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**Knight Capital Europe Limited**

**Response to Review of the Markets in Financial Instruments Directive Questionnaire on MiFID/MiFIR 2 by Markus Ferber MEP**

**Friday 13 January 2012**

Knight Capital Group, Inc. ('Knight')[1] welcomes the opportunity to respond to the Economic and Monetary Affairs Committee on the proposals for a directive and a regulation on markets in financial instruments ("MiFID 2 proposal" and "MiFIR proposal"). Knight believes that MiFID was a significant step in the evolution of the European markets and supports the European Commission's stated objective in these proposals of safeguarding the efficient functioning and integrity of markets.

Knight would welcome a meeting with Markus Ferber and representatives of the Economic and Monetary Affairs Committee to discuss the observations and recommendations made in our response to this review.

## BACKGROUND

Knight opened for business in 1995[2]. Built on the idea that the self-directed retail investor would desire a better, faster and more reliable way to access the market, Knight began offering execution services to discount brokers. Today, Knight services some of the world's largest institutions and financial services firms, providing superior trade executions in a cost effective way for a wide spectrum of clients in multiple asset classes, including: equities, fixed income securities, derivatives, and currencies.

Knight Capital Europe Limited (KCEL), a wholly owned subsidiary of Knight, opened for business in 1998. Today KCEL provides high-quality, client focused trade execution and sales trading services to more than 1000 European clients. Through our network of local brokers, extensive exchange memberships and market access solutions, our clients can access KCEL's full range of voice trade execution services. KCEL also provides a direct market access solution and algorithmic trading on its electronic trading platform, Knight Direct. KCEL is a retail market-maker on the Equiduct Regulated Market, and its market making business provides liquidity to nearly all of the equity trading venues in Europe as well as a large number of institutional and retail broker dealer clients through our Knight Link platform. Additionally, we are one of the largest Retail Service Providers (RSP) in the UK, making markets in a wide range of London Stock Exchange (LSE) listed securities. KCEL's fixed income division provides research and trade execution in high-yield and high-grade corporate bonds as well as distressed asset-backed securities, convertible bonds and bank loans. KCEL also provides clients with access to

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1 Knight (collectively with its subsidiaries, "Knight") has four operating business segments, Market Making, Institutional Sales and Trading, Electronic Execution Services, and Corporate and Other. The Market making segment consists of all global market making which includes Knight Link and the company's activities as a Designated Market Maker at the NYSE. The Institutional Sales and Trading segment includes full-service institutional research, sales and trading as well as equity and debt capital markets, reverse mortgage origination and asset management. The Electronic Execution Services segment includes Knight Direct, Hotspot FX and Knight BondPoint. The Corporate and Other segment includes strategic investments primarily in financial services-related ventures, clearing and settlement activity, corporate overhead expenses and all other expenses that are not attributable to the other reporting segments.

Knight Capital Europe Limited ("KCEL") is a U.K. registered broker-dealer that provides execution services for institutional and broker-dealer clients in U.S., European and international equities. KCEL is authorized and regulated by the FSA and is a member of the London Stock Exchange, Deutsche Börse AG, Euronext N.V. (incorporating Euronext Amsterdam, Euronext Brussels, Euronext Lisbon and Euronext Paris), Borsa Italiana, OMX (incorporating the Copenhagen Stock Exchange, Helsinki Stock Exchange and Stockholm Stock Exchange), Oslo Børs, virt-x and Weiner Börse.

2 Knight, through its subsidiaries, is a major liquidity center for U.S. and international equities, fixed income securities, and currencies. On active days, Knight can execute in excess of five million trades, with volume exceeding ten billion shares. Knight's clients include more than 3,000 broker-dealers and institutional clients. Currently, Knight employs more than 1,300 people worldwide. For more information, please visit: www.knight.com.

Knight's currency ECN, Hotspot, which provides clients with complete anonymity and increased control over FX trade executions.

Knight has spent the last sixteen years building its technology infrastructure so that it can process millions of trades a day on behalf of retail and institutional investors – in a fast, reliable, cost effective manner, while providing superior execution quality and service. Knight spends tens of millions of dollars every year, making its technology platform better, faster and more reliable. Knight's data centres are some of the most reliable in the industry. Today, Knight has the capacity in the US to process nearly 20 million trades per day, with connectivity to nearly every source of liquidity in the global equities market, and trade response times that are now measured in milliseconds. Years of research and development, technology platform enhancements, and connectivity to liquidity wherever it resides is all brought to bear with a single purpose in mind: securing the highest execution quality on behalf of Knight's customers which includes the world's biggest retail brokers, and, in turn, their customers – the retail investor.

## EXECUTIVE SUMMARY

MiFID has facilitated a new level of competition to the European capital markets, with many associated benefits for investors. Today's European market is more transparent, more efficient and accessible at a lower cost than ever before. The market remains dynamic and continually evolving to meet customer needs and we are starting to see a shift to a true Pan-European trading environment.

The advent of MiFID and the establishment of this more Pan-European market have created a market which is no longer defined by restrictive geographic market places serving a local need, but a market place that is defined by customers who have different goals and requirements. There are many nuances to a mature and growing market and we should not fear customer segmentation. Dealer markets and order driven markets can exist side by side, as can a diverse set of market participants and trading venues with different requirements and different abilities to innovate.

It is entirely appropriate that the framework, in which the market operates, defined by MiFID, is under constant consideration and fine tuned to bring further improvements. We welcome many of the Commission's proposals and this focused review of those proposals, which sensibly focuses on some of the most important and controversial proposals, as an important step in that ongoing process.

In considering the Commission's proposals, it is important to remind ourselves that any proposed regulatory change must satisfy two criteria:

1. It must meet a cost benefit analysis i.e. there must be a proven failure in current market structure and/or regulation and the cost of the proposed solution to all affected participants must not outweigh the benefits; and

2. In order to identify proven failure there must be reliable data, possessed and appropriately assessed by regulatory authorities, that demonstrates such failure. Much of the debate to date has been characterised by opinion and conjecture rather than data and fact. Opinion and conjecture are particularly dangerous when fuelled by vested interest.

Knight believes that the Commission's proposals appropriately address many of the issues arising as a result of unintended consequence and market developments post-MiFID I. However, we do have some concerns arising from the proposals, particularly where proposals do not meet the cost/benefit or 'regulatory failure test' or where the proposals risk inappropriate outcomes; particularly in the area of algorithmic trading. We have commented, specifically, on these below. In addition, whilst we applaud the inclusion of proposals to

improve retail best execution, we believe that the proposals will not result in the improvements required in this investor category, and we have commented, specifically, on these as well.

Our comments in this response cover aspects of the MiFID consultation that particularly impacts the ability of the market to best meet the diverse needs of retail and institutional investors. We have included our responses in the requested table format at Appendix A to this letter, and extract these for ease of reference below.

**Question 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?**

Whilst Knight agrees that there is merit in introducing a common regulatory framework for the provision of services by third country firms (and fully accepts that comparable levels of protection should be afforded to investors receiving services from such firms), it is critical that such a regime should deliver certainty and uniform treatment – whether this can be achieved will largely depend on the way in which the equivalence assessment is performed and in the detail to be fleshed out in delegated acts and regulatory technical standards.

Knight is concerned about strict equivalence test for third country firms. Many developed countries will find it difficult to comply with the requirements (let alone less developed countries). We suggest a differentiated approach for treatment of 3rd party firms' branched in the EU and their counterparties not having any branch in the EU but without damaging investor protection. We fear that protection could lead to isolation

**Question 6 – Is the Organised Trading Facility category appropriately defined and differentiated from other trading venues and from systematic internalisers in the proposal? If not, what changes are needed and why?**

It seems that the Organised Trading Facility ("OTF") category is primarily designed to capture Broker Crossing Systems and introduce a significantly higher regulatory threshold for those businesses. From that perspective, the OTF category is appropriately defined and differentiated from other trading venues and from systematic internalisers in the proposal – using discretion as a primary differentiator – but we would recommend that it is properly defined within the Definitions in Article 4 of the Directive proposals.

That said, we do not believe there is a demonstrable need, or failure in the current regulatory structure, which warrants this additional burden or the regulatory cost accruing to the creation of the OTF Category. This business model represents little more than an automation of a longstanding practice within sell-side firms that assist their institutional clients to locate and access OTC liquidity. This practice will continue, without this additional regulatory burden or pre-trade transparency requirement, within firms that have not deployed such technology for the benefit of their clients. It could be argued that the introduction of the OTF category is a victory for regulatory lobbying on behalf of incumbent trading venues threatened by new and innovative execution venues rather than an appropriate regulatory response to the risk associated with this business model. Moreover, we are particularly concerned regarding the prohibition of operators of OTF's giving their clients the benefit of accessing their proprietary liquidity, and we have commented further on this below.

**Question 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 appears not to have been defined, with a negative 'definition' only arising from Recital 13 under which trading outside of an OTF, is OTC. And, as discussed above, the OTF category itself is not fully defined.

The distinction between OTF and OTC is currently unclear. As an example, Recital 13 suggests that executing client orders (unless carried out outside regulated markets, MTFs and OTFs) on occasional, ad hoc and irregular basis should be deemed an SI (however, this view does not seem to be replicated in the actual text of the Directive). There is no similar provision for OTC. Further, it is not made clear what an ad hoc, occasional and irregular basis means.

OTC trading appears to be any execution service conducted away from a Regulated Market (RM), MTF, OTF or SI. It is not clear to us that a definition of OTC is required, but this would be a good starting point.

Any definition, however, should exclude the OTC settlement of client-side transactions, where the market-side has been conducted through a RM, MTF, OTF or SI. This would include the opposite-side riskless principal leg of a financial instrument transaction carried out through a RM, MTF, OTF or SI and the 'derivative leg' (CFD execution, physical delivery of an option expiry, etc.) of a financial instrument transaction carried out through a RM, MTF, OTF or SI. Such transactions have been used by some market commentators in the past to significantly inflate the actual volume and value of OTC activity in European capital markets.

When considering the requirement for an OTF category, and in the context of Question 6, other OTC activity should be excluded when considering the impact of OTC activity on European capital markets. Principal trades relating to block and program facilitation, guaranteed VWAP/close trades that are also executed on exchange and client crosses should also be excluded. Excluding these provides a better picture or what is actually executed off of a defined trading venue – we estimate this to be less than 10% of market volume and of far less significance than some commentators have previously suggested.

We do not believe that the proposals will lead to the channelling of trades which are currently OTC onto existing organised venues. Market counterparties will still need to execute blocks away from the market in certain circumstances to minimise market impact. Certain OTC activity is inherently beneficial to investors and market participants and off-exchange crosses are a good example of this. Europe's capital markets are stronger for the diverse execution solutions they support and the diverse range of investors that they serve. The reclassification of BCNs into the OTF category will, inevitably, lead to a statistical change as the orders executed within these systems will no longer be deemed OTC. However, as noted above, the misrepresentation of OTC statistics in various market commentaries means that current so-called OTC activity will still be large as we estimate that BCNs represent only 20% of that.

**Question 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?**

Any proposed regulatory change must be based upon a proven failure in existing regulation, crystallized or not; and a cost/benefit analysis of any proposed amendments. This is particularly relevant in the context of this question.

Care should be taken to avoid regulating 'technology', per se, and introducing new requirements based on fear of technology, misunderstanding or misinformation. Electronic trading is merely trading using computers rather than humans. Computers do not breach risk limits, 'fat finger' orders or 'put tickets in the bottom of the drawer'. Computers do create an audit trail of everything they do. Whilst automated trading does introduce potential risks worthy of regulatory consideration, the use of technology is also a means of managing risk. It is not clear that this is recognised in the proposals.

The potential risks arising from the use of technology and the development of new trading techniques are primarily operational and systemic in nature. In this regard, Knight supports better regulation, in particular in

relation to algorithmic and other technology dependent trading. Knight supports initiatives designed to protect the stability and integrity of the markets, especially the deployment of robust risk management controls by all market participants.

Knight supports many of the Commission's proposals for MiFID/MiFIR 2 and believes that the specific requirements related to algorithmic trading, direct electronic access and co-location in Directive Articles 17, 19, 20 and 51 do appropriately identify the risks involved. In particular, Knight welcomes the breadth of the definition of "algorithmic trading" as set out in Article 4(30), which is helpful in so far as it underscores an important fact, i.e. that high-frequency trading is simply a new and more efficient means of implementing traditional trading strategies. It is not in itself a strategy but a method that uses low-latency solutions as a means of managing risk. These low-latency technologies have been adopted by many professional market participants for precisely this reason and are deployed by some, including Knight, primarily for the benefit of clients through electronic market making activities.

However, Knight believes that the Commission's proposals lack proportionality and fail to 'hit their target' in some areas. For instance, responding to the new landscape of changing risks in relation to electronic trading requires a change in regulatory approach, as well as a change in the regulations themselves. We would strongly recommend that Competent Authorities should be required to expand their capacity, their use of technology and their knowledge base as a primary response to addressing the risks involved and to conduct effective monitoring and surveillance. The focal points for new regulation should be systemic risk and market conduct, and there also needs to be improvement in coordination between national regulators in response to these issues.

All market participants have the potential to create risks and regulation should require that these risks be managed through risk management controls and supervisory procedures. Regulation should not 'single out' users of electronic solutions. That is not to say that regulatory review is not appropriate, indeed necessary. Capital markets are changing – largely driven by technology – but there is a need to much better define what the perceived problem(s) are that the proposals are trying to address. We have included at Appendix B to this response a Knight presentation addressing some of the facts and myths concerning the use of high frequency trading tools and algorithmic trading, generally. In this, we specifically address the issues of orderly market maintenance and management of systemic risk, amongst others.

Turning to the specific Articles, we would offer the following comments:

**Article 17(1)**

Knight supports efforts to require all investment firms – whether engaged in algorithmic trading or not – to establish effective systems and risk controls. Both human traders and computers have been shown to be prone to make trading errors – but, as noted above, we would argue that, subject to appropriate governance procedures around design, testing and implementation of algorithms, computers are far less prone to error – and investment firms should establish policies and procedures that mitigate the risk of such errors. An approach that is not dependent on the definition of "algorithmic trading strategy," which is subject to differing interpretations and pressure to limit its scope, would be more comprehensive and avoid the potential for regulatory gaps.

Knight supports efforts to minimise the market impact of the challenges to can arise to a firm's business continuity through the adequate deployment of business continuity arrangements. However we must stress that contingency plans should be proportionate to the firm's business based on an assessment of the firm's

responsibilities to clients and market impact. Systemic importance should therefore be used as the benchmark for proportionality, with "effective continuity business arrangements" for low impact firms limited to an ability to conduct an orderly wind down in the event of business cessation, and "effective continuity business arrangements" for high impact firms extending to a fully functional disaster recovery facility.

**Article 17(2)**

Knight firmly believes that Competent Authorities should have a full understanding of a firm's activities and types of trading strategies employed. Generally, Knight supports the requirement for an investment firm to fully document its algorithmic trading strategies, details of its trading parameters or limits, and the key compliance and risk controls it has in place. We believe that the vast majority of investment firms have these in place already.

We do not support the proposal that these be provided to the firm's Competent Authority *on an annual basis* as this creates an unnecessary burden, and cost, on investment firms. Instead, they should be actively maintained and made available, on request, to the supervisory staff of the relevant Competent Authority at any point of time and as part of their normal risk-based supervisory activities.

It should be noted that descriptions of algorithmic trading strategies will only assist Competent Authorities in capturing risks if it is clear what risks the Directive aims to address such that the information provided is both targeted and appropriate. It should also be noted that the detail of trading strategies documented and made available to regulators should respect the highly valuable and sensitive nature of a firm's intellectual property. We believe that regulators should fully understand the trading strategies of investment firms, but this should not necessitate providing access to trading strategy source code other than as necessary in the event of a regulatory enforcement action. We believe this is consistent with the 'ESMA Guidelines on systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities", which states that "Compliance staff need to understand the way in which trading systems and algorithms operate, but not knowledge of the technical properties of the trading systems or algorithms". Whilst this is not a direct comparison, and regulatory authorities should ultimately have access to whatever information and documentation they need to conduct their work, we believe this is the right approach in this context.

The focus of regulators should be on the key risks associated with the deployment of an electronic system and on a firm's systems and controls, including:

- Compliance & risk control frameworks
- Appropriate pre-trade limit checking
- Software conformance testing
- Systems capacity planning at the firm and trading venue levels
- Proportionate business continuity planning

**Article 17(3)**

It is not clear to Knight whether this provision is in response to a perceived risk – such as the risk of liquidity being removed in stressed market conditions – or merely the price the Commission believes algorithmic trading firms should 'pay' for being allowed to post liquidity in the first place. Either way, we believe that this provision is misguided from two perspectives, and is not proportionate to the risks involved:

- Firstly, any such provision could only apply to firms that trade in a principal capacity. Many – we believe the majority – do not and would therefore have to be excluded from such a provision.

- Secondly, if adopted, this proposal would actually introduce new risks. In particular, continuous quotation regardless of prevailing market conditions presents significant risks to an investment firm. Indeed, it may be prudent for an algorithmic trading firm to cease quoting or posting orders as trading strategies are often modeled based on standard deviations and an actual market dislocation may render the strategy redundant and therefore a risk to the investment firm and the market as a whole.

Knight is supportive of a quote obligation for principal algorithmic trading firms, but the terms and parameters for such should be agreed between RM's/MTF's and the quoting firm. Any 'obligation' puts shareholder's funds at risk and must, therefore, be the subject of an appropriate commercial arrangement. When an obligation is imposed on a firm to provide quotations to the market, the firm takes intrinsic risk which it must be able to adequately price. It is therefore key that the right incentives are in place to ensure that liquidity continues to be provided to the market. The appropriate balance between obligations and incentives will vary among products & platforms. It is, therefore, Knight's view that such obligations & incentives can only be adequately established and overseen by the trading platforms.

Such obligations must also allow quoting firms to pause and assess current market conditions, especially if market information is unavailable or unreliable or trading would require firms to take on positions outside of their risk tolerances. This was recognized by ESMA in the Final Report on systems and controls in an automated trading environment.[3] In Guideline 2(d) subparagraph 1 ESMA states that "working effectively in stressed market conditions may imply (but not necessarily) that the system or algorithm switches off under those conditions". In addition in Guideline 2(e) subparagraph 1, ESMA states that investments firms "should deal adequately with problems identified as soon as reasonably possible in order of priority and be able when necessary to adjust, wind down, or immediately shut down their electronic trading system or trading algorithm." Quoting obligations would need to be meaningful – say a minimum of 90% availability within the continuous trading period on a RM or MTF – but not so inflexible so as to prevent firms from exercising effective risk management of their businesses.

Failure to enhance Article 17(3) as suggested above will result in many algorithmic firms being forced out of the market and, therefore, significantly reducing the liquidity of Europe's capital markets.

**Article 17(4)**

Knight believes that appropriate supervision of all market access is an important tool in limiting risk to the financial markets. For this reason, Knight suggests the wording be adjusted to provide that Article 17(4) requirements apply to all firms providing access to a trading venue. Such an approach would avoid ambiguity over the definition of "direct" electronic access and the potential for such an ambiguity to create regulatory gaps.

We would also note that the threshold for orderly market conduct is set unreasonably high. We support the proposal that providers of market access services should be required to use risk controls designed to prevent trading that may contribute to a disorderly market or contravene the Rules, Principles and Regulations of relevant regulatory authorities. But such providers cannot undertake to prevent such activity in all circumstances as this may only become evident 'after the fact', e.g. in the case of a client conducting market abuse in the form of misuse of information.

**MiFID 2 Article 19: Specific Requirements for MTFs**

[3] ESMA: Final Report - Guidelines on systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities, 22 December 2011 [Link]

No comments

**MiFID 2 Article 20: Specific Requirements for OTFs**

Knight believes that the proposals presented in Article 20(4), require greater clarity. Knight agrees that compliance with the conditions of Article 51 in relation to allowing or enabling algorithmic trading – namely Articles 51 (3) and (4) – should extend to OTFs, but it is unclear to us whether the additional conditions of Article 51 are also similarly extended. We do not support their general extension without specific application to the OTF model, and assume that it is the intention only to extend Articles 51 (3) and (4). This should be clarified.

Whilst not specifically related to algorithmic trading, direct electronic access and co-location, we would like to express concern regarding the proposals in Article 20(1). Whilst we agree that there are risks inherent, through potential conflict of interest, or otherwise, in allowing investment firms and market operators to allow the execution of client orders in an OTF against the proprietary capital of the investment firm or market operator, we believe that there are more appropriate ways of addressing this risk.

Knight recognises that neutrality is a cornerstone of the RM, MTF and OTF categories of execution venue, but we believe that such neutrality can be achieved using segregation techniques within investment firms and market operators to manage conflicts arising. These can be supplemented by a disclosure regime for those investment firms and market operators choosing to contribute proprietary orders into an OTF, and the use of discretion through which clients can elect for orders to be executed against certain other order-flow only, and excluding proprietary orders if they so choose.

**MiFID 2 Article 51: Systems resilience, circuit breakers & electronic trading**

**Article 51(4)**

Knight supports the proposals presented in Article 51(4), that regulated markets only allow MiFID authorized investment firms to have direct electronic access.

**Article 51(5)**

Knight believes that co-location is a positive market development. Co-location facilities equalise access for participants who choose to be near the centre of price discovery. We support the proposed requirement that regulated markets' co-location services and fee structures are transparent, fair and non-discriminatory.

**Question 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?**

Generally, Knight supports the provisions in Article 51. Knight believes that the key components in minimizing the risks of a significant dislocation in European markets are the proposed circuit breakers/trading halts, which allow traders to pause, regroup and resume orderly trading, and the proposed pre-trade risk controls, which ensure orders are rejected when clearly erroneous or exceed pre-determined thresholds.

Knight is concerned, however, regarding other proposed provisions which could harm market quality and raise costs for investors, such as regulatory limits on the ratio of orders to transactions and minimum tick sizes.

Subject to other comments in this response regarding the need for proportional application in relation to OTFs, and additional comments regarding our interpretation of the application of Article 51 to OTFs, Knight supports the proposals in both Articles 18 and 19 with regards to resilience, contingency arrangements and business continuity arrangements.

Turning specifically to Article 51, we offer the following comments:

**MiFID 2 Article 51: Systems resilience, circuit breakers & electronic trading**

**Article 51(1)**

Knight supports the requirements that exchange systems be resilient and have sufficient capacity and Business Continuity Planning. In particular, message volume and system capacity must be measured and projected across a range of timeframes. Typically, it is sharp spikes in volume, or burst data rates over short time periods that cause trading platforms to fail, whilst capacity planning is often performed on a multiple of total daily volume basis.

High message and / or transaction volumes can be managed if those messages are not submitted over a brief period of time. Furthermore, risk minimization requires trading platforms to measure, monitor, and manage capacity at multiple levels, such that platform-wide message volumes and session / customer volumes are controlled as appropriate. This approach is necessary to ensure specific users do not impact market integrity through their own excessive data-traffic. It remains a concern that some platforms do not have sufficient excess capacity when dealing with high data rates.

Finally, we would also propose an addition to 51(1) providing for a disclosure regime for Regulated Markets and MTFs in the event of systems failure. The inter-dependency of market operators created by market fragmentation and the common use of pegged order-types means that the operators of RMs and MTFs should be required to declare a market halt on their individual platform in real time in the event of a systems outage that prevents full operation of their core price discovery and trading services. Furthermore, they should fully disclose plans for restoration of normal service to the marketplace as a whole.

**Article 51(2)**

Knight supports a requirement for RMs and MTFs to reject orders that exceed pre-determined volume and price thresholds or are clearly erroneous. Such a requirement should significantly reduce the risk of RMs and MTFs 'facilitating' clearly erroneous transactions, but should also be backed up by clearly erroneous transaction rules under which market participants are clearly informed of the parameters each RM and MTF will use to break or modify trades. This is especially important during periods of market stress, as uncertainty about whether a trade might be cancelled or not could lead some market participants to withdraw from the market and exacerbate the market stress through liquidity shortage.

Knight also supports the proposal that RMs and MTFs should temporarily halt trading if there is a significant price movement in a financial instrument on that or a related market during a short period. Such 'circuit breakers' are common in European markets today and should be enhanced by clear and transparent rules requiring coordinated market-wide trading halts if a severe market price decline reaches levels that may exhaust market liquidity.

**Article 51(3)**

The ability to execute, update, and cancel orders contributes to market quality by allowing market participants to manage positions and risk. In particular, to avoid the systemic risks associated with a continuous quoting obligation whilst restricting a firm's ability to update prices, it is necessary to fundamentally link the continuous quoting obligations addressed in Article 17 (3) with proposals to control order / transaction ratios addressed in Article 51(3).

The appropriate message trade:cancellation ratio should be set by the RM or MTF based upon its messaging capacity and its overall obligation to maintain fair and orderly markets. Knight strongly discourages any uniform approach to ratios across markets, which would detract from market quality, and be anti-competitive to new trading venues or products that often see many orders go unexecuted

Whilst it appears prudent that trading venues are permitted to employ throttles to slow down the flow of orders to a market if there is a threat to market integrity Knight believes that the use of throttles should not be 'encouraged' by regulatory recognition. Knight does not support the using of throttling in terms of order-flow messaging or market data dissemination. Throttling creates disorderly markets and significantly increases risks for firms using algorithmic trading strategies, in particular. Throttles disguise underlying problems derived from inadequate capacity planning. In addition, throttles introduce risk by creating unpredictable behaviour at the matching engine, the true value of an instrument becomes hidden within a queue management system, disrupting price discovery and valuations for the purpose of risk management. Furthermore, this creates risk for those firms pricing derived assets. Instead, trading venue capacity planning should be more rigorous as suggested in our comments to Article 51.1.

Regarding minimum tick sizes that may be executed, Knight believes that the appropriate use of tick increments are an important part of operating and efficient market. We support the use minimum tick sizes, which should be consistent across individual instruments traded on multiple markets. However, a financial instrument's price, liquidity, and volume are all factors that are relevant and tick-sizes therefore need to be flexible enough to allow for these characteristics across multiple instruments and asset classes.

**Article 51(4)**

Knight supports the proposals presented in Article 51 (4) that RMs and (by virtue of Article 20(4)), MTFs and OTFs only allow MiFID authorized investment firms to have direct electronic access.

**Article 51.7(c)**

Knight believes that the responsibility for setting maximum cancellation ratios should be rest solely with RMs and MTFs . Article 51.1 requires exchanges to have systems, procedures and arrangements to ensure their trading systems are resilient and have sufficient capacity to deal with peak order and message volumes. Regulators should not impose limits on order-trade ratios that minimize the need, or reduce the incentive, for exchanges to build systems with adequate capacity or resilience.

Moreover, because limits on the ratio of orders to transactions can harm market quality by reducing the ability of participants to manage risk, it is important that regulators not artificially limit cancellation ratios. An artificial limitation on the ability of participants to adjust orders/quotes based on real-time market data will result in wider quotations and raise costs for investors. Therefore Knight would propose that Article 51.7(c) should be removed and that this should be left entirely to RMs and MTFs to determine, with the overriding responsibility to their relevant Competent Authority do so prudently and responsibly in accordance with Article 51.1.

**Question 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?**

Knight supports the proposal in Article 22 of the Regulation proposal. Knight believes this is largely consistent with the existing systems & controls obligations of investment firms and that the retention period of 5 years is appropriate.

**Question 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?**

In isolation, we do not believe the introduction of an MTF SME growth market will materially provide SME's with better access to capital. The proposal raises the profile of SME's, which we fully support, but it will not improve liquidity in the secondary trading of such instruments and is therefore unlikely, on its own, to increase the attractiveness of SME's to investors.

Electronic market-makers using HFT tools, and others, do not have a presence in the small and mid-caps because the costs of trading such securities are too high. The costs are very much higher than trading large-cap liquid securities as a result of the high cost of stock borrowing (or even unavailability of stock borrows) for such securities to support market making activities and the premium charged by various incumbent exchanges to access liquidity in such securities. The latter may be partly addressed by competition in the SME space, but the likelihood is difficult to predict.

We would also note that these instruments frequently do not trade electronically in a manner consistent with the risk management techniques of algorithmic trading firms.

**Question 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?**

Knight has long been an advocate of enhancing the best execution requirements for retail investors and therefore supports the proposals in Directive Article 27. Knight believes that retail investors have seen little improvement in the way their orders are handled, or the quality of execution they have received, despite the significant changes in the competitive environment since the implementation of MiFID in November 2007.

The main 'barriers' to improvement have been the express consent provision and order execution policy requirements in the existing Directive. In addition to these, the cost of efficiently accessing fragmented liquidity has been beyond many retail brokers.

The market has evolved to address the challenge of accessing fragmented liquidity with investment firms, such as Knight, using its own investment in order aggregating technology[4] to provide execution services through electronic market making and smart order routing services. We also now see retail-focused trading venues emerging, such as Equiduct, which have business models designed to provide a best execution service for retail order flow through the provision of European consolidated BBO execution services.

The administrative burden of obtaining express consent and the need to maintain and update order execution policies act is a disincentive to retail brokers to regularly review the quality of execution services they receive,

[4] Such technology includes high frequency tools which are deployed by some investment firms, such as Knight, for the purposes of improving execution services, including to retail customer flow.

and to re-route order-flow to the most beneficial venue(s). Whilst the requirement to publish data relating to the quality of execution on venues is welcomed, alongside further information about how orders will be executed, this administrative burden remains as a deterrent. We believe that the emphasis on best execution for retail orders should move away from compliance with an order execution policy – which many retail investors may not fully understand – and be replaced with an ongoing obligation on order-flow handlers to use only those venues that they can show consistently provide their clients with the best possible outcome. Investment firms handling retail order-flow should be free to re-direct flow as execution quality statistics dictate, without the burden of an express consent requirement. Order execution policies provide important information to clients but investment firms should be permitted to provide these, exclusively in electronic form on, for instance, the firm's own web site.

In our opinion, the proposal that investment firms publish the top five execution venues used by them annually does not seem, to us, to provide retail investors with any additional protection. Top five, we assume, means the five largest recipients of their order flow (and this requires further definition in terms of what is meant by 'top five'), but 'top' does not necessarily equal best, measured in terms of the best possible outcome.

We would also like to add that there are further barriers to retail investor access to European capital markets that we believe should be considered as part of this review. One key barrier is the excessive cost of market data, which is required by self-directed investors to efficiently access capital markets. In the US, for instance, retail investors can access real-time market-wide data for as little as $10 per month. In Europe, the cost is closer to $10 per month, per market; and often more. That is a major reason why many retail investors treat the US markets as their second most active market, behind their own domestic market. Capital raising activities, particularly in the SME market, would benefit from greater liquidity in secondary markets and we believe that greater retail participation would significantly contribute to that. Trading venues should be encouraged – possibly even required – to provide separate retail pricing structures for market data in order to remove this barrier and improve retail participation in Europe's capital markets.

**Question 18 – Are the protections available to eligible counterparties, professional clients and retail clients appropriately differentiated?**

We believe that the proposals create uncertainty about what is involved in treating eligible counterparties fairly and we would strongly urge clarification on this point.

The Commission envisages that for more complex products, investment firms should provide clients with a risk/gain and valuation profile of the instrument prior to the transaction, quarterly valuation during the life of the product as well as quarterly reporting on the evolution of the underlying assets during the lifetime of the product. Firms holding client financial instruments should report to clients about material modifications in the situation of financial instruments concerned. Knight feels that most of these detailed obligations should be calibrated according to the level of risk of the relevant product.

Knight feels that there are potentially increased burdens on firms dealing with eligible counterparties, the costs of which will ultimately filter to the eligible counterparties.

Investment advice (Recital 51-52, Article 24(3), Article 24(5), Article 25(5) MiFID)

- The requirements apply to retail and professional clients. The requirement in Article 25(5) need to specify how investment advice meets personal characteristics of client also applies to eligible counterparties.

- The rules appear to apply in respect of professional as well as retail clients, and in relation to any MiFID instrument (not just retail investment products). This creates increased burdens, the need for which is unclear, and we believe the requirements should be more proportionate for professional clients.
- It is not clear what is meant by a "sufficiently large number" of financial instruments. This appears to be a quantitative assessment – what about the qualitative element? Fflexibility is important depending on the scope of the advice firms purport to provide. Firms should not be required to consider instruments which are not relevant to the advice, just so they can claim they have assessed a sufficiently large number
- Where shares / bonds / securitised debts have been admitted to trading on an MTF, the appropriateness test will not apply. However it is not always clear whether instruments have been admitted to trading on an MTF.

Inducements (Recital 52, Articles 24(5) and 24(6) MiFID) Existing MiFID rules already require inducements to both enhance the quality of the service to the client and not be contrary to the client's best interests. Therefore, in certain situations inducements are already prohibited. It is not clear to is whether the Commission has provided sufficient justification for an outright ban. Knight believes the existing regulation to be effective and proportional.

**Question 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?**

We believe the grounds need to be clarified in delegated acts, without which it is very difficult to comment meaningfully (although the requirement that all conditions must be met is helpful). There is no actual requirement for engagement with industry before acting and Knight believes that a formal requirement to consult with an ESMA experts committee should be added as a minimum.

**Question 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?**

Knight supports the general intent of MiFiD, the MiFID II proposals and the Regulation proposals with regard to market transparency, subject only to the need to recognise that different business models and different instruments require different approaches.

**Article 3**

Commentary on Article 3 is very difficult without reference to Article 4 of the Regulation. Knight supports Article 3, subject to the appropriate and consistent use of waivers based on the market model or the type and size of orders. It is crucial that this works in practice as many BCNs are inherently dark in nature and will, as new OTFs, require appropriate access to the application process for the granting of waivers. Without such waivers, these business models will likely disappear and an important means of accessing low impact liquidity for institutional orders will be lost.

**Article 4**

Knight is concerned that the conditions for granting waivers are not sufficiently defined in the Directive or Regulation. Our understanding is that these will become Delegated Acts, meaning that they are regarded as

non-essential provisions. We disagree and believe that the conditions for granting waivers should be debated, agreed and fully transparent to the market as a whole.

**Article 13**

Knight believes that there is ambiguity in the drafting of Article 13. Knight fully supports the application of a pre-trade transparency regime to Sis – something that is lacking in the existing regulation. However, it is not clear whether the proposed obligations are applied on an attributable basis. We believe they should not as:

- There is inherent futility in a public quote which is not actually accessible by 'the public' due to the discretionary nature of access applied by the SI; and
- There is a significant risk that liquidity and/or SI's themselves will disappear from the market as public quotes will 'show the hand' of firm's managing principal risk

The quoting obligation should be satisfied by investment firms in a manner that is consistent with their business model. This should include quoting anonymously through a RM or MTF. We do not believe that is clear at present but we believe that the Regulation, as currently drafted (subject to 'practical implementation and guidance' by Competent Authorities) allows for this – this should be clarified.

**Question 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?**

Knight would encourage clarification of the intended scope of the pre and post trade transparency regime with respect to bonds (Articles 7, 8, 9, 17 & 20). In contrast to the equities markets the majority of bonds are not admitted to trading on a regulated market and are traded OTC. They, therefore, will only be subject to the pre and post trade transparency regimes if a prospectus was published on issuance. In our experience the majority of bonds in circulation have been issued subject to some form of offering circular/prospectus. This raises the prospect that all trades executed by an Investment Firm in bonds which have been issued under a prospectus will potentially be subject to MiFID pre and post transparency reporting regardless of the country of residence of the issuer or the currency of issuance. This appears to result in a much broader geographical coverage than applicable to equities where the scope of reporting OTC transactions is limited to shares admitted to trading on a regulated market or on an MTF or OTF. Whilst we recognise the need for post trade transparency to include OTC trading we would encourage the scope to be limited to bonds issued by EU based issuers.

**Question 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?**

See response to Q21

**Question 23 – Are the envisaged waivers from pre-trade transparency requirements for trading venues appropriate and why?**

We do not believe that they are. We believe far greater certainty is required – please see our response to Q20.

**Question 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 do not have any specific comments on Articles 61-68. In relation to Article 67, and the issue of a European Consolidated Tape generally, we would just re-state our previous position that we do not believe that this important requirement should be satisfied by commercially driven market solutions alone.

A consolidated tape offering fair access on an affordable basis would be of significant benefit to many market participants. Efforts to date have not succeeded in delivering this and, whilst it will be a significantly challenging task to agree the specification, it is now time to mandate a solution. Market data costs in Europe remain high and the introduction of a low cost standardised view of the market will increase participation to the benefit of all. It would further offer the regulatory authorities an improved ability to monitor the market and reconstruct cross-venue incidents.

Knight supports the introduction of a single not-for-profit utility to set up a consolidated tape in Europe, with costs paid out of the revenues generated from the utility, and all contributing data having a share of the profits based upon proportion of data provided minus the relative costs.

We also refer readers to our response to Q17 and the need to provide retail investors with very low cost access to consolidated market data.