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.**

This response is submitted on behalf of Morgan Stanley.

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?	• In general, we believe that where exemptions apply, these should be well-justified. This helps to maintain a level playing field for all financial services firms operating in Europe. We regard the Commission's proposal as appropriate in this area. We refer to the response submitted by the Association for Financial Markets in Europe (AFME) for more detail.
	2) Is it appropriate to include emission allowances and structured deposits and have they been included in an appropriate way?	• The inclusion of emission allowances within the scope of MiFID may not be the most effective means of dealing with these very specific instruments. It may be more appropriate to deal with emissions allowances through a separate piece of legislation, perhaps creating a specific regime for them. • The MiFID provisions on structured deposits, as for all retail instruments, should ensure full consistency with the upcoming Packaged Retail Investment Products (PRIPS) legislation.
	3) Are any further adjustments	

	needed to reflect the inclusion of custody and safekeeping as a core service?	
	4) Is it appropriate to regulate third country access to EU markets and, if so, what principles should be followed and what precedents should inform the approach and why?	• We understand that the rationale behind the proposal to impose certain EU-wide requirements on third country firms seeking to provide MiFID investment services to clients based in the EU is to ensure a level-playing field for all financial service providers. In principle, we agree with this aim. • We also welcome the possibility for non-EU based firms to obtain a passport to provide MiFID services across the single market with a single point of authorisation. This could broaden the range of services available to European clients, which may also serve to enhance competition. • However, we are concerned that the proposals as drafted may lead to a number of practical problems that could have unfortunate, if unintended, consequences for financial markets and investors in Europe. • The Commission's proposed regime for third countries would involve a determination that the applicable "prudential framework" in the foreign jurisdiction in question is deemed "equivalent" to that in the European Union. Article 41 of the proposed MiFID elaborates a number of conditions that the jurisdiction would need to fulfil in order to be deemed equivalent. Rather than a focus on specific conditions, we believe that the determining factor should be the extent to which the jurisdiction's prudential framework provides for regulatory outcomes that are substantially in line with international standards, notably the IOSCO Objectives and Principles of Securities Regulation inter alia. There should therefore be scope for discretion in determining equivalence decisions, which would permit the particular circumstances of jurisdictions to be taken into account. • A key difficulty of the proposed regime is that it would seem to envisage a fixed date in the future after which time non-EU firms would be prohibited from providing services in any EU member states. In reality, equivalence determinations and cooperation agreements will need to be carried out for potentially dozens of different jurisdictions, and this process will take many years to complete. It does not seem reasonable to deny access to firms based in countries for which equivalence determinations have not been made by the date specified. A preferable approach would maintain currently applicable member state regimes for regulating overseas access to their markets for any jurisdictions for which equivalence determinations had not yet been made. We believe that the MiFID harmonised approach should only apply once a positive determination has been made. At this point, the full MiFID requirements would apply

		to firms based in the jurisdiction concerned, and the passport would also become available at that time. • A further difficulty is that the requirement for foreign jurisdictions to provide "equivalent reciprocal recognition" of the European regulatory framework. This requirement may not prove workable in reality as the foreign jurisdiction may not have a mechanism to provide such reciprocity. • The rules applicable to the provisions of services into and out of the single market are among the most challenging aspects of financial regulation. We note that several of the legislative dossiers currently under consideration by European legislators (such as EMIR, and Credit Rating Agencies), or already agreed (such as Short Selling and AIFMD) have different approaches towards the treatment of third countries. We believe there may be merit in developing a more holistic approach that takes all of these dossiers into account, allowing greater certainty for firms and a more efficient approach that may be more easily implemented in practice. • The single market provides greater benefits to investors in Europe and internationally. We believe that financial regulation should build on this asset and not impede the flow of capital into and through Europe.
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?	• While diversity in the membership of the management body may be an important factor, it will only ever be one factor among many that need to be considered carefully. Nevertheless, the most important element of a successful management body will be its ability to bring sufficient expertise and experience to decision making and to mount real and constructive challenges to proposed courses of action. The policy to be put in place should promote these characteristics in the management body, rather than mere "diversity". • The provisions of Articles 9(4) and 48(1-4) may prove to be unworkable in practice. Such standards developed in the abstract (rather than in relation to individual firms or specific types of firm) risk being too vague to be useful or too prescriptive to be practicable. It may be better to require firms to be able to demonstrate that their management bodies do, in fact, meet the requirements of Article 9(1)-(3) in the context of their particular businesses. Firms should be permitted to exercise discretion in this area, subject to intensive scrutiny of their use of that discretion by the relevant regulator.
Organisation of markets and trading	6) Is the Organised Trading Facility category appropriately defined and differentiated from other trading venues and from	• A key differentiator between the role of brokers and that of exchanges is that the broker acts in the interests of its client, whereas the market operator of an exchange provides a fair and efficient market-place that brings together different buying and selling interests. Both roles are essential to the optimal functioning of financial markets; it is important not to confuse them.

	systematic internalisers in the proposal? If not, what changes are needed and why?	• Since the role of the broker is to achieve best execution for its client, the broker must be able to exercise discretion over how it deals with its client's orders. There are a number of factors that a broker uses to determine how to handle these orders. These include the need to achieve best price, but may also include speed and certainty of execution, for example. Based on these criteria, the broker chooses how best to fill the client order, including whether to trade on exchange or whether to match two of its client orders together where this is possible. The broker might decide, often for very large orders, to facilitate the trade by supplying its own capital. • In recent years, technological developments have meant that brokers are increasingly using automated trading technology. Particularly for cash equities trading, decisions on how best to execute orders are made using algorithms and smart order routers. Where the broker matches corresponding client orders (i.e. a "buy" order with a "sell"), nowadays this is often done electronically, through systems known as "broker crossing systems" (BCS). • The category of organised trading facility (OTF) is designed to capture BCS, and it is welcome that the Commission recognises that the operators of these systems should be able to exercise discretion in how orders are matched. • However, the Commission proposal would also prohibit OTF operators from introducing their own capital into their trading systems. Preventing brokers from supplying their own liquidity into OTFs would undermine their ability to provide best execution, not least because it would prevent brokers from facilitating trades with their own capital. It would also deny investors a source of liquidity. Concerns over the potential conflict of interest between the OTF operator and the OTF members/clients can be met through more proportionate policy means. For example, certain order handling rules may be appropriate, which ensure that client orders are handled fairly.
	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?	• We do not believe that it would be helpful or necessary to further define the notion of OTC trading. This should be a residual category that captures all trading that is not otherwise captured by the relevant MiFID trading venues. Defining OTC exhaustively could lead to legal uncertainty over the applicable rules for certain types of trades. • The question of the extent to which OTC trading shifts towards a platform-based trading post-MiFID largely depends on the final outcome of the rules themselves. However, there is no doubt that in many asset classes, there is a marked trend towards screen-based electronic trading. The changes brought about by market regulation may accelerate that change. • It is important to recognise that fixed income markets are inherently different from cash equity markets. Fixed income markets, which comprise many hundreds of thousands of instruments,

		are not homogenous. Market size and liquidity differ greatly between various segments with high grade corporate and covered bonds typically being the most liquid and single name credit default swaps and bespoke interest rate swaps, for example, at the lower end of the liquidity spectrum. Here the role of brokers (or "dealers") in providing capital to facilitate trades will always remain crucial. • Certain forms of trading are already done over trading platforms, such as "request-for-quote" (RFQ) MTFs. Nevertheless, certain trades that are large in nature, that involve illiquid instruments or that are bespoke, for example where an investment bank provides a customised hedging solution to a multinational corporate, will need to be transacted bilaterally. • Overall, it will be critical for the definitions of trading venues to be sufficiently detailed and clear to provide certainty over which types of trades fall under which definition. For example, what is the determining factor? For example, is it the nature of the financial instrument or the frequency of trading that is decisive?
	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 broadly support the substance of the revised MiFID proposals where they relate to risk controls, either pre-trade (such as those around direct electronic access) or at the trading venue (such as resilience and stress testing). • However, we have concerns relating to the current proposals for a trading algorithm strategy to have to maintain continuous quotes regardless of prevailing market conditions. • From a practical perspective, we would like to highlight the difficulty of complying with the wording as currently drafted. For example, if we receive a client sell order to work over a period of time, for example over two hours, and we determine that the most appropriate method of execution is to use a VWAP execution algorithm (Variable Weighted Average Price), we would find ourselves obliged to buy shares in the course of executing this order. This obligation would extend across the remainder of the trading day rather than the period of the client order. • From a risk management perspective, we are concerned that if a firm's risk systems or trading management indicate that a particular automated trading strategy should not be in operation, the current wording would oblige the firm to have their trading algorithm continue to post firm quotes in the market in order to meet regulatory requirements. This leaves a firm open to the risk of taking positions which they are not equipped to handle and in practice would result in firms needing to hold more capital and/or widen spreads. • We understand that one of the key drivers for this wording is to ensure that liquidity provided by high frequency trading firms is not withdrawn from the market during volatile market conditions. We would propose that an alternative method of achieving this objective would be
	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?	

		for trading venues to offer formal market making regimes where firms receive the benefits and corresponding obligations of acting as a liquidity provider.
	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?	• We acknowledge the G20 commitment to trade certain derivatives on trading platforms where appropriate. We believe that the Commission's proposals are largely faithful to that commitment and the criteria proposed are broadly reasonable. The criteria for defining liquidity and the requirement for a public consultation in advance of a decision on mandatory trading are both very important elements. The detail of the rules as defined by ESMA through technical standards will be critical here.
	12) Will SME gain a better access to capital market through the introduction of an MTF SME growth market as foreseen in Article 35 of the Directive?	
	13) Are the provisions on non-discriminatory access to market infrastructure and to benchmarks in Title VI sufficient to provide for effective competition between providers? If not, what else is needed and	• We fully agree with these provisions, which are strongly supportive of the effective realisation of a single market in financial services.

	why? Do the proposals fit appropriately with EMIR?	
	14) What is your view of the powers to impose position limits, alternative arrangements with equivalent effect or manage positions in relation to commodity derivatives or the underlying commodity? Are there any changes which could make the requirements easier to apply or less onerous in practice? Are there alternative approaches to protecting producers and consumers which could be considered as well or instead?	• Position limits have a role to play in ensuring certainty of supply of physical commodities traded on exchanges. They can therefore help to support orderly and efficient markets. We are less sure how they would be applied to spot commodities, which are overwhelmingly traded outside of exchanges, given the global nature of these markets and as recognised by the G20, the lack of reliable data on supply and demand in physical commodity markets. • However, it should not be assumed that position limits are necessarily a panacea that can be imposed as a means of ensuring orderly markets. In that regard, it will be important for regulators and commodity exchange operators to have available a wide tool kit of options including the ability to set position limits as well as a robust system of position management, which are dynamic and capable of reacting to specific markets and market circumstances. • Rigid position limits imposed without regard to the role of certain market participants, whether they are consumers, producers or financial participants, may undermine the relevant market's price formation role. Moreover, absolute thresholds set ex-ante will be in practice somewhat arbitrary in nature since they will not take account of market evolutions and the relative size of a position as demand and supply factors change. • For a more detailed response, please refer to the submission provided by AFME, with which we are in agreement.
Investor protection	15) Are the new requirements in Directive Article 24 on independent advice and on portfolio management sufficient to protect investors from conflicts of interest in the provision of such services?	
	16) How appropriate is the proposal in Directive Article 25 on which products are complex and which are non-complex products, and	• The catch-all provision in Article 25(3)(a)(v) may introduce unwelcome uncertainty into an otherwise carefully-worded definition. • It may be better to distil the essential characteristics of non-complex financial instruments from Articles 25(3)(a)(i)–(iv) and to state in Article 25(3)(a)(v) that a financial instrument will be

	why?	deemed to be non-complex for the purposes of this paragraph if it possesses those characteristics, or to provide that firms may apply to member state regulators for a determination as to whether a particular financial instrument should be deemed to be complex or non-complex. • The concept of complexity in MiFID currently relates to the ease of understanding the risk profile of an instrument, rather than the degree of risk posed by the instrument itself. We believe this concept should be maintained and, therefore, that where an instrument's risk profile can be easily understood, such products should remain non-complex, regardless of the structure of the instrument.
	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?	
	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?	• Banning certain products and/or services should be a last resort and undertaken only on grounds of clear and well-evidenced regulatory imperative. It is important that firms retain the responsibility for ensuring that the products and services they supply are robust, well-designed and appropriate for the client base targeted. Regulators should not have to bear responsibility for this since otherwise there is a risk of de facto transfer of fiduciary duties and consequent moral hazard. Thus, this kind of regulatory intervention should be undertaken sparingly and on the basis of a transparent and predictable process that provides legal certainty for market participants.
Transparency	20) Are any adjustments needed to the	

	pre-trade transparency requirements for shares, depositary receipts, ETFs, certificates and similar in Regulation Articles 3, 4 and 13 to make them workable in practice? If so what changes are needed and why?	
	21) Are any changes needed to the pre-trade transparency requirements in Regulation Articles 7, 8, 17 for all organised trading venues for bonds, structured products, emission allowances and derivatives to ensure they are appropriate to the different instruments? Which instruments are the highest priority for the introduction of pre-trade transparency requirements and why?	• The precise meaning of pre-trade transparency for non-equity markets is not fully clarified by the proposed Regulation. However, the recitals do make clear that different types of transparency should be applied depending on the market model, for example. We do not believe that pre-trade transparency should mean continuous firm bid-offer prices as this would be inappropriate for most asset classes other than cash equities and futures. However, for trading venues, it may be appropriate to require certain types of pre-trade pricing, such as composite or average pricing or benchmarks, to give an indication of liquidity. • The proposals for pre-trade transparency for non-equities under the systematic internaliser (SI) regime are potentially problematic. As discussed above, brokers often use their own capital to respond to requests for liquidity from clients. This is particularly the case in many fixed income and derivative instrument classes, where trades are infrequent and, where they do happen, often very large in scale. When the broker provides liquidity to a client, the broker is then left with a large position that has to be unwound through a series of subsequent trades, often taking several days to complete. • Particularly for instruments that trade infrequently, a requirement to disseminate quotes pre-trade could effectively disclose the existence of a particular individual position to the market, likely resulting in market impact, whereby prices could move against the broker's position. This could negatively impact the price of the trade for the end client. We therefore do not believe pre-trade requirements are appropriate for bilateral market-making. • Moreover, the requirement to provide firm quotes in an instrument, once a trade has been agreed in that instrument with a client, to an unspecified number of clients would present severe difficulties in implementation. Such a requirement would be heavily capital intensive as the firm could not be certain how many trades it will be required to perform subsequent to the initial trade. It would expose a firm's balance sheet in a way that would be difficult to 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?	manage effectively. Moreover, there are more prosaic problems of how to implement this provision: for example, what if the firm had sold the entire issue of a bond in the initial transaction? We do not believe that mandating firm quotes is a reasonable requirement to impose on brokers. • Overly restrictive requirements around continuous price making in non-equity instruments may result in brokers withdrawing liquidity either substantially or completely from less liquid markets as the balance between potential earnings and risk (generated from effective disclosure of position) becomes untenable for brokers. Calibration of market making requirements with liquidity is therefore critical to ensuring that any pre-trade transparency regime works effectively and liquidity is maintained in markets.
	23) Are the envisaged waivers from pre-trade transparency requirements for trading venues appropriate and why?	
	24) What is your view on the data service provider provisions (Articles 61 - 68 in MiFID), Consolidated Tape Provider (CTPs), Approved Reporting Mechanism (ARMs), Authorised Publication Authorities (APAs)?	
	25) What changes if any are needed to the post-trade transparency requirements by trading venues and investment firms to ensure that market participants can access timely, reliable information at reasonable cost, and that competent authorities receive the right data?	• Mandatory post-trade transparency was introduced for the cash equity market when MiFID was introduced in November 2007. However, the quality and consistency of trade data has been questioned, particularly for OTC trade data. This has given rise to concerns over the ability of investors to analyse best execution, for example. • We recognise these concerns and have been working actively with ESMA and industry associations to establish guidelines for how trade reports should be made, to enhance the uniformity and integrity of trade data. We believe these efforts have been fruitful. More granular transparency requirements should be codified in the MiFID framework through Level 2 measures. • The lessons learned through the cash equities experience should be carefully considered when expanding post-trade transparency requirements into the fixed income and derivatives markets. Care will need to be taken to ensure that data standards are rigorous and appropriate.

		• Moreover, it will be important to ensure that post-trade transparency does not lead to inadvertent damage to liquidity. Deferred publication of trade reports is currently permitted under MiFID for equities, recognising that transparency requirements that are too aggressive or too short in time may have implications for the willingness of brokers to provide liquidity (due to market impact, discussed above). We believe that this principle should be respected in the revised MiFID framework. • We therefore believe that a new transparency regime should be established that is sensitive to the different features of fixed income and derivative markets, notably the vast range of instruments in scope, the differing liquidity profiles and the larger relative trade sizes. • It would be helpful for ESMA to establish a database that provides for reporting delays based both on the size of the particular trade and the liquidity of the instrument involved. Hence, larger trades in more illiquid instruments should benefit from greater deferred publication delays. This database should be revised and updated on a regular basis to take account of changes in liquidity patterns. • We also note two features of the TRACE transparency regime that currently applies in the U.S. Firstly, this regime was subject to a phase-in period, whereby transparency rules applied first to certain instrument classes (corporate bonds) before being expanded to incorporate less liquid instruments (certain types of securitisation). It will be important for Europe to phase in these requirements appropriately so that the market has time to digest the implications of transparency and that any negative effects can be mitigated. • Secondly, the TRACE rules provide for a 'volume mask' whereby the specific volumes of large trades (above $5m notional) are not revealed to the market. This provides price transparency, while limiting the potential market impact implications for liquidity. Adopting volume masking may permit shorter time delays for publication. • The industry has been working through its principal trade association, the Association for Financial Markets in Europe (AFME), on a project to set out the essential elements of an effective transparency regime for fixed income and derivative markets. We believe this project should be viewed as a constructive contribution towards an appropriately-tailored transparency regime. • It is important that whatever regime is adopted, it is subject to regular review by regulatory authorities to determine the continued appropriateness of the calibration. Liquidity is variable and often unpredictable. It is important to ensure the regime is calibrated according to underlying market conditions, if efficient market-making is to be preserved. • We also believe that more detail at Level 1 may be appropriate, at least to define the key

		criteria of the transparency regime.
Horizontal issues	26) How could better use be made of the European Supervisory Authorities, including the Joint Committee, in developing and implementing MiFID/MiFIR 2?	
	27) Are any changes needed to the proposal to ensure that competent authorities can supervise the requirements effectively, efficiently and proportionately?	
	28) What are the key interactions with other EU financial services legislation that need to be considered in developing MiFID/MiFIR 2?	
	29) Which, if any, interactions with similar requirements in major jurisdictions outside the EU need to be borne in mind and why?	
	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?	
Detailed comments on specific articles of the draft Directive		
Article number	**Comments**	
Article ... :		
Article ... :		
Article ... :		
Detailed comments on specific articles of the draft Regulation		
Article number	**Comments**	
Article ... :		
Article ... :		
Article ... :		