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.**

Response by World Economy, Ecology & Development – WEED

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World Economy, Ecology & Development - *WEED* is a Berlin based think tank and advocacy organization that has worked on global finance issues for about 20 years. It has outstanding expertise on the development impact of the global financial system. This response is part of the EU funded project "Towards a Global Finance System at the Service of Sustainable Development"). *WEED* is a registered EU interest representative organisation (Register ID number: 73788681242).

Theme	Question	Answers
Scope	1) Are the exemptions proposed in Directive Articles 2 and 3 appropriate? Are there ways	We **support the deletion of the former commodity (derivative) traders'**

	in which more could be done to exempt corporate end users?	**exemption** (Directive Article 2-1(k) old). Evidence on the trading activity of the big commodity firms suggests that these firms use derivatives much beyond their hedging needs as speculative instruments. Furthermore, they increasingly offer and advertise financial services via subsidiaries. In these two respects, they should also be treated as financial entities and be covered by the appropriate rules and authorization requirements. We are **worried about the many remaining exemptions**, especially for entities dealing on own account. Given the experience from the financial crisis that proprietary trading can be a source of financial instability and that the self-interest of dealers does not prevent financial disasters, we think that these exemptions should be deleted. We also note that the distinction between dealing on own account and for clients might be rather artificial. One example is that Deutsche Bank claims to have no proprietary trading in commodities while it is clear that it engages in proprietary trades to manage its (synthetic) index commodity funds. At least, the exemptions should be clarified as they now often read opaquely, e.g. Directive Article 2 (d) with its many negations. We welcome that the provision for **ancillary activities** is more clearly defined in Directive Article 2 paragraph 3. However, we are worried that these activities are considered “on a group basis” according to Directive Article 1 (i). Given the size of some multinational commodity firms, this may allow for huge positions. At least, it has to be ensured that all subsidiaries’ activities are taken together in calculating the level of position taking. We also wonder in general **what exactly the exemptions include**. For example, it needs to be clear that the exemption really does only cover the general authorisation provisions but not the provisions for trading venues such as position limits, or for particular types of trading such as high frequency trading. Such provisions also explicitly need to apply to the entities exempted in Article 2 and 3. (See also comment on Article 2 below).

	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?	We **strongly support regulating third country access**. We think that the level of regulation within the EU should not be circumvented by third country markets or parties in order to prevent regulatory arbitrage.
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?	We question **if it is appropriate to create a third multilateral trading venue**. One of the core lessons of the financial crisis is that modern financial instruments need strict regulation and that the markets for these instruments need to be less complex, and non-OTC and more transparent where possible. Having another trading venue only creates additional complexity. We see no reason why in general OTC trading should not be rigorously directed to the existing platforms, especially regulated markets, instead of officially approving opaque trading practices. We **wonder why the OTF should explain itself** why it does not operate as a regulated market, MTF or systematic internaliser (Directive Article 20-3). This implies that the proposal intends to limit the application of the OTF category. However, there are no clear rules in which way this limitation is intended or even enforced by MiFID. We **welcome the rule that OTF operators are not allowed to trade against**

		their proprietary capital. However, we think that the non-application of many other safeguard rules will still create problems and conflicts of interest. For example, the fact that the "conflict of interest" provision for MTFs (Directive Article 19-3) does not apply to an OTF is worrisome. The recent collapse of the US trading firm MF Global as well as the recent complaint against the New York Mellon bank due to unfavourable client orders' execution have demonstrated how big the dangers of insufficient rules for conflicts of interest and of the handling of clients' money are. We finally wonder if the provision in Regulation Article 24-3 that the respective derivatives shall be traded on all trading venues **"non-exclusive and non-discriminatory" is compatible with the non-discretion** of OTFs.
	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?	It seems hard to assess the channelling of trades as this mainly depends on the extent to which derivatives will be required by the procedure in Regulation Article 26 to be traded on multilateral platforms. In addition, there are obviously no rules that an instrument needs to be traded on one particular type as MTFs and OTFs are equally addressed in Regulation Article 24-1 (b) and (c).
	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 are **generally worried** about the effects algorithmic trading, and high frequency trading in particular, can have on market and price stability. Even if there would be only a high probability that such undesirable impact takes place, we would be in favour of banning high frequency trading from commodity markets as has also been called for by Ann Berg, former wheat trader and now FAO advisor. We welcome that OTFs also need to implement the rules of Directive Article 51 on algorithmic trading.
	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?	We recommend that **OTFs should implement all rules** of Directive Article 51 (not only in relation to algorithmic trading, as it is the case now). (See also comment on article 51 below).

	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 welcome this rule in general, however we think that there is **vast space in the application** of this rule given the procedure of Regulation Article 26.
	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 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 for commodity derivative markets are vital**, given the limited physical supply of the underlying commodities, and given the hedging and price discovery interests of commercial undertakings active on these markets. As Ann Berg, former wheat trader and now FAO advisor, 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.” A long list of academics and analysts and public bodies has uttered concerns about negative price-distorting influences of (excessive) commodity speculation by financial entities, particularly index funds (see http://www2.weed-online.org/uploads/evidence_on_impact_of_commodity_speculation.pdf). It is worth noting that position limits do not only exist and are just being reinforced in the US but also on other major commodity futures exchanges

		such as in Dalian (China), Mumbai (India), Sao Paolo (Brazil) or Johannesburg (South-Africa). As particularly the US experience before 2000 shows, commodity exchanges can function well without the massive participation of financial entities. Therefore, we welcome that a position limit rule is included in MiFID. However, the following should be taken into account in designing the rule: 1. The limits should be **ex-ante position limits**. No “alternative arrangements with equivalent effect” (Directive Article 59-1) should be allowed and thus the respective wording be deleted. The US has such binding ex-ante limits, partly set according to a formula, partly – for the most important “legacy” agricultural commodities – even lower. The CFTC has just stressed again its clear obligation to set limits (“shall set”) in its final rule on position limits from 18 November 2011. – In order to have sufficient data for the application of ex-ante limits, a transition period could be considered. 2. The limits must be **set by the authorities**, ideally by ESMA for entire Europe. If it is only up to member states to ensure that the limits are set by venues, a uniform application of limits is at risk – despite the powers ESMA and the Commission have according to the Commission proposal to ensure a coherent approach. 3. The reasons for the limits should include a **precautionary** approach, giving the authorities the clear order to “prevent” undesirable events. 4. The **reasons for the application of limits are insufficient**. The “liquidity” provision should be either deleted or amended by “for hedging activities”. We note that trading volume is not the same as liquidity as liquidity is also depending on the variety of opinions and the confidence of traders into the market. This is one of the key lessons from the financial crisis. The list should also include **“excessive speculation”** as in the US. Excessive speculation takes place, at least, if a considerable share of the contracts traded does not involve any hedger (producer/merchant/processer/user etc.) anymore. The list could also

		5. The limits need to **apply to all markets including OTC trading**. Now, they only apply to regulated markets, MTFs and OTFs and thus can be circumvented via OTC trading. The US is currently extending their position limits equally across all markets ("Designated Contract Markets" and "Swap Execution Facilities"), covering also OTC swaps as far as economically equivalent to futures and options. As also EMIR – in its latest version – will require that literally all derivatives will have to be reported, there is also the basis for applying the limits to OTC markets too. 6. The limits should **cover spot, single and all delivery month(s)** in order to prevent the rolling of funds in front of the spot month. It is often said that mainly the spot month would be important. However, all tradable months are important for the price discovery function of these markets. If e.g. index funds can built up huge positions with futures which are due in the longer run, and roll this position ahead of the spot month limit, the price can still be inflated. The current position limits at the Euronext Matif (Paris) only relate to the next two delivery months (of the five which are traded) and thus are insufficient. 7. The limits should also apply to **classes of traders,** not only to single traders. This would prevent circumvention of limits by setting up many small trading units. It would also ensure that the share of financial speculation would never cross a certain threshold. A participation of up to 25 percent would be sufficient in our view to meet hedging needs. For example, the share of Producers/Merchants/Processors/Users for the Euronext Liffe (London) Feed Wheat Contract was 73% on average (long and short) from 6 September 2011 till 3 January 2012, according to new trading data provided by Liffe (see https://globalderivatives.nyx.com/en/nyse-liffe/end-of-day-files). There is no need to allow more speculators on this market. 8. **Exemptions, if any, should be clearly defined** in the MiFID and not by the Commission (Directive Article 59-3). In the US, there is a clearly

		defined "bona fide" hedge exemption which has also been tightened with the Dodd-Frank Act. Entities that apply for the exemption need to prove that their position, amongst others, "represents a substitute for transactions made or to be made … at a later time in a physical marketing channel" and "is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise". This rule means that now in the US even some of the commodity firms trading units are counted as swap dealers and not as producer, merchant etc. anymore. Furthermore, swaps are only exempted as bona fide hedges if there is a real bona fide hedge behind them ("pass-through swaps"). 9. We welcome that **ESMA** can apply limits too. However, the long list of preconditions (Regulation Article 35, paragraph 2 and 3) might hinder effective and precautionary measures. Especially, we think that it should be sufficient that the measure simply "addresses" the threat or "improves" the authorities' ability to monitor the threat but not necessarily "significantly". However, position limits might still be too weak and circumvented by financial entities. Therefore, it would be easier and more effective to **completely prohibit the participation of certain types of traders –** such as index funds, exchange traded funds, non-specialised hedge funds or UCITS funds – in commodity derivatives markets. As said at the beginning, commodity derivatives markets can function without the huge amount of money by these funds. Accordingly, till 2007 UCITS had very strict limits on (commodity) derivative trading which have just been relaxed then. (See also comments on articles 35 and 59 below).
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	We think that **commodity derivative products in general should be**

	Article 25 on which products are complex and which are non-complex products, and why?	**considered as complex.** The commodity futures business is a highly risky and volatile one which makes it unsuitable to most investors. Products based on, and using commodity futures – like commodity index funds and commodity exchange traded funds – are complex by their very nature given the way indices and rolls of the funds are set up and work.
	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?	The **conditions of interventions should be not too manifold and restrictive** for authorities, and especially ESMA. This includes: 1. ESMA should not only be allowed to intervene "temporarily" (Regulation Article 31-1) but permanently. 2. As justification for intervention (Regulation Article 31-2) ESMA should also be allowed to take into account risks outside of financial markets, like the public interest, especially in the case of commodity derivative markets 3. The detrimental effect to the financial markets should not be taken into account as provided in Regulation Article 31-3. It is in the very nature of such measures that the might be directed against the financial markets. (See also comment on article 31 below).
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 that competent authorities receive the right data?	We think the weekly report in commodity markets (Directive Article 60) needs to be **compiled and published by ESMA**. ESMA also needs to ensure that the categories for the different types of traders are defined and applied thoroughly. If the publication and definition are left to the trading venues, there is a risk of not having comparable and useful reports.

		The provision of the breakdown should be presented **automatically**, not just on request. We **welcome the real-time reporting**, which is also being required in the US. (See also comment on article 60 below).
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?	The supervisory committee should ensure that **third country interests, including developing country interests, are duly taken into account.** This relates to all effects that activities of European markets and actors have.
	27) Are any changes needed to the proposal to ensure that competent authorities can supervise the requirements effectively, efficiently and proportionately?	Sufficient supervisory capacity is crucial for effective market oversight, particularly for commodities. Therefore, **ESMA needs to have at least a specialised unit for commodity markets**. Given the fact that the US has a single specialised body for commodity derivatives with the CFTC with a staff much bigger (675 in mid-2011) than the entire ESMA, there is a high probability that ESMA will not have sufficient means to exert any considerable control over these markets.
	28) What are the key interactions with other EU financial services legislation that need to be considered in developing MiFID/MiFIR 2?	The provisions of the **Market Abuse Directive** (particularly on commodity derivatives and OTC markets) and the provisions of the EU's funds directives, like **AIFM** and **UCITS**.
	29) Which, if any, interactions with similar requirements in major jurisdictions outside the EU need to be borne in mind and why?	As demonstrated on the position limits, there are various new and old rules from the **United States** that MiFID/MiFIR should take into account. The current position limit rule in MiFID is clearly weaker than the new US rule and thus creates regulatory arbitrage. It is also surprising that MiFID/MiFIR do not explicitly address "swaps" even though they are one of the most prominent financial instrument in today's markets and even though the US devote a large part of their regulation efforts to these instruments.
	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?	We generally are in **favour of regulating issues on Level 1** because Level 2 provisions create high potential for regulatory arbitrage between member states, and for rules being watered-down by financial lobbyists.

Detailed comments on specific articles of the draft Directive

Article number	**Comments**
2	***Add:*** 4. Exemptions under this article do not apply to the general provisions for market members and participants, such as, but not limited to, the provisions on position limits and real-time reporting.
20	***Add in paragraph 3 (in bold):*** “Member states shall ensure that Articles 24,25,27~~ and~~**, 28** **and 51…”.** ***Delete*** **paragraph 4.**
59	***Change as follows with amendments (bold) and deletions:*** “1. Member states’ **competent authorities or ESMA must determine ex-ante limits covering all trading in commodity derivatives** ~~shall ensure that regulated markets, operators of MTFs and OTFs which admit to~~ on the number of contracts which any given market members or participants**, or class of participants** can enter into over a specified period of time ~~, or alternative arrangements with equivalent effect such as position management with automatic review thresholds,~~**, in order to:** (a) support liquidity **for hedging activities**; (b) prevent market abuse; (c) support orderly pricing and settlement conditions **for hedgers**; (d) **prevent or eliminate excessive speculation.** **The limits need to apply to the aggregate position the respective market member holds both on multilateral trading venues and through over the counter derivatives which are economically equivalent. They should cover spot-month, single-month and all-months combined. They** ~~The limits or arrangements~~ shall be transparent ~~and non-discriminatory~~, specifying the persons to whom they apply and any exemptions, and taking into account the nature and composition of market participants and of the use they make of the contracts admitted to trading. They shall specify clear quantitative thresholds such as the maximum number of contracts persons can enter, taking account of the characteristics of the underlying commodity market, including patterns of production, consumption and transportation to market. **Exemptions from the limits shall be only allowed for commercial undertakings hedging a risk arising from their physical commodity business. Further details will be determined by ESMA.** **(…)** 4. Competent authorities shall not impose limits ~~or alternative arrangements~~ which are ~~more~~ **less** restrictive than those adopted

	pursuant to paragraph 3…" (Justifications see answer to question 14)
60	***Proposal for amendments (in bold) and deletions:*** “1. Member states shall ensure that regulated markets, MTFs, ~~and~~ OTFs**, investment firms and credit** institutions which admit to trading or trade commodity derivatives or emission allowances or emission allowances or derivatives thereof ~~(...)~~ provide the competent authority with a complete breakdown of the positions of any or all market members or participants, including any positions held on behalf of their clients~~, upon request.~~ **ESMA shall collect all data from the competent authorities and** make public a weekly report with the aggregate positions held by the different categories of traders for the different financial instruments traded on their platforms in accordance with paragraph 3. (…) 3. The members, participants and their clients shall be classified by **ESMA or the competent authorities** ~~the~~ ~~regulated market, MTF or OTF~~ as traders…” (Justifications see answer to question 25)
Detailed comments on specific articles of the draft Regulation	
Article number	**Comments**
1-4	“Market operator” is defined as the manager or operator of a regulated market. However, the term “market operator” is afterwards frequently used for persons operating or managing an MTF or an OTF. This seems inconsistent to us.
31:	***1. Delete*** “temporarily” in the ***title and in paragraph 1.*** ***2. Add in paragraph 2(a) at the end:*** **“or to the economy as a whole or to the public interest”** ***3. Delete*** paragraph 3(a). (Justifications see answer to question 19)
35-3	***Delete*** “significantly” before “address” and “improve”.