Review of the Markets in Financial Instruments Directive

Questionnaire on MiFID/MiFIR 2 by Markus Ferber MEP

HSBC Response

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.**

NOTES: We welcome the opportunity to comment and the reasonable time frame to respond. We would like to highlight the following points:

- **As a general observation, we would comment that there is a lack of clarity in the text as to its intended scope and consequences. It is important that the final text provides clarity to ESMA and the market to assist with the technical rule- making at a later date. Otherwise (a) ESMA will be left to define much of the detail at Level 2 without clear parameters and objectives and b) it is difficult for market users to determine unintended consequences (which is critical at the drafting stage);**
- **HSBC supports moves to make markets more transparent. However, there is a risk that the transparency proposals in the draft text undermine liquidity. Also, account should be taken of the transparency that end users currently enjoy, particularly in wholesale markets.**
- **The Systematic Internaliser (SI) regime for non-equities contains transparency requirements that will have a detrimental impact on market liquidity. This would be harmful for the corporate bond market, for example. However, this topic does not feature in the**

questionnaire (and we have therefore added our comments against question 21).

- **Post trade transparency requirements should be appropriately calibrated to reflect the specific characteristics of the asset class**
- **We welcome proposals to allow branches of non-EU firms to passport activities; proposals should permit access of non-EU firms to EU wholesale markets because EU firms benefit from being able to access pricing and services outside the EU.**
- **The text treats high frequency trading and algorithms similarly, although they are not the same. Many clients and market users rely on the use of algorithms to reduce market impact of buy or sell orders (rather than make execution decisions). This should not be prevented.**
- **The OTF requirements require improvement to be flexible to different products and models.**
- **The proposals ban activities in several areas where we believe a more subtle approach could achieve the same objectives with fewer negative consequences. For example, as explained below, outright bans on portfolio manager inducements and on certain liquidity being put into Organised Trading Facilities may have unintended consequences (such as harming the research industry and removing best execution opportunities respectively).**
- **For less liquid products, especially derivatives, an important function of firms is to honour existing client relationships and to support their clients by providing liquidity, even if the resulting transactions are not commercially attractive. In this way firms provide the access for end-users to hedges that would not be available to them in a completely anonymised market as these proposals may create. Onerous restrictions will prevent investment from firms in client platforms and pricing mechanisms which create transparency and liquidity.**

We have completed this questionnaire on an exceptions only basis.

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	It is appropriate to include structured deposits if they are clearly defined. They should be defined by referring to PRIPS at Level

	appropriate way?	1 (recital 26 does not include a definition).
	3) Are any further adjustments needed to reflect the inclusion of custody and safekeeping as a core service?	We do not agree with custody's inclusion as a core service. It should remain as an ancillary service. If custody continues to be included as a core service there needs to be a clear definition of this service and clarity on which provisions apply. Custodians do not generally execute client orders. Custodians do carry out corporate action instructions as directed by their clients and allocate odd lots on corporate actions, but this is not "execution of orders" in accordance with the intended meaning of MiFID I. The suitability, best execution and appropriateness requirements do not have any meaning in this context. We welcome the proposal to make custody a passportable service, but we believe that making custody a core service creates confusion for custodians as to the obligations required of them, bearing in mind that custodians generally provide a post trade service. This is an area where there will shortly be further EU regulation, for example under AIFMD, UCITS V and the Securities Law Directive. Additional paperwork and determinations (if required) could result in increased cost to end investors but without any increased investor protection. Recital 19 states that investment firms in charge of the administration of employee participation schemes are not covered by the Directive if they do not provide any other investment services for third parties As safekeeping and custody are considered in the proposal as core investment services, investment firms in charge of employee participation schemes providing safekeeping of employees' assets would be covered by

		the Directive. The Level 1 text should give clarification on that concern.
	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?	• The existing requirements (in MiFID I) do not require alteration. • HSBC is supportive of measures to allow the establishment of passportable services from branches of non-EU firms. The position of existing EU authorised branches of third country firms needs to be addressed, for example through 'grandfathering' provisions ensuring all such firms retain their authorisation. • EU customers and the financial services sector benefit from services provided by non-EU firms. More restrictive access requirements for non-EU firms will ultimately harm the competitiveness of EU markets (some non-EU firms may simply exit the EU; we are unsure why more restrictions are required for sophisticated counterparties, particularly eligible counterparties). • There may also be unintended consequences from restricting access by non-EU firms to eligible counterparties (in particular). For example, firms that use back to back structures for risk management will find these unworkable under the current proposals (unless there is intra-group relief at a global level). This penalises subsidiary / separate legal entity structures and

		• Because access is conditional on an equivalence decision, third country firms could be precluded from accessing EU markets even where they are adequately capitalised and willing to follow MiFID rules in their dealings with EU consumers. Accordingly, we would caution against strict equivalence requirements and suggest there should be a mechanism enabling third country firms from non-equivalent jurisdictions to obtain authorisation.
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?	The definition and purpose of the OTF regime requires further work including the following points: • We are not clear on the final purpose of the OTF regime. We assume that OTFs have more flexibility in the way transactions are arranged (order-book, quote-driven systems, hybrid and voice broking systems) and an element of discretion but the proposals require clarity and enhancements. The success, or otherwise, of the regime

		• The current operational model for OTFs may reduce client choice and make execution arrangements more complex and costly for clients. For less liquid products, especially derivatives and some bonds, an important function of firms is to honour existing client relationships and to support their clients by providing liquidity, even if the resulting transactions are not commercially attractive. In this way firms provide the access for end-users to hedges that would not be available to them in a completely anonymised market as these proposals aim to create. Onerous restrictions on OTFs (and how they operate) will prevent investment from firms in client platforms and bilateral pricing mechanisms which create transparency and liquidity. This should be borne in mind in the systematic internaliser and OTF requirements. • The complete ban on firms operating OTFs using proprietary capital will restrict the number of OTFs and their liquidity. Most non-equity markets rely to some extent on investment firms putting their own capital at risk (for example: firms are required to hold inventory for a period to facilitate client demand in certain bond markets). Many of those firms operate trading platforms that may fall within the definition of OTFs.

		• Client facilitation must be excluded from the scope of business for which the use of proprietary capital is prohibited, otherwise client best execution opportunities will be lost (for example, off exchange client crossing options that do not incur exchange/ MTF execution charges will be lost, so clients will pay more total consideration in such instances). If the purpose is to avoid conflicts of interest, we believe there are better ways of doing this (such as client opt outs and opt ins). • The proposed ban on proprietary capital for OTFs is likely to benefit the operators of exchanges / MTFs by driving most clearable trades onto their platforms, thereby reducing competition. • The concept of an OTF (not the detail) could work for derivatives if the model respects RFQ quoting (rather than continuous quoting and open order book) and use of a firm's balance sheet.
	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?	• OTC trading can be only deduced by looking at what is not included in the RM, MTF, OTF and SI rules. • On the second question: trades are more likely to move onto organised venues if rules do not unduly harm liquidity (e.g. appropriately calibrated pre and post trade transparency regime).

	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?	Many clients and market users rely on the use of algorithms to reduce market impact (rather than make execution decisions). This should not be prevented. Some alterations are needed to reflect the following fundamental points: **The draft text incorrectly treates high frequency trading (HFT) and algorithms as being identical:** • HFT needs to be clearly defined and its treatment distinguished from the treatment given to algorithms. The use of thresholds is a relatively straightforward way of distinguishing HFT from other types of trading. There are key differences: HFT replaces trader execution decisions with computers and risks the firm's proprietary capital to search for arbitrage and timing differences; algorithmic trading is a method of execution following the decision to trade being taken by a human - use of algorithms is not dictated by market liquidity and will not be withdrawn suddenly (and many algorithms are not necessarily altered by sudden liquidity changes). Many algorithms assist in bringing liquidity to the market. Algorithms bring customer and market benefits and provide a legitimate function. **There is a misconception that all algorithms are harmful - many are client friendly:** • Many algorirthms are beneficial to end clients and used by clients directly.

		• Examples of the benefits of algorithms for investment managers and market participants are: avoiding market impact or achieving an average execution price over a given time period. We have provided more detailed examples at the end of this response. • Algorithms can provide the client with best execution by assessing and accessing fragmented pools of liquidity quickly and efficiently. • It should be noted that algorithms can be extensively tested (historical back testing). They make data driven decisions rather than emotional ones. Execution plans provide transparency on the decisions that algorithms make. • Many clients specifically request the use of algorithms on their orders as they recognise the benefits. **There will be unintended consequences from current proposals:** • Use of technology requires appropriate systems and controls, and responsible dealing. However, obliging algorithms to two way market make would stop a considerable amount of beneficial activity (much of this client activity) and harm end users. • Inappropriately scoped proposals (covering all algorithms) will harm end users because orders that are

		• Liquidity may disappear in some markets (from non-high frequency traders) as cost of trading (and manual trading) increases. • It will force firms into increased risk taking. Some of the drafting also requires careful consideration (see below).
	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?	
	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?	The Level 1 text should give greater certainty as to the criteria to decide which products will be captured, liquidity parameters that will be taken into account and how the products will be traded. Rules for organised venues will need to be set in a way that does

		not harm liquidity. Current execution methods (order book, request for quote and voice) must be preserved. The continuous quoting requirements may remove this flexibility. If there are rigid quoting requirements, only the most standardised and liquid products can be traded on an recognised venue. Products should only be deemed clearable once CCPs have actually accepted them for clearing. It is vital that end users do not lose access to key products or quotes .We are supportive of thresholds for trade execution that are consistent with those for clearing under EMIR.
	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?	It is unclear whether these rules provide any tangible benefit.
	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?	Yes - we are strongly supportive of requirements to open up access and increase competition. We fully support the text as drafted.
	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 note the five possible levels of regulatory intervention (at local exchange, competent authority, coordinated action, ESMA and ACER level) which may cause market uncertainty. This may ultimately impact the ability of end users to hedge, the cost for end users and decisions on whether they will in fact hedge their risk.

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?	The proposals go too far. The Commission has not followed ESMA's advice (which focussed on disclosures rather than bans, which are structure neutral) and there may therefore be unintended consequences. If outright bans are anticipated (which we would not agree to in principle), there must be some exceptions, for example in relation to execution-related services, research services, and intra-group services. Investment managers may start to find technical difficulties with the cross selling text (as the definition of service is unclear). One example of consequences from this type of intervention is the Retail Distribution Review in the UK, which (because it mandates separate payment for investment advice for certain services) will lead to the reduction of advised services in the UK (as only the top end clients will be willing to pay for advice, and many will choose to opt for execution only services instead, to save cost, at a risk. This may also lead to some corporate clients not hedging at all).
	16) How appropriate is the proposal in Directive Article 25 on which products are complex and which are non-complex products, and why?	Some of the proposals are flawed - complexity does not equate to risk. Return volatility, risk of investment not being returned and counterparty default should be taken into account. Whether or not a product is complex can change over time (as products evolve). The proposal to treat a loan and derivative as automatically complex does not make sense for eligible counterparties and professional clients and creates uncertainty (if it remains, which is not merited). The scope of this requirement should be clarified to include retail clients only. Without this clarification,

		it will capture every prime brokerage client (a sophisticated client base) who will not generally want additional transaction by transaction periodic reporting or to incur the cost of such reporting (for example). It is not clear what the proposal means for other equity finance transactions (for example sale and repurchase of equities (repos)). Clients should be free to choose different levels of service on an opt in or opt out basis- ultimately end clients must decide which services they want to pay for.
	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?	
	18) Are the protections available to eligible counterparties, professional clients and retail clients appropriately differentiated?	No (see 16 above as an example) • The investor protection proposals do not adequately differentiate between professional clients and eligible counterparties. • Eligible counterparties are sophisticated market users who are unlikely to benefit from increased protections. This will result in cost and administration without benefit. Eligible counterparties and professional clients have the ability to opt down for increased protection, so increasing protections across the board makes little sense. • In eligible counterparty to eligible counterparty dealings,

	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?	The ability of a local regulator to prohibit any financial instrument within their jurisdiction is contrary to any market harmonisation objective. It is important that any proposals for product intervention strike the right balance between protecting investors and not damaging the financial markets. Any proposal for a product ban or restriction must have transparent procedures and, include reasonable safeguards such as: • ability to challenge; • due process; and • right of appeal. Without this, intervention uncertainty may result in higher pricing for end users (as uncertainty will need to be taken into account when pricing).
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	**Pre Trade Transparency Requirements for trading venues:**

	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 text requires improvement. In particular, the text requires guidance for ESMA on the trade off between transparency and liquidity. The objectives of the pre-trade transparency rules are unclear. This makes it uncertain how the rules will be applied in practice with potential for unintended consequences. The requirements (if too inflexible), may cause/force liquidity to move outside the EU, or may irreparably damage liquidity, if they are not appropriate. **The OTF pre-trade requirements require more flexibility:** • Mandating continuous market making (and or exposing depth of trading interest) in markets that currently work on a Request for Quote basis is likely to harm liquidity as some participants may withdraw from the market altogether in some products. The US proposals recognise this and may therefore attract liquidity. • There are situations where RFQ works better than continuous quoting obligations. Continuous market making in non-equities has been "gamed" on venues in the past proving that, in certain circumstances, continuous quoting obligations are not appropriate (as more sophisticated dealers can take advantage of the fact they know two way market making is obligatory). **Pre Trade Transparency Requirements for Systematic Internalisers:** We would question whether pre-trade transparency for Systematic Internalisers (SIs) (in anything but a liquid market)

		will have any positive benefit. There are also a number of practical difficulties on transparency for SIs that are not addressed: • There are practical difficulties with the inclusion of derivatives in the SI regime. If non-cleared trades (which are clearable but exempt, for example) are covered by the SI regime, pre-trade transparency may lead to misleading information (because a major element of the price relates to counterparty risk and the price may not be available to other customers with a different credit risk). This will impose a cost on the industry for little or no corresponding benefit. It may also lead to market confusion. • It is unclear how firms will be able to make quotes available to all clients simultaneously when they may trade across a range of venues. • The establishment of "transparent limits" under Article 17(4) and publication of depth of trading interest in Article 7(1) may effectively expose depth of trading limits which would be harmful in many markets where data is published by a single firm. For example, if dealers have capacity limits - these could quickly be reached, such that publication of their quote will confuse as it will not indicate availability. Also, publication of depth of interest for a particular security could signal a dealer's inventory position. Both of these could impact

		• In Article 17(1) the text appears to be based on the misunderstanding that all bonds with a prospectus will be liquid. A prospectus does not mean an instrument is exchange traded or liquid - it is often produced as a regulatory requirement or because of client preference and investment criteria. **Monitoring by ESMA (Article 18)** This imposes unrealistic demands on ESMA (and competent authorities) unless they have specialist and specific resource to track particular markets and the impact of transparency on liquidity (real time) which would be required outside cash equities (to ensure a dynamic regime which does not harm liquidity). ESMA would need to track markets as if it was an exchange (across multiple venues real time). We have recently seen several markets become less liquid in very short timeframes. The regulatory regime would need to be able to respond to this promptly to ensure that the application of regulations remains appropriate and does not further damage liquidity. There should be appropriate exemptions for large trades, otherwise this will reduce market liquidity. This, in turn, will increase costs for end users (if they have large trades to execute and/ or because pricing will increase to include the fact that firms may be left with disclosed risk).

	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 instrument? Will these proposals ensure the correct level of transparency?	Exposure of depth of trading interest may be very harmful in some of the less liquid instruments - as stated above, the RFQ model (rather than a cash equities order book with depth of trading interest) would be the only suitable model in these markets. Even then liquidity might be affected if firms are required to transact at the quoted price with other market participants, and be forced to build directional exposures that for illiquid products might not be hedged easily.
	23) Are the envisaged waivers from pre-trade transparency requirements for trading venues appropriate and why?	The lead time period required is too inflexible if markets suddenly change. This could effectively halt trading in instruments as they become illiquid.
	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)?	Data quality is paramount here to ensure that the cost (ultimately borne by end users) is commensurate with the benefit. Proposals should be enhanced to take this into account (particularly where there are multiple providers of consolidated data and multiple ways of them aggregating data).
	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?	The text should simplify trade reporting requirements to remove discrepancies introduced by different interpretations of the rules. The post trade reporting requirement needs to be tailored very carefully depending on the current liquidity of a product and currency. Mandating close to real time reporting for the less liquid products, will enable other market dealers to have an accurate picture of the risk the dealer needs to offset in the market. This will increase the hedging cost to the dealer and this cost will be passed onto the clients through much wider spreads.

		This needs to be taken into account. To define a set of rules as to which products / currencies need to be reported within a specific timeframe will be very complicated as liquidity changes very quickly (for example, in the foreign exchange market it will change due to market/country news or events). The Trade Repository should be used as a base for these reporting timeframes, but this will only be looking at past liquidity and will not give a view of current future liquidity. This point needs to be very well considered (as to impact) as it has the ability to seriously impact best execution.
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?	ESAs should be used wherever possible to create market harmonisation. Adequate resourcing is key.
	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?	The EMIR link is crucial on vertical silos. Clarification is required on whether 'MiFID structured deposits' would be covered by investor protection compensation schemes and excluded by deposit guarantee schemes.
	29) Which, if any, interactions with similar requirements in major jurisdictions outside the EU need to be borne in mind and why?	Consistency with Dodd-Frank and global convergence is essential in certain areas, particularly on trading venue requirements, transaction reporting requirements and exemptions

		from G20 venue trading (for example for FX forwards and swaps). This is critical to avoid regulatory arbitrage.
	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?	No. The Level 1 text needs to be clearer to provide market certainty and to establish objectives in specific Articles themselves. Many of the objectives are unclear in the current proposal for example, see our answer to question 21 above-where the text does not demonstrate sufficient certainty as to objectives of the systematic internaliser regime for derivatives.

Detailed comments on specific articles of the draft Directive

Article number	**Comments**
Article 24(7) Directive	This provision should only apply to retail clients. The scope of the products (financial instruments) and services (MiFID investment services) needs to be clarified.

Article 25(3) Directive:	This provision should specify that it applies to retail clients only. This provisions states that a firm will no longer be able to offer an execution-only service, if the service is provided in conjunction with the ancillary service of granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm is also involved in the transaction. Recital 53 explains that firms should not be able to do so on an 'Execution Only' basis because the complexity of the transaction increases and it is more difficult for the client to understand the risk involved. The new text will impact transactions with professional clients who understand the risks involved such as prime brokerage transactions.
Article 30 Directive	The following provisions should not apply to eligible counterparties under Art 30 : • Art. 24(3): information to clients including information on the firm, its services, financial instruments, investment strategies, whether the firm will provide an on-going assessment of suitability etc. • Art. 25(5): report on the service provided to the client, including periodic communication to clients taking into account the type and complexity of financial instruments involved and the nature of the service provided to the client, the costs associated with the transaction, how the advice meets the personal characteristics of the client.
Article 17 Directive	Some of the draft wording requires redrafting or careful consideration, for example: In Article 17(3) replace references to "algorithm" with "high frequency trading algorithms." In Article 17(4), firms should implement reasonable controls to provide assurance that their clients (where given access to their trading systems) do not trade inappropriately. Regulations should reflect these reasonable standards, with clients taking primary responsibility for their actions.

Examples of algorithms:

Algorithm	**How it Works**

Volume Weighted Average Price (VWAP)	Designed to achieve the volume weighted average price of exchange order book traded volume during a certain time period e.g. trading day. The algorithms are usually based on historical trading patterns. This is market neutral and provides market liquidity.
Close- this will trade the order in the closing auction of an exchange.	E.g. buy 100,000 xyz in the close. The benchmark is the closing price of the exchange. Orders will complete if there is sufficient liquidity. If the order is large, it may need to be set to start earlier or intelligently start the order before the close period. This benefits the market as it provides liquidity.
Implementation Shortfall	Primary objective is to minimise market impact using historical volume patterns. It will take a methodical calculated approach and will not be altered by unusual price or volume changes. It is reactive/ passive.