

## Review of the Markets in Financial Instruments Directive

### Questionnaire on MiFID/MiFIR 2 by Markus Ferber MEP

#### Response from the World Development Movement, London, UK

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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](mailto:econ-secretariat@europarl.europa.eu) by **13 January 2012**.

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?	<p>We are concerned that, as currently drafted, Directive Articles 2 and 3 are ambiguous. It is unclear which entities are intended to be exempt, and what measures they are intended to be exempt from – for example, position limits applied to regulated trading venues where such entities trade.</p> <p>These articles should be clarified to ensure that:</p> <p>a) <b>Firms may only be exempt from MiFID so far as their activities are solely and exclusively for the purposes of genuine hedging of risks core to their commercial business</b>, such as commodity or currency fluctuations. Corporate end users often use commodity derivatives for speculative as well as hedging purposes, both on own account and offering such</p>

		<p>services to other firms. An exemption for all activities of such traders could put them at a competitive advantage compared to actors not involved in the markets for the underlying assets. <b>Such exemptions should be granted on a case-by-case basis only as needed for the hedging of their underlying commercial risk with the burden of proof on the entity in question.</b> To facilitate this, consideration should be given to empowering regulators to assess the size of positions held in derivative markets relative to underlying physical risk. Without this provision, there is a risk of commodity firms providing under-regulated financial services or undertaking activities that could be damaging to market efficiency such as excessive unregulated speculation on commodity derivative markets. This is of particular concern as large commodity firms may benefit from significant information advantages with regards to other market participants, and may be able to exploit this information at the expense of others outside the regulatory framework of MiFID.</p> <p><b>b) The definition of “ancillary to their main business” is clarified to prevent exemptions for trading which is not necessary to hedge a commercial risk.</b></p> <p><b>c) Any exemptions do not release exempt participants from provisions for trading venues, such as position limits.</b></p> <p>In addition, the <b>exemption for pension funds should be removed</b>. Pension funds are financial service providers and have played a key role in pushing up commodity prices in recent years through their investment in commodity index funds. The enormous sums invested in baskets of commodities through such ‘long only’ funds has exerted an upward pressure on prices due to demand on one side of the market.</p>
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	2) Is it appropriate to include emission allowances and structured deposits and have they been included in an appropriate way?	
	3) Are any further adjustments needed to reflect the inclusion of custody and safekeeping as a core service?	
	4) Is it appropriate to regulate third country access to EU markets and, if so, what principles should be followed and what precedents should inform the approach and why?	It is important that third country access is regulated to avoid regulatory arbitrage which could otherwise occur.
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?	
	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?	<p>The significant size of the current OTC market hampers effective price formation through the barriers to information flow; allows dealers to maintain and exploit information asymmetries at the expense of their clients; and does not guarantee equal and fair pricing between clients. In order to ensure transparency, oversight, effective competition (both within and across trading venues) and accurate, uniform price formation, the vast majority of derivatives should be traded on regulated trading venues.</p> <p>The continuation of significant volumes of OTC trading could have a knock-on effect on regulated public markets due to the inter-relationships between markets in related derivative contracts (e.g. futures and swaps) and in underlying asset classes (e.g. between commodities).</p>

		<p>The goal in addressing these market failures should be to ensure that as many derivatives as possible are traded through a regulated exchange, as agreed by the G20 (with a deadline of the end of 2012, which unfortunately seems likely to be missed). We therefore welcome the provisions in Regulation Article 24, but are concerned that Regulation Article 26 could fail to lead to the channelling of enough OTC trades onto organised venues.</p> <p>We consider that the majority of OTC derivatives could be restructured into a number of constituent derivatives that would be eligible for market trading, with only a very small minority of derivatives not able to be standardised so that they could be exchange traded.</p> <p>We note that the CESR has recommended that ESMA work to increase the standardisation of derivatives to ensure that they can be exchange traded, and we recommend that this be required. To support this, <b>the proposals must set out clear targets (or mandate ESMA to produce ambitious binding targets) for moving OTC trading onto regulated trading venues.</b></p> <p><b>Traders of any remaining OTC derivatives that cannot be standardised should be required to show they fulfil a genuine hedging need, with the burden of proof falling to the market participants involved.</b></p> <p>Further, we recommend a provision be included within the proposals to avoid new, unregulated trading venues being created so as to circumvent these measures.</p>
	<p>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?</p>	<p>High frequency algorithmic trading can add significant volatility to markets, disrupting the impact of information regarding fundamentals and flooding underlying price signals, destabilising markets and undermining effective price formation.</p>

		<p>There are also significant risks that such trading can cause markets to over-react to market events, significantly overshooting market equilibrium and contributing to the formation of bubbles. This impact is particularly dangerous in commodity derivative markets, where price signals should play a crucial role in allowing producers to plan production and mitigate price risk. Highly volatile derivative markets fundamentally undermine both these functions, leading to markets not responding correctly to restore equilibrium and producers being unable to manage risks effectively due to the prohibitive margin costs.</p> <p>The dangers of this form of trading are most clearly seen in the 'flash crashes' that took place in the international sugar market in late 2010 and the cocoa market in early 2011. Falling prices triggered the computerised models to automatically sell, fuelling a downward trend that led to prices falling 11 per cent for sugar and 12.5 per cent for cocoa in a single day.</p> <p>While high frequency trading has been hugely profitable for commodity exchanges, which profit from the increased trading volume, it has been heavily criticised for providing little if any benefit to commercial hedgers. High frequency traders only enter the market for short periods of time and will often close out any positions at the end of every trading day. As a result they do not provide the long term hedging partner needed for commercial hedgers to transfer price risk. Consequently, WDM believes that they should be closely regulated if not prohibited.</p> <p>Any regulation of this type of trading should be 'future-proofed' as far as possible to avoid provisions being circumvented by future developments in this type of trading.</p>
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	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?	<p>As described above (question 7), we are concerned that the provisions in Regulation Article 26 are inadequate to ensure that the majority of OTC trading is brought on to regulated trading venues. It is vital that this problem is addressed in the Regulation through the inclusion of ambitious binding targets for the proportion of OTC trading to be brought on to regulating trading venues (or that ESMA is mandated to produce ambitious binding targets for moving OTC trading onto regulated trading venues).</p>
	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?	

	<p>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?</p> <p>If not, what else is needed and why? Do the proposals fit appropriately with EMIR?</p>	
	<p>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?</p>	<p>Commodity derivative markets are increasingly dominated by financial, rather than commercial participants. According to an analysis of CFTC reports and other data, from 1998 to 2008, <i>“physical hedger positions have risen 90%. During this same time, speculator positions have grown by more than 1300%.”</i><sup>i</sup> Financial traders frequently make trading decisions based on portfolio concerns, such as trends in stocks or currencies, rather than on information regarding the fundamentals of the underlying asset. The extent to which this has taken place can be seen in recent reports that energy options traders are moving to soft (i.e. agricultural) commodities, highlighting the fact that trading strategies are based on the derivatives market, not knowledge of the underlying market.<sup>ii</sup> The effect of these market participants is to decrease the correlation between derivative prices and physical market fundamentals, and to increase volatility through momentum trading and certain forms of technical analysis.<sup>iii</sup> The result is that these markets’ core functions of enabling price discovery and commercial risk management are disrupted.</p> <p>As Ann Berg, former commodity trader and currently advisor to the FAO, has stressed, “Over 150 years of futures trading history demonstrates that position limits are necessary in commodities of finite supply to curb excessive speculation and hoarding.” Position limits are used on exchanges in Brazil, China, India and South Africa, and have recently been reintroduced in the US.</p> <p><b>It is vital therefore that position limits are used to curb the</b></p>

		<p><b>disruptive influence of excessive financial participants within commodity derivative markets, whether regulated trading venues or OTC. This is especially important for food commodity derivatives.</b></p> <p><b>These limits can be set to allow sufficient liquidity to allow commercial hedging while minimising the negative impacts of excessive speculation.</b> Such position limits can be used to set a sustainable balance of market participants that allows sufficient liquidity, avoids market abuse, ensures price discovery is linked to movements or information regarding the fundamentals and reduces the impact of certain ‘uninformed’ traders such as passive index funds.</p> <p>In order to be effective, Directive Article 59 must be strengthened in the following ways:</p> <p>Because trading venues make a profit from the volume of trading carried out, there is a conflict of interest in the requirement that they apply position limits. Therefore <b>Article 59 (1) should be strengthened to ensure that authorities, if not ESMA, apply ex-ante position limits.</b> The application of position limits by ESMA would ensure uniformity across the EU, and avoid the risk of regulatory arbitrage. <b>These position limits should apply to commodity derivative trading conducted OTC as well as on regulated trading venues.</b></p> <p><b>Position limits should cover spot, single and all delivery month(s)</b> to prevent the rolling of funds before the spot month. Position limits which cover all tradable months are important for the price discovery function of these markets. Article 59 (1) should be strengthened to allow this.</p>
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		<p>participants' opinions and confidence, for example in their continued ability to trade.</p> <ul style="list-style-type: none"> <li>• <b>To Article 59 (1c), “ensuring commodity markets’ core functions of enabling the hedging of commercial risk and providing price discovery for the physical market are fulfilled” should be added.</b></li> <li>• <b>Article 59 (1d) should be added “to prevent or eliminate excessive speculation”</b>, with “excessive speculation” defined as trading by financial participants which exceeds the level required to allow sufficient liquidity for the genuine hedging needs of commercial participants and which drives prices away from levels justified by fundamental factors in the market for the underlying assets.</li> </ul> <p>Article 59 (1) also fails to make provision for aggregate position limits, which would be needed to avoid excessive concentration of a single group, such as financial speculators, within the market. Such aggregate limits could be used to ensure that there is sufficient liquidity to allow commercial hedging while minimising the negative impacts of excessive speculation. Currently only individual limits are permitted which, while they could be used to prevent market abuse, would be ineffective in addressing the excessive influence of a particular category of traders. Without aggregate limits, there is a risk of traders dividing their trading activities between different entities to circumvent individual position limits. <b>Provision for aggregate limits should be included within this Article 59(1).</b></p> <p>Article 59 (3) allows the Commission to determine position limits, and exemptions to them. Given the fundamental importance of this tool to ensuring that markets function effectively and do not have negative impacts for commercial</p>
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		<p>participants, producers and consumers, we consider that this should not be left to the Commission to determine. <b>Any exemptions, which should only be granted to corporate end users so far as their activities are solely and exclusively for the purposes of genuine hedging of risks core to their commercial business, should be set out clearly within the provisions of the Directive and or Regulation.</b></p> <p>Article 59 (4) forbids national authorities from imposing more restrictive limits or alternative arrangements than those set out by the Commission. However there is a risk that, under Regulation Article 34, the Commission's actions to ensure consistency could be less than is necessary. In this case, <b>national authorities should be able to apply additional restrictions to address a threat. We therefore recommend that Article 59 (4) is deleted.</b></p> <p>WDM considers that the purpose of financial markets is to serve the productive economy. Given the way excessive speculation by financial actors has contributed to food prices spikes, causing hunger and poverty across the world, the objective of these measures should not be to make the requirements easier to apply, but to provide adequate protection for citizens and consumers from the impacts of financial markets.</p> <p>Finally, we welcome the provision in Regulation Article 35 which allows ESMA to intervene with regard to participants' position, should national authorities fail to act. However, the conditions for this in Article 35(3) could undermine ESMA's ability to act. We therefore recommend that <b>Article 35(3a) be reworded to enable ESMA to act to curb excessive speculation, and that Article 35(3c) be removed.</b> In addition, <b>ESMA should be given powers to implement position limits</b></p>
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		<p><b>on a permanent, not just temporary, basis.</b></p> <p>In addition, we are concerned that Regulation Article 34 could result in ESMA only enforcing as little action as the most reluctant national regulator, and reducing the ability of national regulators in other member states to address threats. Regulation Article 34 should be strengthened to avoid this.</p> <p>We note that position limits can only be implemented effectively if regulators have adequate resources, access to data and surveillance powers. This provides an additional reason for ensuring that the provisions for improved transparency within the commodity derivative markets are robust.</p> <p>If position limits cannot be implemented in the way described above, or regulators are not adequately resourced to ensure proper surveillance, commodity derivative trading should be limited, and products that are purely speculative and which are not needed to provide liquidity for commercial hedging in these markets, such as commodity index funds and exchange traded funds, should be prohibited.</p>
Investor protection	15) Are the new requirements in Directive Article 24 on independent advice and on portfolio management sufficient to protect investors from conflicts of interest in the provision of such services?	
	16) How appropriate is the proposal in Directive Article 25 on which products are complex and which are non-complex products, and why?	We consider that all commodity derivative products are complex, and should be considered as such according to Directive Article 25.
	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?	<p>WDM considers that the purpose of financial markets is to serve the productive economy. The events of recent years have demonstrated the serious negative impacts an unregulated financial sector can have on the productive economy, and how excessive speculation by financial actors has contributed to food prices spikes, causing hunger and poverty across the world. Thus, concerns about damaging financial markets should not be allowed to obstruct measures to protect citizens and consumers from the effects of financial markets.</p> <p>We therefore welcome Regulation Articles 31 and 32, which could be used to protect users of the food markets from investment products of practices that disrupt their operation (for example by increasing or amplifying volatility in the markets for the underlying assets).</p> <p>However, <b>regulators should be able intervene permanently to prevent harmful products and practices</b>, with pre-authorisation requirements to prevent such products or practices becoming established. <b>Justification for intervention should include protection of the public interest</b> – for example, eliminating speculative practices which contribute to hunger through their effect on food prices.</p> <p>We are concerned that the wording of Regulation Articles 31 and 32 is currently vague, with “orderly markets” and “efficiency of markets” currently undefined. <b>We consider that commodity derivative markets can only be orderly and efficient if they fulfil their primary purposes, namely enabling price discovery and risk management for commercial participants, and recommend that this be included in the definition.</b></p>

		Finally, we note that ESMA must be adequately resourced and given appropriate mandate to enable it to intervene to stop excessive speculation, market manipulation and harmful products and practices.
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?	
	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?	
	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	In order for markets to function effectively it is essential that price formation takes place through the free flow of information, and not through a small number of dealers exploiting information asymmetries to make profit at the expense of

	that competent authorities receive the right data?	<p>investors and clients. It is vital that pre- and post- trade transparency in non-equity products is introduced for both OTC and exchange-traded products to ensure that price formation can function effectively.</p> <p>We therefore welcome the provisions in Directive Article 60 for real time reporting from members of regulated trading venues. However, we have the following concerns with this Article:</p> <p>Article 60 (1) – detailed reports should be regularly provided to regulators, not just on request.</p> <p>Article 60 (1) – there is a risk that the minimum thresholds could be set too low to have an effect.</p> <p>Article 60 (1a) – <b>the weekly reports should be compiled and published by ESMA to ensure that the categories of traders are applied thoroughly and consistently.</b></p> <p>Article 60 (3) – the stated definitions are inadequate, particularly as regards “commercial undertakings”. It is important that these categories be defined across all markets according to the nature of the actor’s main business. Such a definition is included in the equivalent US legislation, and so a similar definition in the EU would avoid regulatory arbitrage.</p>
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?	<p>Effective supervision must include ensuring that the vast majority of derivative classes are traded on regulated trading venues, and adequate position reporting.</p> <p>As stated above (questions 7 and 25), the relevant articles must</p>

		<p>be strengthened as follows:</p> <p>To ensure that the majority of OTC trading is brought on to regulated trading venues, Regulation Article 26 must set out clear targets (or mandate ESMA to produce ambitious binding targets) for moving OTC trading onto regulated trading venues.</p> <p>To ensure that data is accurate and can be compared across markets, in Directive Article 60 (3) the categories of trades must be defined across all markets according to the nature of the actor's main business, as in the equivalent US legislation, and the weekly reports should be compiled and published by ESMA to ensure that the categories of traders are applied thoroughly and consistently</p> <p>Finally, we note that, <b>for competent authorities, including ESMA, to supervise the requirements effectively, efficiently and proportionately, they must be adequately resourced.</b> These resources should include a dedicated department specialising in commodity markets, akin to the CFTC in the US. If these resources cannot be provided, commodity derivative trading should be limited.</p>
	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?	<p><b>In order to avoid regulatory arbitrage, it is important that the provisions of MiFIR and MifID II are as strong as those in the US Dodd-Frank (Wall Street Reform) Act.</b> This includes the use of position limits to avoid excessive speculation in the commodity derivative markets distorting prices in the physical commodity markets. As they currently stand, the Commission's proposals are inadequate, and we therefore recommend that they be amended as described in this response.</p>

	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?	Given the considerable level of lobbying by the financial sector regarding this legislation, we consider that issues should be regulated at Level 1 rather than Level 2 to give full legal weight, increase transparency and avoid provisions being weakened.
<b>Detailed comments on specific articles of the draft Directive</b> These are included within our response to the questions above.		
<b>Article number</b>	<b>Comments</b>	
Article :		
Article :		
Article :		
<b>Detailed comments on specific articles of the draft Regulation</b> These are included within our response to the questions above.		
<b>Article number</b>	<b>Comments</b>	
Article :		
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<sup>i</sup> Michael Masters and Adam White, *How Institutional Investors Are Driving Up Food and Energy Prices*, The Accidental Hunt Brothers. 31/07/08. <http://www.loe.org/images/080919/Act1.pdf>

<sup>ii</sup> □ Meyer, G. (2011) *Energy options traders cotton on to soft commodity volatility*. Financial Times. 24/01/11. <http://www.ft.com/cms/s/0/ff5fc2ac-27dc-11e0-8abc-00144feab49a.html#axzz1C2ccJpmk>

<sup>iii</sup> UNCTAD (2009) *Trade and Development Report, 2009: Chapter II The Financialization of Commodity Markets*. United Nations. [http://www.unctad.org/en/docs/tdr2009ch2\\_en.pdf](http://www.unctad.org/en/docs/tdr2009ch2_en.pdf)

<sup>iv</sup> Farge, E. (2011) FSA does not act on commodities but says exchanges do. *Reuters*. 21 March 2011.