Review of the Markets in Financial Instruments Directive

Questionnaire on MiFID/MiFIR 2 by Markus Ferber MEP

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.

Goldman Sachs International welcomes this opportunity to respond to your questionnaire on the Commission's proposals for MiFID/MiFIR. We have focused on answering those questions where we have most relevant input or concerns; we have not answered all the questions you posed. The proposals raise a number of very important questions for the future of the European financial markets and we feel that it is appropriate for us to concentrate on the issues that are most important for our clients and for the markets in which we participate. We would appreciate the opportunity to discuss these issues further with you as the legislative process develops and as part of those discussions we may wish to raise other concerns that we have not addressed in this response.

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?	n/a
	2) Is it appropriate to include emission allowances and	

	structured deposits and have they been included in an appropriate way?	n/a
	3) Are any further adjustments needed to reflect the inclusion of custody and safekeeping as a core service?	n/a
	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?	We support the idea of a harmonised framework governing the interaction between EU and non-EU firms. However, such a framework should be designed in a way that allows EU professional parties, such as governments, central banks, financial institutions, large corporations and professional individuals access to non-EU firms, including firms from less developed jurisdictions. If professional market participants' interactions with non-EU firms are restricted, they will lose their existing access to non-EU capital, investment opportunities, risk diversification and market information, including from less developed jurisdictions. We are concerned that the current MiFID/MiFIR proposals would allow such interaction only with counterparties that operate in an environment with a very similar regulatory regime to the EU regime, a standard which would be challenging to meet even for more developed jurisdictions, given the different regulatory approaches around the world. A number of EU jurisdictions, including Belgium, Germany, the Netherlands, and the United Kingdom have developed exemptive regimes which regulate the interaction between non-EU firms and professional EU firms in a way which balances investor protection with the needs of professional market participants to access non-EU markets. These models should further inform the development of the third country framework in the MiFID/MiFIR context. We would be happy to discuss them with you in more detail.

		In addition. It is important to consider the way in which any proposal might affect the existing outsourcing regime (a regime which often involves the creation of customer relationships). This is of particular interest to the buy-side (such as portfolio and wealth managers) who routinely engage delegates to provide specialised services outside the EU and who use the services of brokers and counterparties located outside the EU to execute trades in locations outside the EU. We list below what we would view as the appropriate requirements for non-EU firms to be able to interact with professional EU clients: • supervision by a competent authority, • the home country should not be on the FATF list of non-cooperative countries, • an MoU between the local regulators and the EU competent authority or ESMA as regards supervisory co-operation.
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?	n/a
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?	We believe the rationale for the new category of Organised Trading Facility (OTF) should be better articulated. It appears to be designed to address two very separate issues. On the one hand, it responds to the G20 requirement to trade certain classes of liquid derivatives on organised trading venues and, on the other hand, it responds to the desire on the part of some to further regulate broker crossing networks for cash equity products. This has resulted in a somewhat confusing set of concepts.

		We believe that broker crossing networks and other forms of automated handling of orders in cash equity products on a discretionary basis should be excluded from the definition of OTF. This activity is not, as is commonly argued “unregulated” or “unorganised”. It is already the subject of broad regulation under MiFID, including prudential regulation of the firms operating such systems and extensive conduct of business regulation including best execution rules, order handling rules and the obligation to manage conflicts of interest. It is also subject to the same post-trade transparency regime as trading on regulated markets. It is incumbent on firms which wish to trade with or on behalf of their customers outside regulated markets and MTFs to obtain express consent for this activity from their customer. Customers choose these forms of trading because they provide access to greater liquidity. We have not heard any convincing arguments why this form of trading needs to be subject to further regulation. To the contrary we believe that competition between these forms of trading and other venues and the introduction of different approaches to trading better serve the needs of customers. As regards trading of liquid derivatives, we believe that the category of OTF should be an elective regime rather than a mandatory regime consistent with the approach being adopted in the United States. In other words, market participants wishing to establish an OTF to trade liquid derivatives can choose to do so but it would not be a requirement that any particular form of trading should be required to become an OTF. Market participants would still have an incentive to become subject to OTF regulation because it would enable them to trade the classes of derivatives for which trading on an organised venue becomes mandatory whereas those who chose not to become subject to OTF regulation would not be able to trade such products. As a precursor to the trend of market participants electing to establish trading venues, we have already seen examples of platforms registering as MTFs for non-equity products on a voluntary basis, prior to any trading venue requirement (e.g. TradX, Brokertec, eSpeed,

		Tradeweb, MarketAxess, iSwap). If the current definition of OTF is maintained then, as a minimum, Article 20(1) should be amended. As drafted, it would effectively prohibit brokers from internalising client orders against their own book even in circumstances where that internalisation would give the client a better execution than was available elsewhere in the market. We see no logic in depriving clients of best execution in this way. We understand that this measure is designed to address conflicts of interest but we believe that these conflicts can be addressed in other ways (for example, by separation of the activities of operating the system and trading on the system) that protect the client's interests but do not deprive them of the ability to interact with the broker's own capital. We would suggest that brokers operating OTFs should be permitted to trade for their own account in the OTF as part of ordinary course customer facilitation and market making activities in order to improve the quality of execution and enhance the competitiveness of the venue for the benefit of clients.
	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?	n/a
	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?	We support the proposal in Article 51 for the introduction of minimum tick sizes and of a harmonised tick size regime across the EEA. Similarly, we support the introduction of a limit to the percentage of unexecuted orders on a trading venue as an operational control against orders without a genuine intention of execution. We also support the Commission's proposal for the introduction of a harmonised EEA-wide standard of governance and risk management for firms providing sponsored access, direct market access, or allowing

		automated trading to occur on their venues. The final sentence of Article 17(4) would require a firm to enter into an agreement with its client which stipulates that the firm retains responsibility for ensuring that trading using the service complies with the requirements of the recast Market Abuse Directive. As market abuse is a practice ascribable to the person who commits it, we disagree with the reversal of the burden from the individual to the firm which provides the system, especially as that firm may not have cross-market information or other means of ascertaining whether the relevant person engages in abusive practices. As an example, it will be impossible for a firm providing direct market access to know whether its client is engaging in insider dealing or whether a client is engaging in a market manipulation strategy that involves the use of multiple brokers. We agree with the necessity for the existence of an agreement and for the application of appropriate controls on the service provided by the firm, but these are adequately dealt with in the first part of Article 17(4).
	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?	n/a
	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?	n/a
	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?	Without the need for regulatory intervention, there is already an increasing number of derivative products which were formerly traded over-the-counter, but which are today traded on regulated venues. We expect this trend to continue.

		However, there will continue to be many products for which execution on an organised venue is less appropriate due to a range of factors including: • the large size of the transaction (the reduction in average ticket sizes makes it increasingly difficult and risky for buyers and sellers to execute large orders on trading venues); • the lower liquidity of the product; • the trading venue is less cost-effective (e.g. because it is not subject to sufficient competitive pressure); • the trading venue is not trusted by market participants, e.g. in an emergency situation. Further, we do not consider the "clearing-eligible" designation to be a proxy for sufficient liquidity to trade on an organized trading venue. The liquidity threshold for a product to be clearing-eligible and for the clearing house to be able to value and risk manage that trade on a daily basis is substantially lower than that which is required to trade a product on an organized trading venue. We are therefore sceptical that there will be many cases where it will be appropriate for regulators to mandate that specified derivative contracts are traded on organised venues in the absence of a commercial driver for trading of that contract to migrate to such venues. We think it would be sensible to build further safeguards into the Title V provisions including, for example, an obligation for ESMA to consult not only on broad technical standards for the inclusion of derivative products within the Article 24(1) obligation but also on any decision to include a specific derivative contract or class of derivative contracts within that obligation. We do not believe this would be an unduly burdensome requirement because we believe that the total number of derivative contracts that are sufficiently liquid to be capable of trading

		on an organised venue is relatively small. In addition, we believe that there should be a block trade exemption, similar to that proposed in the United States under the Dodd-Frank Act so that trades which are large in scale and difficult to execute in a continuous trading environment can still be executed outside organised trading venues.
	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?	n/a
	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?	n/a
	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?	We believe it is important that regulators having authority for particular markets have full transparency with respect to the transactions executed in such markets. With respect to public transparency, we support adopting an approach that corresponds to the current and proposed US "large trader" reporting requirements to ensure consistency and minimise burdens on firms who are currently reporting this data. This approach contemplates that the regulators are provided position information either by clearing brokers or swap dealers. The regulators then group this information by entity type and publish it on a delayed, aggregated basis. That said, we do not believe that it would be appropriate to apply a comprehensive public reporting requirement to commodity derivative

		transactions generally. Generally speaking, we find that commodity derivative positions having a term that extends beyond the period during which the futures contract on the same underlying commodity have meaningful open interest are illiquid positions that are typically executed by end-users as hedges. Public disclosure of these positions would further diminish liquidity and raise hedging costs to end-users without providing meaningful transparency benefits to the market as a whole. We believe that the success of a futures contract and its effectiveness as a hedge is dependent on a convergence between the futures and the spot price. Without this convergence the futures contract is not truly representative of the underlying commodity. We also believe that the keys to obtaining futures/spot convergence are appropriately defined contract specifications and an efficient and effective delivery process. We believe accountability limits (i.e. limits which trigger review when exceeded) rather than hard position limits are appropriate outside the spot month. Assuming there is good convergence between futures and cash prices, hard position limits in the spot month are an effective means of preventing manipulation and squeezes without disrupting the price discovery function or the ability of hedgers to access liquid markets in future months. By contrast, in our experience the imposition of price limits has not been an effective means of promoting convergence. Because such limits apply to futures and not the underlying commodities on which the futures contracts are based, price limits actually impede price convergence. Further, price limits typically exacerbate volatility insofar as they act as artificial barriers that motivate market participants to seek to position themselves ahead of a particular price point rather than allowing the market to find its natural equilibrium.
Investor	15) Are the new requirements in Directive Article 24 on	n/a

protection	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?	If the category of products considered complex is broadened, it is important for the definitions of the new complex product categories to be clear and certain. We consider certain of the new provisions to be overly subjective and open to interpretation, for example "debt instruments or money market instruments embedding a derivative or incorporating a structure which makes it difficult for the client to understand the risk involved."
	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?	n/a
	18) Are the protections available to eligible counterparties, professional clients and retail clients appropriately differentiated?	n/a
	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?	n/a
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?	An investment firm that is a systematic internaliser should remain free to execute orders that it receives from its clients at prices better than the price that it is quoting publicly where that better price represents best execution for the client. Without this flexibility clients will not receive best execution for their order because the systematic internaliser will be obliged to send the order to the market for

		execution. This in turn will introduce additional delay into the execution of the order and exposes the client to the risk of missing the best price. We do not believe this is in the interests of investors. We think it would be helpful to introduce a recital clarifying that a systematic internaliser is entitled to improve on its quoted price in order to give best execution so that the provisions of Article 14(2) can be understood in this context. We agree that systematic internalisers should only be obliged to publish quotes in instruments for which there is a liquid market. We think that Article 13(2) should be amended so that it also excludes investment firms that only deal in shares below standard market size as part of a programme trading business. Such business is characterised by transactions with wholesale market participants in portfolios of securities where the total size of the portfolio is greater than the size envisaged by the systematic internaliser regime and the size of individual constituents of the portfolio is less relevant to the manner of execution.
	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?	We believe that an investment firm that is a systematic internaliser in non-equity products should only be obliged to disclose its quotes to clients on request in the same way as for illiquid equity instruments. Price levels should not be made public, including to other respondents, prior to clients executing the quote. Doing so would damage a client's ability to trade at the best price and at prices which reflect current market levels, as prices could move adversely before the client transacted. This would further impact the executing dealer's ability to appropriately hedge the trade, leading to a higher cost for trading. Essentially such a measure would disadvantage clients and dealers to the benefit of firms who do not manage risk intra-day. If, however, there is a requirement to publish firm prices below a binding threshold, it is important that non-executable indicative prices

		are not comingled with firm prices because this could result in confusion. As a practical matter, indicative prices are not meaningful as a client would still need to send a request for a firm price. Additionally, to attract the requisite firm liquidity, the threshold should be set at a low level, which is unique to each product. It is also important to highlight that price levels are often made specific to the individual client based on a dealer's analysis of counterparty risk and credit risk. It is not appropriate to assume that prices for trades below any firm threshold size reflect prices for larger trades, as size drives price. Large risk transfers occur further from mid-market prices than small trades because of the risk that the price maker has to take on and to take into account the cost of hedging that risk. We also believe that none of the relevant products trades with sufficient liquidity to support continuous public quoting. To illustrate this point, the most liquid OTC derivative is the ten-year USD swap which typically only trades around 200 times per day globally. These markets are heavily reliant for liquidity on dealers committing risk capital. Dealers will be less willing to commit capital if they are obliged to publish quotes to the market at large and the practical implication of this will be that end-users of these markets will be less able to trade at attractive prices. If there is to be a pre-trade transparency regime for non-equity products, it should be confined to the most liquid bonds and exchange-traded derivative products, and there should be waivers based on liquidity and size. In particular, it should not depend on the same criteria that are used to determine whether a product is required to be cleared because those criteria do not protect market participants from the detrimental effects on the quality of execution that can be introduced by unnecessary pre-trade transparency.
	22) Are the pre-trade transparency requirements in Regulation Articles 7, 8 and 17 for trading venues for bonds, structured	See our answer to Question 21.

	products, emission allowances and derivatives appropriate? How can 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?	n/a
	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)?	We are supportive of the proposals.
	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?	First, we think that the EU should exempt significant distributions from the post-trade transparency rules. This would be consistent with the approach adopted in the United States. Significant distributions are already defined in EU law in Commission Regulation (EC) No. 2273/2003 as "an initial or secondary offer of relevant securities, publicly announced and distinct from ordinary trading both in terms of the amount in value of the securities offered and the selling methods employed." The price formation process for significant distributions works very differently from normal secondary trading and disclosing too much information to the market on the status of such distributions can have the effect of making these transactions more difficult to underwrite and therefore more expensive to the ultimate sellers who are typically corporates. In addition, it is important to distinguish between post-trade transparency in equity markets and in non-equity markets.

		• Equity markets: The current post-trade transparency regime in equity markets (MiFID I) strikes an appropriate balance between the integrity of the price formation process and the need for intermediaries to receive protection in return for the assumption of large amounts of risk. The price at which large blocks are executed is less important to the price formation process than the price for normal market size executions. Any reduction in reporting delays is likely to lead to less willingness of market makers to provide tight prices on large blocks of shares, particularly in less liquid securities issued by smaller companies. To the extent that reporting delays are reduced, great care must be taken to calibrate the relevant thresholds properly. • Non-equity markets: Post-trade transparency regimes must be specific to each asset class and transaction-based. The concerns we raise above in relation to the willingness of dealers to assume risk in the equity markets apply equally here. In the current market structure a dealer provides prices to a potential counterparty based on the exposures that it would assume upon trade execution. However, the dealer does not generally have to factor in the market impact of speculative transactions entered into by unrelated market participants taking advantage of knowledge of the size of the position traded and the expectation of hedging trades by the dealer. If, however, counterparty trades are disclosed before the time the dealer expects to complete his hedging, the price that the dealer provides its counterparty would be adjusted to reflect the risk of the additional market impact. As a consequence, disclosure of counterparty transactions will increase the cost of liquidity provided by dealers. We support the three-tiered block system proposed by CESR in its technical advice to the Commission for bonds and CDS in summer 2010. We further support CESR's suggestion that before expanding its advice to other asset classes, it be permitted to undertake the same consultation and study as the one undertaken prior to the release of its

		most recent findings.
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?	n/a
	27) Are any changes needed to the proposal to ensure that competent authorities can supervise the requirements effectively, efficiently and proportionately?	n/a
	28) What are the key interactions with other EU financial services legislation that need to be considered in developing MiFID/MiFIR 2?	It will be important to co-ordinate MiFID/MiFIR with a range of different single market legislation, including the CAD (especially on organisational requirements), AIFM and MAD/MAR. But the priority is that MiFID/MiFIR is appropriately co-ordinated with EMIR, especially as regards the proposal governing the execution and clearing of OTC derivatives in a cross-border context. For both, we suggest to follow the approach which the European Parliament has suggested for EMIR (see answer to Question 4 above).
	29) Which, if any, interactions with similar requirements in major jurisdictions outside the EU need to be borne in mind and why?	We strongly believe that the whole of MiFID/MiFIR needs to be consistent with globally agreed standards and with recommendations and guidance issued by the FSB, IOSCO and other global bodies. A globally harmonised set of rules, reflecting a common understanding of the desired regulatory outcomes and applied consistently, will be a vital tool in safeguarding global financial stability and minimising opportunities for regulatory arbitrage. In particular, it is important for global trade, risk management, systemic stability and for the access of EU issuers to non-EU capital that the new MiFID/MiFIR framework provides an appropriate framework in which EU investors, issuers and counterparties can interact with non-

		EU firms. EU rules should generally only apply where EU investor protection or market integrity is affected and in these cases they should be applied proportionately, taking into account that differing regulatory approaches outside the EU can achieve the same regulatory aims as the EU regulatory approach.
	30) Is the sanctions regime foreseen in Articles 73-78 of the Directive effective, proportionate and dissuasive?	n/a
	31) Is there an appropriate balance between Level 1 and Level 2 measures within MIFID/MIFIR 2?	n/a

Detailed comments on specific articles of the draft Directive	
Article number	**Comments**
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Article ... :	
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