFMA)

Questionnaire on MiFID/MiFIR 2 by Markus Ferber MEP

This response is being submitted by the Global FX Division (GFXD) of the Global Financial Markets Association (GFMA). The GFMA joins together some of the world's largest financial trade associations to develop strategies for global policy issues in the financial markets, and promote coordinated advocacy efforts. The member trade associations count the world's largest financial markets participants as their members. GFMA currently has three members: the Association for Financial Markets in Europe (AFME), the Asia Securities Industry & Financial Markets Association (ASIFMA), and, in North America, the Securities Industry and Financial Markets Association (SIFMA).

The GFXD supports the responses made by AFME its response. This document seeks to add detail and clarification on specific areas as it pertains to the impact of MiFID II on the Foreign Exchange markets.

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?	
	2) Is it appropriate to include emission allowances and structured deposits and have they been included in an appropriate way?	
	3) Are any further adjustments needed to reflect the inclusion of custody and safekeeping as a core service?	
	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?	

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?	
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?	Liquidity in the FX market is currently provided through a range of channels including single dealer platforms (SDPs), multi-dealer platforms (MDPs), interdealer platforms and other manual (non-electronic) execution channels. Around 60%[1] of trading is estimated to occur through electronic channels, providing high levels transparency and end-user choice. Execution has developed to serve the needs and choices of a diverse client base and covers methods such as order book, request for quote (RFQ) and voice. The expansion of MiFID II and the introduction of, in particular the OTF and SI trading regimes will mean a significant change to the regulation of the FX market – a market which is characterised by a significantly high number of participants and transactions. The market also plays a fundamental role in the global economy by forming the basis of the global payments system and underpinning international trade and investing. Under the current definition, SDPs are unlikely to qualify as OTFs given (i) the prohibition on the execution of client orders against the proprietary capital of the operator of the OTF and (ii) the requirement to bring together third party buying and selling interests (SDPs are in-house platforms that provide a portal for clients to trade with a specific dealer). Consequently, instruments subject to the obligation to trade on organised venues (Article 24) may not be

[1] According to Oliver Wyman analysis

		traded on SDPs. SDPs provide significant liquidity to the dealer-to-customer FX market (c. 25% of dealer-to-customer flows[2]) as well as facilitating a direct trading relationship. The ability to use an investment firm's own capital in such transactions promotes innovation and quality in executing client business. The model is highly competitive, providing end users with a variety of products based on their specific needs particularly given the bespoke hedging nature required for FX products. SDPs also enable clients to develop relationships that cover more than solely execution including research and advice. It is not clear that disrupting the existing structure of the market and forcing certain instruments to trade away from these venues would provide overall benefits to the end user and we believe that many of the intentions of MiFID may be implemented around the SDP regime. Accordingly, we believe the legislation should retain the ability for instruments subject to the mandatory trading obligations to be traded through SDPs. This could be achieved by widening the acceptable venues for executing such trades to include SDPs. Clients would benefit from investor protection provisions that would apply in any event. To the extent that the trading obligation is intended to provide for enhanced transparency, this can be achieved by applying carefully calibrated transparency requirements where necessary. Alternatively the OTF regime could be adjusted to allow SDPs to qualify as OTFs, principally through enabling the use of proprietary capital. However, further adjustments would be required since SDPs in the FX market do not conform with the requirement to bring together multiple third party buying and selling interests.
	7) How should OTC trading be defined? Will the	As proposed, OTC trading under MiFID II will be narrowly defined,

[2] According to Oliver Wyman analysis

	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?	constituting "ad hoc and irregular and are carried out with wholesale counterparties and are part of a business relationship which is itself characterised by dealings above standard market size, and where the deals are carried out outside the systems usually used by the firm concerned for its business as a systematic internaliser" [Recital 18]. There should be more clarity on the distinction between trading via Systematic Internalisation and pure OTC trading and in particular areas which might fall between the two (e.g. is it intended that all non-venue / non-SI trading be captured by the OTC regime?). In addition, we believe that for it should be made clear whether the SI regime is intended to apply by instrument (as in the equities regime) or at some other level of the asset class taxonomy.
	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?	
	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?	
	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?	Given the high volumes and number of participants in the FX market, obligations pertaining to recordkeeping can pose significant additional burdens. In respect of keeping records for all trades, we believe investment firms should only be required to maintain records in the format and with the data retained at trade inception. Where additional trade details are subsequently required or introduced e.g. identifiers, these should not be required to be 'backloaded'. With respect to the requirement under article 16(7) to record telephone

		conversations and electronic communications, the requirement to provide this to clients on request will add significant burden and cost. Such information may not be specifically allocated or stored on a client by client basis which would require data to be reviewed to identify specific client or trade related information. AFME has suggested that the telephone record retention requirements should be reduced to a maximum of 6 months and not three years, as proposed under Article 16 (7). However, given the volumes and numbers of clients in the FX market, even a six month retention requirement will add significant cost and retrieval burden when responding to client requests. We request that there should at least be some concept of reasonableness applied to client requests for records and note that records would remain available for regulatory supervision purposes.
	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?	For clarification purposes, we believe the trading obligation should only apply to those subsets of instruments subject to mandatory clearing and for which a clearing solution exists as this suggests a necessary degree of price discovery and transparency. We believe this is the intention but note that the EMIR legislation has not yet been finalised. <u>Qualification as an organised venue</u> For FX, and as discussed in the response to 6 above, we believe it is important to preserve the flexibility for clients to trade instruments subject to the mandatory trading obligations through SDPs. These provide a significant source of liquidity in the FX market and benefits to clients. Recital 22 of MiFIR refers to the G20 commitment to move trading in standardised OTC derivatives to exchanges or electronic trading platforms. SDPs clearly qualify as electronic platforms and are referred to in the IOSCO Report on Trading of OTC Derivatives (Trading Report), published in February 2011. The Trading Report does not make a clear recommendation as to whether SPDs should or should not come within the definition of an electronic trading platform. However, certain IOSCO members recognised that

		"benefits can be realised where the opportunity to seek liquidity and trade with multiple liquidity providers is offered within a product market as a whole, irrespective of whether a particular platform offers access to multiple liquidity providers" further recognising that "*benefits of centralisation may differ according to market structure [and] that a market consisting of a mix of single and multi-dealer platforms for standardised derivatives may also provide systemic risk benefits."* The Trading Report conclusion advocates for a flexible approach encompassing a range of platforms that would qualify as "exchanges or electronic trading platforms". In light of this, and given the structure of the FX market, we believe that the effective prohibition on classification of SDPs as an organised venue should be reconsidered. <u>Determining liquidity</u> Provision is made for determining when a product is sufficiently liquid to be subject to the trading obligations. In FX, liquidity can vary significantly across time zones given the 24-hour nature of the FX market; for example liquidity in less commonly traded currencies is often greatest during home market trading hours. Accordingly, in making an assessment of sufficient liquidity, the text should also require an assessment by tenor and currency-pair and the average width of two-way prices in addition to the stated proposed criteria. This will allow market depth to be benchmarked for different product groups over different time periods. <u>Concentration risk</u> We note that any instrument subject to these obligations need only be traded on a single venue. This raises the prospect of concentration risk if the market was forced to use a single venue with trading migrating from platforms that did not qualify as an acceptable venue. It would seem sensible to ensure that implementation be via a number of platforms, particularly given the number of transactions in FX. This risk is ameliorated if SDPs can serve as acceptable venues. The FX market has evolved to provide a diverse range of venues

		providing liquidity on a disaggregated basis to cater for a wide variety of client needs. This is positive for the market and reduces issues around single or limited points of failure. <u>Phased implementation</u> Similarly, there should be a phased approach to implementation, potentially by product, where participants can observe performance over a defined period before compliance becomes enforceable. Typically, new clearing and exchange products gradually build liquidity. It would be unprecedented to have a big bang transfer of a huge pre-existing market to a potentially small number of platforms.
	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?	
	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?	
	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 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?	
	16) How appropriate is the proposal in Directive Article 25 on which products are complex and which are non-complex products, and why?	
	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?	For FX markets, an approach that moves away from defining best execution for market participants and towards establishing or requiring best execution processes within participants' corporate and / or investment policies would better serve the market. We believe that this is an area where a one-size-fits-all approach is not optimal. Many firms already have such processes in place and they are designed to suit the needs of their particular firms. In the FX markets, which exhibit well established pre and post trade price transparency, not dictating a specific definition of best execution allows for innovation by market participants. Several years ago, best execution was thought to obtained by seeking prices from a minimum number of banks, dealing on the best price and then documenting the process. This has evolved into a number of market participants using audited FX benchmark rates against which they execute their FX trades. Clients will leave orders with their preferred providers to execute and receive a guaranteed fill against the audited benchmark rate. A number of index fund providers have been doing this for over a decade as it helps them minimise tracking errors against their performance benchmarks. The latest development in the FX markets is the use of execution algorithms by clients to minimise the market impact of their orders. These enable clients to choose the algorithm most suited to their needs and which subsequently

		provides them with detailed transaction cost analysis. We would suggest that the experience in the FX market shows that by simply requiring market participants to establish a policy of best execution, documenting this policy and periodically updating it, it leads to competition amongst banks which leads to innovation and better service to end users.
	18) Are the protections available to eligible counterparties, professional clients and retail clients appropriately differentiated?	
	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?	
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?	
	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?	The FX market already exhibits a high degree of pre-trade transparency that compares favourably with exchange traded marketplaces in terms of market information, execution speeds and cost, while offering more flexibility and improved choice to the end client. Investors are able to assess best execution through a range of venues including across single dealer platforms and through access to multi-dealer platforms. Likewise for the interdealer market transparency is high. The highly fungible nature of FX risk means that significant flows in any product are quickly reflected in the pre-trade pricing across all relevant grid points. We believe that transparency is not an issue in principle for the FX market, given the high degree of existing pre-trade transparency.

		Streaming executable prices are generally available to clients of an investment firm where sufficient liquidity exists. However, these will be calibrated on a client by client basis to take account of a number of factors, inter alia, counterparty credit risk. All other contracts, which are necessarily infinitely variable in currency exchange, are priced on a Request-for-Quote (RFQ) basis i.e. upon client demand. These enable clients to receive a firm quote with no obligation to trade and provide a valid and effective mechanism for establishing prices pre-trade. <u>Venue trading</u> For venues, the pre-trade transparency requirements as drafted do not make adequate distinction between the types of trading that occur and assume an order book mechanism exists. In particular, the obligation to 'make public prices and the depth of trading interests....on a continuous basis' (article 7.1 of MiFIR) is applicable to this trading method. It is not clear how other trading models would be supported and we recommend a more differentiated approach that takes into account these execution methods, needs of clients and characteristics of traded products. It is our view that the existing pre-trade transparency available through streaming prices / RFQ mechanisms either satisfies either the requirements or should fall under a waiver. <u>Systematic internalisers</u> The systematic internaliser requirements of article 17 appear more stringent than some of the requirements for the equity markets and present a number of issues. • As suggested by article 16(1) quotes provided to clients take into account a number of factors, including credit risk, settlement risk, investor credit status but also include others such as the purpose, competitive nature and operational costs of dealing with a client and

		• Where firm quotes are intended to be executable for other clients of the investment firm (i.e. below the stated size), the same pricing considerations apply. Investment firms should be able to take into account the various pricing factors when entering into transactions. This could be achieved through applying a 'fair' pricing obligation that takes into account the factors mentioned above. Clearly, if liquidity providers cannot price clients according to their characteristics, there will be an incentive to implement pricing that takes account of the possibility of executing against the most risky clients and accordingly quote wider spreads, resulting in poorer execution or reduced liquidity. It is not clear how long quotes should remain transactable although we assume that this would follow current RFQ policies. • Given the high number of participants compared to other asset classes and the range of distribution channels, including voice, making quotes available to other clients of the investment firm raises the simple practical difficulties of how such a quote is to be communicated and whether the price remains or is 'live'. Moreover, it is not clear how 'other' clients is to be defined – is this all clients of an investment firm or a subset based on comparable characteristics? • We note that SIs in equities instruments that deal in sizes above standard market sizes are not subject to the pre-trade transparency requirements (MiFIR article 13 (2)). We do not see a reason why the same exemption should not apply to non-equities. • In addition, the equity SI regime 13(1) applies the firm quoting obligations only where there is a liquid market. We assume that similar considerations should apply for FX.

		• The pre-trade transparency requirements for venues make specific provision for the application of waivers. These are equally important to be applied under the SI regime. Enhanced pre-trade transparency, particularly in less liquid areas of the market, may cause dealers to withdraw liquidity or charge a risk premium as a result of the risk that the market will move against them when trying to hedge in a market where trade details are known to other dealers. Taken alongside the Title V obligations to trade clearing eligible and sufficiently liquid products on venues, the rules imply that one set of products that will trade under the SI regime and therefore be subject to article 17 would be those clearing-eligible but <u>not</u> sufficiently liquid instruments which would therefore be subject to enhanced transparency. This seems counterintuitive. • Note that given the market structure for FX, it could be the case that SIs would be simultaneously subject to both the SI transparency regime and potentially (indirectly) the venue transparency regime e.g. if providing quotes through an OTF. This makes harmonisation of the transparency requirements between the regimes e.g. in respect of waivers important. Overall, and given the high levels of pre-trade transparency in the FX market, we believe that any benefits of the proposed measures are likely to be significantly outweighed by the disadvantages and would present significant risks to a market that forms the basis of the global payments system. If the regime is to be implemented, it should take into account the varied methods of trading in the FX markets to ensure that liquidity and client choice are not unduly compromised.
	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	Please see our response to 21.

	there be appropriate calibration for each 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?	Waivers are an essential part of preserving liquidity in less liquid areas of the market. Waivers should be capable of taking into account short-term changes to liquidity and the continuous trading nature of the FX market. It should also do so on an instrument by instrument basis, as this will vary e.g. G10 currencies vs emerging market currencies. We would suggest that criteria for granting a waiver can be re-assessed and recalibrated on a regular basis (and certainly on a less than six months basis) to take account of market conditions.
	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)?	
	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?	For the FX market, similar trade-offs between transparency and liquidity apply as in other asset classes. However, we believe that a properly calibrated post-trade transparency regime is the most appropriate method of enhancing transparency, both for regulators and the public. To the end, the FX Division ran an open and transparent RFP process in May 2011 as a result of which DTCC and SWIFT were appointed as partners to develop a trade repository for the FX industry. This solution is expected to start operating and reporting during 2011. We are also aware of other proposed solutions in the market that will contribute to enhanced transparency. Deferred publication and appropriate waivers will be important in calibrating transparency. We believe the text should make express reference to the 'liquidity profile' and 'specific characteristics of trading activity' to be taken into account as for pre-trade waivers. We note that in the US, if the proposed Treasury exemption is finalised, FX forwards and swaps would be excluded

		from this requirement (please see our response to question 29). As regards, transaction reporting and transparency to regulators, we note that all FX instruments within the scope of MiFID must be reported to a trade repository under EMIR. The MiFID transaction reporting requirements apply to a subset of these instruments broadly classified as being traded or linked to instruments traded on an MTF or OTF. Given that FX has traditionally been outside the scope of transaction reporting requirements and in the context of the vast number of transactions, this will place a significant reporting burden on market participants. Duplicate reporting should be avoided where at all possible. Accordingly, we welcome the waiver on the obligations to report if a transaction has already been reported to a trade repository registered under the EMIR legislation. However, the text should be explicit that if such trades are reported under EMIR (and they contain the appropriate information) the obligation is satisfied irrespective of whether the trade repository is a registered ARM. The impact of any local data protection and client confidentiality requirements may need to be taken into account to ensure sound and legally compliant reporting. As was the case with EMIR, the MiFID legislation may need to take this into consideration.
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?	
	27) Are any changes needed to the proposal to ensure that competent authorities can supervise the requirements effectively, efficiently and proportionately?	

	28) What are the key interactions with other EU financial services legislation that need to be considered in developing MiFID/MiFIR 2?	
	29) Which, if any, interactions with similar requirements in major jurisdictions outside the EU need to be borne in mind and why?	There are numerous international requirements that will need to be borne in mind but probably the most significant given the current legislative timetable is Dodd-Frank in the US. However, we note that given the global nature of the FX market, there is a significant concern to ensure a level playing field across all jurisdictions to avoid the prospect of regulatory arbitrage. Therefore movements in legislation e.g. in Hong Kong, relating to transparency, should also be borne in mind. To that end, we note that US Treasury has the power to exempt foreign exchange forwards and swaps from certain requirements of Dodd Frank. US Treasury has issued a proposed determination to exempt those products, meaning that they would not be regulated as swaps under Dodd-Frank. Most importantly, this means they would not be subject to mandatory clearing, nor mandatory trading on Swap Execution Facilities, nor the real-time public reporting requirements. Forwards and swaps would remain subject to reporting requirements to a trade repository and to Dodd-Frank's business conduct standards. This has clear implications for regulatory convergence, particularly in a market as liquid and global as FX. Furthermore, and with respect to the SEF requirements, there is a clear link between the additional pre-trade transparency required under this regime and the link to instruments being clearing eligible. Where instruments are exempt from the mandatory clearing requirements (as would be the case for FX forwards and swaps as detailed above) and in addition if they are subject to mandatory clearing but are not "made available to trade" (which has parallels to the sufficient liquidity for the obligations to trade on specific venues under MiFID), then they would not be traded on SEFs and therefore not subject to enhanced pre-trade transparency. Again, we believe consistency between regimes should be sought given the nature of the FX market.

	30) Is the sanctions regime foreseen in Articles 73-78 of the Directive effective, proportionate and dissuasive?	
	31) Is there an appropriate balance between Level 1 and Level 2 measures within MIFID/MIFIR 2?	

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The Global Foreign Exchange (FX) Division of the GFMA, was formed in co-operation with the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and the Asia Securities Industry and Financial Markets Association (ASIFMA). Its members comprise 22 global FX market participants, collectively representing more than 90% of the FX market.