FESE POSITION ON THE MiFID II PROPOSAL

Executive Summary

FESE represents 46 exchanges active in Europe which enable access to EU markets for more than 9,000 companies. FESE's positions on the MiFID II Review are a result of the wealth of experience and detailed knowledge of the markets and of the activities and services provided by FESE members. In particular:

- FESE members and the financial instruments traded on their markets are fully covered by MiFID provisions. FESE members' are committed to a sound regulatory framework.
- FESE members' business has been radically influenced by MiFID I, which opened many of their services to full competition. FESE members support open and fair competition on level terms.
- The financial crisis has shown the strength of regulated market infrastructures and the importance of the safeguards provided on FESE members' platforms. The gaps identified as a result of experience of MiFID I and of the crisis should be addressed as part of the review of MiFID to ensure ongoing provision of orderly markets.

Additionally, FESE members have been proactive in identifying solutions to the lessons learned and observed in the application of MiFID I to strengthen the frameworks in place independently of the review of legislation. Examples of this are seen in equity data consolidation, where FESE has spearheaded a major industry initiative to improve data standards ahead of the MiFID II Review and FESE members have pioneered many of the cost reduction measures later proposed by the Commission on data, thus pro-actively supporting the set-up of a consolidated post-trade tape.

FESE members welcome the Commission's proposals and fully endorse the objectives supporting the revision of MIFID, as indicated in our joint press release with investors[1].

In particular, we support:

- **Recognition that Europe's main legislation on trading should ensure that all the market participants active in trading ultimately serve the real economy**, as identified by Commissioner Barnier. We believe that the Review covers many valuable areas which however require further clarification and change to help the functioning of the markets in the service of the real economy (investors and companies);
- **The Commission's overall approach to ensure that qualifying OTC derivatives are traded in a well regulated environment**, which is in line with the G20[2] recommendations, and believe this should be implemented clearly. However, standardised OTC derivatives should only be traded on platforms complying with all the multilateral trading rules (therefore we do not believe Organised Trading Facilities as proposed should be part of the acceptable venues);
- **Proposals to extend transparency requirements to bonds and derivatives**. These should be appropriately calibrated and the details set in implementation should leave no doubt that all asset classes will benefit from transparency;

[1] http://www.fese.eu/_mdb/news/MiFID%20Proposal%20Joint%20Press%20Release_FINAL.pdf

[2] The Group of Twenty, or G20, is the premier forum for international cooperation on the most important aspects of the international economic and financial agenda. It brings together the world's major advanced and emerging economies. The G20 includes 19 country members and the European Union, that all together represent around 90% of global GDP, 80% of global trade, and two thirds of the world's population.

- **Policies aimed at greater investor protection**. We support proposals that will improve the protection of all clients as well as clarifications made to the classification of clients;
- **Planned improvements to transaction reports,** as we believe supervisors need more tools to monitor the markets. FESE has been a supporter of the transaction reporting regime from the beginning and welcomes the extension in the scope of instruments covered and harmonisation of these reports (with the exception of extending the obligation to trading venues, which we believe goes against the objective of transaction reporting);
- **Measures to ensure the transparency and supervisory oversight of commodity markets**. We in particular welcome the inclusion of measures equivalent to position limits in recognition of the diversity of markets and different ways of achieving the regulatory goals;
- **Proposals designed to ensure that the fragmented trading environment produces data which is capable of consolidation in a competitive environment**. We especially welcome the pro-competition framework for consolidating the data and the improvements to the main stumbling block to consolidation, which concerns the availability, quality, reliability of OTC data and its comparability with other sources of data;
- **The fact that the Review rightly accepts technological advances in trading speed as fact, and includes mostly sensible solutions to reduce the systemic risks, counter potential of market abuse, and ensure fair treatment of clients**. We broadly welcome most of the proposals on high frequency trading (with the exception of the continuous quoting obligation – please see next section), and believe that they are complementary with safeguards already provided by FESE members on their platforms;
- **The proposal for the creation of a special type of MTF for SMEs meets with our qualified support**. The creation of a special MTF label is not likely to change the main obstacle faced by SMEs, the lack of scale to attract institutional investors. However, as long as this MTF label is not mandatory and is designed flexibly, we have no objection to it;
- **Harmonisation of the 3rd Country regime**. The EU should open its doors to investment firms, exchanges, CCPs and CSDs, etc from outside the EU only on the basis of <u>reciprocity</u> and <u>equivalence</u>. We therefore welcome the introduction of a clear 3rd country regime within MiFID based on these principles but believe it should be significantly more comprehensive than has been proposed (in particular by including a framework for a regime for trading venues).

The above summary demonstrates that FESE agrees with many of the improvements proposed by the Commission. At the same time, on a number of other issues, FESE has significant concerns with the proposals. FESE members have been active in analysing the implementation issues with MiFID I and have brought several items to the attention of the Commission or the supervisors over the last years which has led to some of the important issues being highlighted in the Review (e.g. the unregulated equity platforms). While the broader industry appears united in endorsing the Commission's overall objectives in the MiFID Review, there remains controversy regarding some elements of the proposals. This is ultimately because industry participants view the implementation of MiFID differently and draw different lessons from the crisis. The Commission has understandably tried to balance these differences and has tried to find compromises across differing views. However, we firmly believe that the outcome needs to be stronger than a compromise solution as the final legislation will determine the ground rules on how capital markets function in the real economy for the foreseeable future. We therefore think that the final legislation should be less complex, more concise and more ambitious than the Commission has currently proposed. Additionally, we strongly believe that the provisions of MiFID should be aligned with other legislation with which it might overlap (eg EMIR/RCSD/MAD) and avoid any uncertainties or arbitrage among market participants, CCPs, and trading venues.

Therefore, FESE proposes the following changes to the proposals, which, if adopted, would provide welcomed additional clarification and strengthen the draft legislation:

- **There should be a clear definition of OTC.** EU law should draw a clear distinction between activities that must be subject to full trading platform rules (i.e. trading venues – RM/MTF/SI) and those that should remain outside and subjected to intermediary rules only (i.e. OTC). This distinction should be in the form of a 'definition of OTC' and included in the main body of the legislation (Article 2 of MiFIR), not in a recital, to ensure full compliance. In the future, no platform should be able to conduct trading platform business while being exempted from trading venue rules. Experience with the original MiFID has shown that a clear and legally binding definition is necessary to achieve this goal. This OTC definition should be accompanied by clearer definitions of each type of trading platform.
- **MiFID Review should maintain the existing protections designed for all types of trading platforms. In particular, multilateral trading of equities, bonds and standardised derivatives should only happen on platforms that provide identical transparency, non-discretionary execution, non-discriminatory access, and full market surveillance capabilities.** The creation of an OTF as currently proposed would make two of these protections optional for the market, since some platforms (RM, MTF) would continue to be subject to all four measures, whereas OTFs would not have to provide either non-discretionary execution or non-discriminatory access (while potentially being held to a lower standard of market surveillance). This would have grave consequences for the quality of market regulation (as measured by proper price formation, efficiency, and fairness) as well as fair competition among trading platforms. We therefore fundamentally disagree with the view that any type of multilateral trading platform, old or new, should be exempted from these core four regulatory obligations.
- **Systematic Internalisers (SI) should remain classified as "regulated" trading venues and not moved into the OTC classification.** We accept that the SI regime should continue to be calibrated to reflect the risk assumed by the investment firms operating these platforms and therefore remain "regulation light". However, we believe that OTC should remain an exemption from SI (ie, bilateral trading should be considered as SI unless it falls into the OTC definition), as is the case in the current MiFID, rather than the reverse proposed in the new text (ie all SI being considered as OTC unless it is systematic, etc).
- **Conflicts of interest arising from the combination of roles of investment firms should be better managed.** As with RMs, which are subject to extensive conflict of interest rules, investment firms operating MTFs should be subject to strict conflict of interest rules. In addition, all organisational requirements should also be aligned with RMs.

- **Standardised OTC derivatives should only be traded on platforms complying with <u>all</u> the multilateral trading rules.** We strongly support the implementation of G-20 by requiring to trade derivatives on well-regulated trading venues. However, we believe this objective is not served if the venues for this purpose include venues that are not subjected to the key regulatory requirements of multilateral trading, ie the OTF as currently proposed. We therefore object to the inclusion of this less-regulated platform in the implementation of the trading mandate for standardised OTC derivatives.

- **The requirement for algorithmic trading to provide continuous quotes throughout the day may have detrimental effects on liquidity and may not always reflect the business model of the investment firms conducting this activity.** We would propose that this requirement be removed from legislation and that the trading platforms be allowed to utilise existing controls to manage this business.
- **Regulation relating to access for CCPs and trading venues and benchmarks must not affect the overall safety and competitiveness of EU markets negatively**. We recommend that these issues be studied further, as they have not been part of the MiFID consultation, to ensure that measures proposed do not result in negative or unintended consequences.

DETAILED REMARKS BY ISSUE

1. **Adding a clear 'definition of OTC: Why EU law needs to draw a clear line between trading activities subject to trading venue rules and regular intermediation activities (OTC)**

One of the Commission's main stated objectives in the MiFID Review is to 'capture' some of the trading activities currently labelled as OTC but which should be shifted to a regulated trading venue environment. On page 2 of the new MiFID, the Commission states, 'market and technological developments have outpaced various provisions in MiFID'. On page 7 (3.4.4) of the new MiFID, the Commission goes further, ***'Market developments since MiFID*** have partially challenged the current regulatory framework applicable to different types of execution venues (…)and ***the fact that not all modes of organised trading which have evolved in recent years adequately correspond to the definitions and requirements of the three-pronged division foreseen in MiFID – regulated markets, multilateral trading facilities, systematic internalisers – all signal the need to provide for a refinement of the present framework***. The proposals create a new category for organised trading facilities ***which do not correspond to any of the existing categories***, underpinned by strong organisational requirements and identical transparency rules, and upgrade key requirements across all venues to account for the greater competition and cross-border trading generated together by technological advances and MiFID.' (emphasis added)

To 'capture' such trading activity, the Commission is proposing the creation of a new venue category (please see next section for our views on this). While we disagree with the proposed solution, we do agree with the Commission that there is a concrete problem: **trading activity by brokers that is taking place in the OTC space which does not belong there, and which is therefore escaping trading venue rules**. For us, the right solution is to establish a clear and binding definition of OTC trading in the main body of the text (Article 2 of MiFIR). **Without a clear definition of OTC, whether a new trading venue category is introduced or not, it will make a very small difference in eliminating organised equity trading activities in the OTC space.**

One of the reasons why the Commission does not come up with the right solution is because a thorough analysis of OTC is missing from the Review. In fact, the Commission's Impact Assessment confirms that the aggregate market share of OTC in equity trading is about 38%. However, the Impact Assessment does not include an analysis of what exactly has been traded on an OTC basis since 2007 through a *trade-by-trade* analysis. Thus the Commission fails to analyse how much and what kind of business is done as OTC, and instead immediately concludes that any business currently done in the OTC space must be due to new developments and technology, implying that this could not have been foreseen or captured by any of the existing MiFID venues and must be 'legitimate OTC' according to the current text. In doing this, the Commission does not ask whether any trading happening outside MiFID venues today is in line with MiFID and may have been captured by MiFID in any way (through clearer rules or tighter enforcement).

Actually, such an analysis was in fact possible to do with the existing data and has been done in a recent study by Frankfurt University and Celent[3] based on trading that has happened in the EU since the introduction of MiFID. This study concluded that:

[3] Please see the Frankfurt University/Celent study for a more detailed legal analysis of OTC as defined in Recital 53: http://efinance.wiwi.unifrankfurt.de/index.php?id=start00

- the post-MiFID trading that has been reported as OTC is very different **in overall size** from the OTC activity envisaged in MiFID Recital 53; namely**, at about 40% reported market share**, trading on an OTC basis is much bigger than one would have expected from a category that was meant as a residual category;
- the post-MiFID trading that has been reported as OTC is very different **in nature** from the OTC activity envisaged in MiFID Recital 53; namely, the OTC label is being used essentially **for small size trades that would not face any market impact** (73% of OTC trades would not have faced market impact if executed on lit public markets);
- **about half of OTC trades** are at sizes that one would normally have expected to see subjected to SI pre-trade transparency rules if they had been bilateral and **close to 90% of OTC trades** would have been subjected to full transparency (as well as other MTF & RM rules), if they had been multilateral. In fact, **about 39% of trades reported as OTC are actually retail size** (less than 7,500 Euros).

This evidence suggests that an important amount of trading appears to be escaping the current MiFID rules on trading venues for MTFs or SIs by being labelled as OTC even though it seems to be different from what OTC was supposed to be under MiFID. The study also goes on to explain that the intention of MiFID was to capture all types of trading platforms as RMs, MTFs, or SIs. The only kind of trading that does not fit into these three categories (ie, which is OTC) is defined clearly in Recital 53, which is the basis of a definition of equity OTC trading.

In fact, while Recital 53 does provide a basic definition of OTC, due to relatively minor ambiguities in the wording and the fact that the main OTC definition is only in a recital (which is non-binding), this line between platform and OTC in MiFID has been interpreted very differently by market participants with different commercial interests. In the end, we need to conclude that the line was not clear enough and has led to a lot of uncertainty and confusion in the market. In particular, many investment firms have come to argue that they can set up trading platforms in the OTC space. This is the origin of the so-called "broker crossing networks" trading equities.

As a result, we have the following types of trading activities in the market today:

- MiFID-compliant trading platforms: RMs, MTFs and SIs[4]
- Broker crossing networks not regulated as trading platforms, subjected only to OTC rules.

These platforms claim not to be either MTF or SI for a number of different reasons, all of which result from the imperfect definitions. A number of the most common reasons cited – and our views on why these are not valid reasons - are explained in Annex 1.

We believe this situation is against the spirit and letter of MiFID, it is simply not sufficient to insist on a correct reading of MiFID. **The right solution is to use the MiFID review to clarify the intention of MiFID and to draw a clear distinction between trading venue activity and OTC business.** With a limited number of clarifications, it should be possible to re-establish the distinction which MiFID envisaged between trading venue and OTC business and to ensure that no trading activity (such as BCNs) fall

[4] Please note that, according to the current MiFID text, SI is a trading venue, and we believe this should continue to be the case. We believe that cash equities OTC should be an exemption from SI, and not the other way around. Under the new proposal, although the content of the SI rules do not seem to have changed, now the SI is classified not as a trading venue but instead as a sub-set of OTC, which we find confusing and harmful.

outside the scope of trading venues or regulation. Importantly, we believe that the existing MiFID equity venue classification is already sufficiently exhaustive to capture most types of BCN activity, which should fall under either the MTF or SI categories. Therefore MiFID does not need to be revised in any fundamental way to 'capture' BCNs. The same intended definitions should be used, but improved by eliminating any wording that creates ambiguity.

However, since the Commission does not analyse the main characteristics of OTC trading as it happens today, the Impact Assessment and the resulting proposal also fail to consider the full range of options available to deal with the problem and quickly dismiss the option of using the existing framework with clarified definitions. There is an unproven assumption that 'to capture' OTC trading, one must establish a new category. In particular, **there is no real discussion of the option of using the existing venue classifications together with a clarified distinction between trading venue and OTC business.** Instead, the Commission seems to be hoping that the currently unregulated trading business will move from the OTC space to the OTF space voluntarily, essentially because the OTF rules are so much more relaxed than the MTF rules (under which, we believe, many of these platforms should actually be regulated). If this approach works, then we will have platforms that are 'lighter regulated' instead of being 'fully unregulated', which is far from optimal. However, because the Commission does not introduce a clear definition of OTC, there is a risk that some activity might still be considered OTC and thus remain fully unregulated. Furthermore, there is a possibility that some MTFs may downgrade to OTF or new venues may choose OTF rather than MTF which will perpetuate the issues and further reduce the activity which is fully regulated.

Given the evidence on OTC trading and the difficulties encountered in the implementation of MiFID, we firmly believe that EU law should draw a fully clear distinction between activities that must be subject to full trading platform rules (i.e. rules for RM/MTF/SI) and those that should remain outside and subjected to intermediary rules only (i.e. OTC). Such a line is an essential element of any well-regulated marketplace, because it makes a distinction between two fundamentally different trading activities which must be subject to very different rules:

(1) Operating a multilateral or bilateral trading platform, and
(2) Over-the counter-trading ('OTC').

Under (1) - 'operating a multilateral or bilateral trading platform **- the operator brings together issuers and investors who want to buy and sell a financial instrument in a trading platform.** This may happen either in a 'neutral' way (the operator is never a party to any trade, so the trading is 'multilateral') or based on the operator's own trading book (the operator runs an inventory of some instruments, so the trading is 'bilateral'). A multilateral platform can be operated by a market operator or an investment firm, while the internalisation platform is run by an investment firm. The common element to both is that the operator (the word is used to denote either a market operator or investment firm) has created a 'liquidity pool' which is both advantageous for the market as a whole but also raises concerns which must be addressed with appropriate policy measures. The market as a whole wants to be reassured that any liquidity pool set up in any financial instrument will result in properly priced trades, will be accessible to all investors, and will be monitored for market integrity. While these concerns are common whether the platform is multilateral or bilateral, it is only in the case of the neutral platform that rules can be very stringent, because it is natural that an investment firm than runs his own inventory should not be subject to all the exchange rules as he is running the risk of the instrument going up or down in price. Hence, for example, both types of trading platforms should be subject to rules on pre-trade transparency to ensure proper pricing of instruments. But these need to be calibrated in the case of the bilateral (internalisation) platforms. Similarly, while all investors must have access to all multilateral trading platforms, it is accepted that a bilateral platform will take on board only its clients.

By contrast, the activity under (2) - Over-the counter-trading ('OTC') - **is fundamentally different from running a platform.** Under (2), there is no explicit liquidity pool. The investment firm is executing a large trade for a wholesale client. The trading is considered too inconsequential and is not systematic and therefore is not subject to any of the market rules. Instead, it is sufficient for the investment firm to simply comply with the usual conduct of business rules vis-a-vis the client. Under OTC, since the investment firm is trading for its clients on an ad hoc, irregular basis and only for large trades that could not have been executed in trading platforms without market exposure risk, the market as a whole is not affected by it. Hence, the activity does not have to be subjected to all the rules expected from trading platforms. Moreover, this activity is beneficial for the market, so it must be allowed without undue restrictions. **However, precisely because OTC is exempted from all the trading platform rules, the market must be sure that this regulatory flexibility is used only for large, ad hoc trades executed by the investment firm on his own account.** This means all the elements defining OTC must be present together. If the investment firm is allowed to run a multilateral or bilateral trading platform while claiming to be doing OTC business, then the activity is significantly under-regulated. If the line is not respected, then an investment firm would be able to operate a platform without any rules on transparency of orders, predictable execution, open access for investors, and market surveillance. This is why a clear, indisputable line between trading venue business and OTC business is essential for a well-regulated marketplace.

Unfortunately, this is not the approach taken by the proposal adopted by the European Commission.

Instead, the proposal includes a new recital (Recital 18 in MiFIR) based on the exact same wording of the original MiFID Recital 53. In doing so, it has not addressed any of the elements of the original uncertainties:

- The definition is again in a recital, not in the main body and can be contested legally;
- It can still be debated as to whether the definition is exhaustive or only partial (are there activities not described in the OTC definition that can nonetheless be considered as legitimate OTC?)
- Key terms are still open to interpretation (eg ad hoc, frequent, large, wholesale);
- Key characteristics of OTC are still implied and not explicit (eg bilateral);

We understand that the Commission has taken this different course of action because it believes that:

- It is not necessary to define OTC more clearly than what has been included in the new recital, as long as the trading venue definitions are clear (so that OTC is a 'residual');
- Similarly, most of the trading for which the new OTF category has been proposed in the equity area is currently happening in the 'OTC' space and therefore if the OTF category is successful in shifting trading away from OTC to OTF, then there will be no need to define OTC;
- Moreover, it is not desirable to define OTC more clearly because it would constrain the innovation in the market and/or create more loopholes around which certain market participants can develop new business models.

We disagree with these assumptions. On the contrary, we believe that:

- It is absolutely essential to establish a clear distinction between trading activities that should and should not benefit from the OTC freedoms. This distinction should be in the form of a 'definition of OTC' and included in the main body of the legislation, not in a recital, to ensure full compliance so that, in the future, no platform will be able to conduct trading platform business while enjoying the benefits of being exempted from trading venue rules. This OTC definition should be accompanied by clearer definitions of each type of trading platform, but having clear definitions of the venues is not sufficient.
- Irrespective of whether there is an OTF category or not, there needs to be a clear definition of OTC;
- Having a clear definition of OTC would not constrain innovation; it would simply establish a clear line between the kinds of trading that should and should not be subject to trading platform rules.

FESE RECOMMENDATION:

- **We propose:**
    - **Introducing in Article 2 of MiFIR, ie the main body of the text (and <u>not</u> in Recital 18), a clear definition of what trading activities are allowed and not allowed in the OTC space (which is exempted from all market-facing rules); this definition should include the concepts already present in the current MiFID but be made more explicit: bilateral, ad hoc, irregular, large trades with wholesale counterparties. Each of these terms should also be defined clearly: bilateral, ad hoc, irregular, large trades with wholesale counterparties.**
    - **Clarifying that the combination of (for example) multilateral trading and bilateral trading in the same platform does not exempt the operator from both RM/MTF and SI rules and therefore does not qualify as OTC;**
    - **Clarifying the definitions of RM/MTF and SI (as was the case in MIFID I) to ensure that all trading which is functionally identical is subject to identical obligations and rules (please see answer to next question) to ensure that all trading which is functionally identical is subject to identical rules. The RM and MTF definitions should not refer to 'non-discretionary execution' and focus only on defining the attributes of multilateral trading. The SI definition should be clarified to capture all systematic bilateral trading business.**
    - **Clarifying that, to comply with the G20- trading mandate, standardised derivatives should be traded on RMs and MTFs, and not on OTFs.**

2. **On-market trading: Properly distinguishing between multilateral and bilateral trading and applying the principles of proper market regulation and 'same business, same rules'.**

As explained above, the most important contribution of the MiFID Review to a well-regulated market will be to introduce a clear definition of what trading activities should and should not be conducted utilising the OTC freedoms in the main body of the MiFID text. This should be based on existing definitions with additional clarifications. Once this is clarified, the next step is to ensure that all trading venues are subject to proper rules. This requires properly distinguishing between multilateral and bilateral trading and applying the principles of proper market regulation and 'same business, same rules to platforms that carry out multilateral and bilateral trading.

Again, **the regime established by the current MiFID is by and large satisfactory, and must not be changed** – it **only needs to be clarified.** MiFID already requires anyone running a RM/MTF (multilateral) or SI (bilateral) to do this business subject to a set of safeguards intended to ensure that any liquidity pool set up will result in properly priced trades, will be accessible to all investors, and will be monitored for market integrity.

Namely, **according to the current MiFID**, the protections to be provided by all trading venues are as follows:

- **All <u>multilateral</u> trading platforms must be subject to the following key public safeguards:**
  - Pre-trade transparency
  - Post-trade transparency
  - Non-discretionary execution
  - Open and fair / non-discriminatory access:
  - Market surveillance
- **All <u>bilateral</u> trading platforms must be subject to the following key public safeguards:**
  - Pre-trade transparency
  - Post-trade transparency
  - Non-discrimination within client categories

Unfortunately, in the proposal, the Commission deviates from the existing functional regime in a fundamental way by creating an additional category (OTF) for multilateral trading and proposing that OTFs will be subject only to:

  - Pre-trade transparency
  - Post-trade transparency, and
  - 'Adapted' or 'proportionate' market surveillance,

But <u>not</u> to:

  - Non-discretionary execution[5]
  - Open and fair / non-discriminatory access[6]

In other words, the introduction of an OTF category as proposed would mean that the multilateral trading of any financial instrument (equities, bonds or standardised derivatives) would occur subject to different rules when executed within a RM/MTF as opposed to an OTF – in our view, an OTF would entail serious problems for proper regulation and fair competition. Specifically, under the RM and MTF rules, this trading would be subject to all the key market-facing obligations (identical transparency, non-discretionary execution, non-discriminatory access, and full market surveillance capabilities), whereas when the operator decides to opt for an OTF category, the trading would be subject to only some of these obligations (notably, the OTF would have the ability to use discretionary execution, discriminatory access, and potentially lower market surveillance).

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[5] Among others, see p. 7, MiFIR.

[6] See Recital 12 of the new MiFID which states that OTFs should be able to 'determine and restrict access' based inter alia on their relationship with their clients.

We do not see any need for an OTF category for the purpose for which it has been proposed (ie, to capture multilateral trading business currently escaping the MTF definition). We believe that any multilateral trading in any asset class has to be subject to the same market-facing rules and these should include identical transparency rules, non-discretionary execution, open & fair/non-discriminatory access, and market surveillance.

By contrast, the proposal is based on the assumption that 'to capture BCNs' (or 'to implement G20' with regard to the trading of qualifying OTC derivatives), it is necessary to establish a new trading venue category. However, this is just an assumption based on the view that the existing framework (with certain clarifications) could not be used for the same purposes. Consequently, the proposal leaves the existing framework as it is, with the main sources of misunderstanding regarding OTC intact, as explained earlier. Hence, while acknowledging that there is trading happening outside MiFID venues, the Commission appears to assume that, going forward, any trading happening outside MiFID venues today should continue to be treated ***as different*** from the trading happening on the 3 main MiFID venues and be exempted from at least some of the trading venue rules. In taking this approach, the Commission also seems to reject the main recommendations of the European Parliament's Report 'Regulation of trading in financial instruments – "dark pools" etc' on equity market structure, OTC and broker crossing networks from December 2010. There is a fundamental clash between the assumptions made in the proposal and the Parliament's views.

Since any investment firm that wants to run a trading platform can choose to be licensed as MTF or OTF, the full effect of the proposed OTF is **to make non-discretionary execution and open and fair / non-discriminatory access <u>voluntary</u> options in the EU regulatory regime**. Investors will not be able to expect the same protections from all trading platforms. Depending on whether the platform is run as a RM/MTF or OTF, the investor may not have access to a platform, and even if he has access, he may not have predictable execution.

While not stated explicitly, the Commission's reasoning for creating a lighter-regulated OTF regime seems to be based on the following implicit assumptions:

- *Transparency is the most important public safeguard, and as long as this is in place, the absence of other rules is less important*; and
- *It is not appropriate/necessary to impose execution and access rules on OTF business because they will be doing a different business than RMs/MTFs and this business is good for Europe (ie good for choice, etc)*.

We acknowledge that, if trading is currently happening in the OTC space but which has the characteristics of trading venue and it were to be subjected to at least some of the trading venue rules, this would constitute an improvement over the current state of affairs. While we commend the Commission for having proposed identical transparency rules for OTFs as for RMs and MTFs, we fundamentally disagree with the proposal of switching off the two key requirements on execution and access for OTFs. We think that a trading platform should provide <u>all</u> of these protections, and <u>not</u> just a sub-set of them, because they all fulfil different functions and are needed as a whole. Hence they should not be made voluntary but remain mandatory. In fact, these four basic rules are inter-related: For example, pre-trade transparency without non-discretionary execution is not particularly helpful to safeguard the efficiency of the price formation process.

FEDERATION OF EUROPEAN SECURITIES EXCHANGES

We are also aware that the Commission believes that the implementation of the G20 mandate requires the introduction of a new category. We disagree with this view, since the EU framework already has two types of multilateral trading – RMs and MTFs – that can be used for meeting the G20 objective.

We believe that a much better approach would be to ensure that all functionally identical trading is subject to the same rules. This can be done through (1) drawing a clear line between trading venue and OTC business and (2) clarifying the existing definitions of trading venues.

We believe in maintaining MiFID's principle of strict regulation of all multilateral trading platforms. Any such venue should operate on a level playing field with other multilateral trading venues, and in particular, should not be allowed to execute orders on a discretionary basis, trade on own account or to restrict access to selected clients. A more in-depth analysis of why these measures are needed is included in Annex 2.

FESE RECOMMENDATION:
We recommend that either the OTF category is eliminated from MiFIR Article 2, Para 1, (7); or, *if it is kept*, the following modifications are made to its regulatory framework:

- **OTFs also have to provide non-discretionary execution;**
- **OTFs also must provide open and fair / non-discriminatory access;**
- **Duty to conduct market surveillance within the trading venue (must be the same level of surveillance as for RMs and MTFs, and not be 'proportionate/adapted' to the venue)**

Meanwhile, for the reasons explained above, we strongly agree with the inclusion of the following rules for the OTF regime, including:

- **Identical transparency requirements as for RMs and MTFs**
- **Separation of proprietary trading and client business (with the former being regulated as an SI and the client business going to an MTF or OTF)**

We acknowledge that, with the changes we recommend, it would not be necessary to have a separate OTF category, since it would be subjected to the same rules as an MTF.
Finally, we believe that the revision of MiFID should also serve to establish a level playing field between RMs and MTFs.

3. Managing conflicts of interest arising from new trading platforms.

We have some comments on the rules for RMs versus MTFs from the perspective of fair competition and conflicts of interest that could undermine investor interests. New venue entrants have been exclusively user-sponsored, and among these user-shareholders, high frequency firms dominate – so now over 1/3 of lit volumes take place on user-owned platforms. There is nothing wrong with this as such. However, these platforms have appeared to operate business models that are structurally unprofitable as stand-alone corporate entities, but at the same time they are ultimately revenue-generating for their shareholders who earn indirect rents from them, notably in the form of (i) maker taker pricing (ii) control over market structure and (iii) fee reductions from incumbent markets.

We call for a clear regime for managing conflicts of interest for investment firms that operate platforms; Regulated Markets are subject to substantial conflicts of interest regulation. The accumulation of roles

in investment firms operating MTFs include: (i) operating a platform (ii) providing own account flow to that platform (iii) providing client flow to that platform (iv) operating automated routing arrangements between the platform and the firms' own books and finally (v) being responsible for the market supervision and integrity of the platform.
(Please note that we agree with the Commission's proposal to prohibit own account trading by the operator of an OTF, which is consistent with the principle of neutrality described in this section. However, since we also disagree with the proposal of an OTF as currently designed, we limit our remarks here to RMs and MTFs only).

In addition, we believe that RM and MTF rules have to be further aligned. MTFs were given an explicit helping hand in MiFID I and in supervisory application with 'proportionate' regulation: lighter organisational requirements, market surveillance and systems resiliency. MiFID has been successful in creating MTFs that now have volumes equivalent to or larger than most exchanges. Accordingly, we call for identical rules between RMs and MTFs as the latter can no longer be classified as start up enterprises and allowed the benefits of reduced obligations. Hence, all organisational requirements on MTFs (eg market surveillance, access) should be identical to RMs, as well as any wording that could be the source of double standards (eg the reference to surveillance requirements being 'proportionate'[7] to the business model) should be eliminated.

FESE RECOMMENDATION:

- **We recommend a clear regime for managing the conflicts of interest for investment firms that operate platforms.**
- **In addition, all organisational requirements on MTFs (eg market surveillance, access) should be identical to RMs, as well as any wording that could be the source of double standards (eg the reference to surveillance requirements being 'adapted' or 'proportionate' to the business model) should be eliminated).**

4. Implementation of the G20: EU law should require qualifying OTC derivatives to be traded in a well-regulated environment in line with the EU's commitment to G20.

The MiFIR proposal suggests OTC derivatives should be traded in a well-regulated environment. Given their link with the financial crisis, there are a number of different reforms needed to improve the functioning of OTC derivatives. In addition to reforms on risk management through post-trading and capital adequacy, it is also necessary to improve the transparency, safety and liquidity of standardised OTC derivatives markets by obliging standardised OTC derivatives to be traded on a RM or MTF (Article 24 of MiFIR). We therefore fully welcome the Commission's proposal to mandate these derivatives to be traded in a strictly regulated environment. We also agree with the proposal to establish a legal obligation to CCP-clear all derivatives traded on regulated venues (this being already the case for derivatives traded on RMs).

[7] MAR Recital 21- *In order to ensure uniform market conditions between trading venues and facilitiessubject to this Regulation, operators of regulated markets, MTFs and OTFs should be required to adopt **proportionate** structural provisions aimed at preventing and detecting market manipulation practices. (emphasis added)*

However, the inclusion of the newly proposed OTFs in Article 24 contradicts the Commission's objectives. Standardised OTC derivatives should only be traded on platforms complying with all the multilateral trading rules. This objective is not served if the venues for this purpose include venues that are not subjected to the key regulatory requirements of multilateral trading, ie the OTF as currently proposed. We therefore object to the inclusion of this less-regulated platform in the implementation of the trading mandate for OTC derivatives. Specifically, standardised OTC derivatives that are traded on a multilateral basis cannot be considered to be traded in a well-regulated environment if there is no requirement to have non-discretionary execution (or non-discriminatory access). The absence of non-discretionary execution, for example, would severely undermine the price formation process, undermine the safety of clearing of these instruments, and also make pre-trade transparency less useful. (Please see Section 2 for detail).

It is also not necessary to subject "clearing eligible" OTC derivatives to any further tests (such as **liquidity tests**) prior to determining that they are suitable for exclusive trading in a multilateral trading venue. This is because to be deemed eligible for clearing, OTC derivatives will have to meet the criteria for multilateral trading – i.e. the need to be suitably standardised and capable of being valued on a continuous basis. This is the approach that has been taken under the Dodd-Frank Act. Moreover, any liquidity test is likely to be backward looking, not forward looking. Multilateral trading, for instance on a RM, would further enhance the liquidity of OTC derivatives because of the participation of specialist proprietary trading firms which are excluded from the OTC environment but which typically provide up to half of the liquidity in products traded on RMs. Liquidity tests are therefore likely to significantly underestimate the liquidity of an OTC derivative were it to be traded on a RM or MTF.

FESE RECOMMENDATION:

- **Towards the objectives of increasing transparency, safety and liquidity of OTC derivatives markets, we support articles 24 and 26 of the MiFIR proposal, with the exception that trading on OTFs should not satisfy the trading mandate for standardised derivatives.**
- **Moreover, it is also not necessary to subject "clearing eligible" OTC derivatives to any further tests (such as liquidity tests) prior to determining that they are suitable for exclusive trading in a multilateral trading venue.**

5. The Review should introduce transparency for bonds and derivatives.

The crisis has shown that transparency is a vital element of well-functioning markets, even and perhaps especially during periods of stress. This has challenged previously existing assumptions about the lack of usefulness of transparency in non-equity markets. Just like equity markets, non-equity markets should also be subject to transparency rules, with appropriate exemptions and delayed reporting mechanisms as are provided in equity markets. While we fully support the proposal, we also believe that MiFID II needs to give more guidance as to how these requirements should be implemented at Level 2.

FESE very much welcomes the proposal of requiring pre- and post-trade transparency for all bonds admitted to trading on a RM, or MTF (or OTF) or with a prospectus. Based on our experience, we fully believe that properly calibrated pre- and post-trade transparency regimes should apply which will benefit all market participants, in particular investors. We fully support that price, volume and time of the transactions executed should be made public. Post-trade calibration should be based on elements, such as the nominal value of the transaction based on the outstanding size issue – i.e. size of the trade relative to the size of the issue and the level of recent trading in that issue.

As for derivatives, we again strongly welcome pre- and post-trade transparency as a principle. The European Commission's proposals are in line with the G20 objectives of providing further transparency to the OTC derivatives markets. Nonetheless, as with bond markets, it is inappropriate to envisage a mere extension of requirements from one market to another. We welcome the suggestion to apply such a transparency regime by type of derivative product/market as we consider that some calibration may need to be performed because products/markets are very different from one another.

FESE RECOMMENDATION:
Towards the goal of ensuring adequate transparency for bonds and derivatives markets, we support the general approach described in articles 7, 8, 9 and 17 of the MiFIR proposal. Further details should be defined in Level 2.
More generally, the list of pre-trade transparency waivers should be adopted in a Level 1 text (MiFIR) and only technical details should be left to Level 2 texts. In addition, the consistency of the implementation of these waivers should be ensured by enabling ESMA to issue binding opinions on the use of these waivers by national competent authorities.

6. Ensuring fair pricing and integrity of commodity markets.

FESE Members note the proposal to oblige trading venues to apply 'position limits' or 'similar arrangements' to market members or participants in order to support liquidity, prevent market abuse and support orderly pricing and settlement conditions. In fact, commodity markets represented by FESE already apply these types of regimes, which are supervised at national level and tailored to the specific needs of the commodity type that is traded in every market. These regimes can be classified into three different categories:

- **Position Management**: Ongoing system that allows intervention when appropriate or necessary, in particular as the settlement time of physically settled commodities approaches. This mechanism is intended to prevent settlement squeezes while not interfering with the legitimate hedging requirements of physical market users.
- **Delivery limits**: Systems that limit the quantity of physical commodities that can be delivered on expiry and the size of the associated positions that can be held in the weeks approaching that expiry.
- **Lending Guidance**: Specific tool to the LME to deal with LME's daily settlement requirements (other regulated markets have monthly or less frequent contract settlement) which relieves short-term pressure on the delivery mechanism.

We can agree with the Commission's proposal as long as it acknowledges the existing diversity of methods to achieve the same objectives. It is important that the EU should not simply opt for a regime based on 'US-style position limits' exclusively, because this is only one of several equally valid methods and it will not be suitable for each and every market in Europe.

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The proposed Directive also gives powers to competent authorities to impose position limits or alternative regimes in extreme situations, which again finds our approval.

FESE RECOMMENDATION:
In order to ensure fair pricing and integrity of commodity markets, we support Article 59 of the MiFID proposal as long as it continues to acknowledge that there are alternative regimes to 'US-style' position limits aimed at supporting liquidity, preventing market abuse and supporting orderly pricing and settlement conditions.

7. Transaction reports: Improving the information that supervisors have about trading activities.

The MiFIR proposal requires that investment firms, approved reporting mechanisms (ARM), RMs, MTFs, OTFs and trade repositories shall report details of transactions as early as possible or no later than the close of the following working day. These transaction reports must include greater detail, including: the names and numbers of the instruments, quantity, dates and times of execution, prices, identity of the clients, identity of persons and computer algorithms responsible, and identity of the investment firm. For transactions not carried out on a RM, MTF or OTF, the reports shall also include the identity of the type of transaction that took place. ESMA will be charged with drafting technical standards on the information to be reported and the definition of the most relevant market in terms of liquidity.

The obligation to report shall not apply to financial instruments not admitted to trading or traded on an MTF or an OTF, or whose value does not depend on or that might affect a financial instrument admitted to trading or traded on an MTF or an OTF.

Under MiFID I, the transaction reporting (TR) obligation only applies to EU-regulated investment firms. A broker from a 3rd country, if not registered as an investment firm under MiFID, is not under an obligation to report their transactions to a regulator in the EU. The Commission has therefore proposed in MiFIR that the EU Regulated Market on which a third country firm is trading should be required to fulfill this obligation. Currently, RMs facilitate the reports on behalf of members' obligations as a service to their members, but only covering the transactions of their trading members and not fulfilling a regulatory obligation for themselves. The Commission's proposal to require the RM to report either the third country firm or their end client is unworkable. **We disagree with the new proposal to extend this requirement to trading venues because it will be difficult for trading venues to obtain all the necessary information to do the detailed reports.** Moreover, we believe that it is an **unjustified** change to the basic rationale of transaction reports, which are there to serve the supervisors' ability to detect market abuse based on information from the intermediaries. The RMs already contribute a lot to market surveillance through their obligations to monitor their markets; adding any part of the provision or policing of the transaction reports to these obligations would be **unfair and impracticable**.

FESE RECOMMENDATION:

- **Towards the goals of improving the quality of transaction reports, we support the Commission's proposal: In particular, we agree that these reports should become more harmonised and should cover a greater degree of products.**
- **We also agree that this reporting should not be applicable to derivatives listed on-exchange and not traded on an MTF (or OTF) as it is much more useful to have position reporting in place for these instruments. We support the proposal contained in Articles 21, 22, and 23.**
- **However, we strongly oppose the extension of any element of the reporting requirement to trading venues.**

8. Equity data consolidation: Achieving meaningful market data consolidation in a multi-venue world.

MiFID has promoted competition which has yielded significant benefits for European markets, but also resulted in fragmentation of liquidity. This fragmentation, however, can be addressed by market data consolidation, which in fact has already been provided very successfully by market data vendors before the introduction of MiFID I (the reliable and high-quality consolidation of market data from the German market, which was already fragmented along different trading venues before MiFID I, being one of the best examples).

Meaningful and useful data consolidation, however, requires data of similar quality. If data differs in terms of quality and reliability, data consolidation will not be able to provide a reliable and usable stream of data. The real problem regarding sensible consolidation is the inferior quality and availability of OTC data after the introduction of MiFID I. The shortcomings are as follows:

a) OTC data cannot be consolidated if it is posted on a web-site only. Therefore we welcome the introduction of the APA regime.
b) OTC data is unreliable due to the fact that trade data is either not being published or, alternatively, published several times. The reason is the lack of pan-EU harmonised reporting requirements clearly defining which trades have to be reported and which do not have to be reported, creating significant uncertainty for the reporting parties.
c) Trade publication can be delayed up to several days making a real-time data view/feed difficult to use for practical purposes.

In order to come up with a meaningful consolidation, OTC data shortcomings must first be addressed. In this context, FESE strongly supports the proposed APA regime. However, in order to address the problems described under b) above, FESE strongly recommends that the EU Commission introduces Pan-EU harmonised OTC Post-Trade transparency requirements at a very detailed level. ESMA could play a major role here.

A competitive, multiple consolidator framework as proposed by the Commission is based on the spirit of competition promoted by MiFID I and is in line with technological improvements which have been experienced during the last years. We therefore fully support this approach.

The key is to create common standards which will allow different Consolidated Tape Providers to offer the same complete picture. Exchanges have led an industry initiative which is offering a practical solution to create standards before MiFID II comes into force. We believe that the proposals made by the Commission are mostly complementary with the steps we have taken.

Finally, we note that the proposal rightly recognises that it is too early to introduce a regime for consolidating non-equity data (new MiFID Recital 113). However, the section on the CTP regime seems to include non-equity instruments. We assume that this is a mistake and needs to be corrected. We believe that the introduction of a consolidated tape regime in equity will help the industry to gain experience and to analyse whether there is the need for a consolidated tape and any accompanying measures for non-equity financial instruments. At present such a tape is not deemed necessary because of the way in which these other markets are structured.

FESE RECOMMENDATION:

- **We are fully supportive of the Commission's choice of a multiple consolidator model, which will be the basis for competition and innovation. In order to support this approach, the development of standards are the right way forward and FESE is actively promoting this.**
- **We generally agree with the steps proposed to improve OTC data availability, quality, and comparability. However, we would like to point out that a significant issue has not been covered by MiFIR yet. In order to create more reliable OTC market data, it is essential that harmonised OTC trade publication rules will be implemented on a pan-EU level. This could be done via another delegated act to be introduced by the EU Commission.**
- **Furthermore, the rather heavy regulation of CTP Providers should be re-considered as this might result in unintended consequences, e.g. work as an entry barrier to a broader adoption by multiples of Consolidated Services Providers due to additional costs involved. Articles 65, 66 and 67 of the MiFID proposal may need to be revised slightly to avoid a cumbersome regime for CTPs which may keep some providers away from the business.**
- **Regarding non-equities, we agree with Recital 113 of the new MiFID that the introduction of a consolidated tape regime in equity will help the industry to gain experience to analyse the need for a consolidated tape and any accompanying measures for non-equity financial instruments. At present such a tape is not deemed necessary because of the way in which these markets are structured. Any part of the proposal that contradicts this general principle by extending such measures to non-equities should be amended.**

9. High frequency trading: Balancing the technological advances in trading speed and the wider public's needs.

FESE has been a supporter of ESMA's guidelines on high frequency trading. We welcomed the introduction of these guidelines ahead of the MiFID Review to ensure that all steps are taken to strengthen the safety of EU markets at the earliest possible moment. Many of the necessary improvements were already possible in the context of the current MiFID and have already been adopted by ESMA. The MiFID Review gives the EU an additional opportunity to identify the few additional areas where the current framework needs to be changed. Our views on the proposed measures are outlined below.

Enhanced regulation for investment firms:

We agree that all firms involved in HFT must be registered as an investment firm in order to do this business.

In order to ensure a robust market, it is vital that these firms must have in place effective systems and controls to monitor and ensure that their trading systems cannot be used to intentionally conduct abusive behaviour. In accordance with this, firms could submit a description of the nature of their algorithms to the competent authority to ensure that they are not abusive in nature.

What is a concern in the proposed text is the provision for investment firms operating an algorithmic trading strategy to be obliged to remain in continuous operation throughout the trading day by providing quotes at competitive prices, regardless of prevailing market conditions. We believe that this obligation will force a significant part of the market that is not currently employing a market making business model to become a *de facto* market maker. In practice this will not only affect HFT firms but any investment firm operating algorithmic trading strategies and therefore have unintended consequences. We believe that this would have grave consequences for the markets in terms of systemic risk with increased order flow and for credit risk as firms are forced to provide quotes. We believe that the market making mechanisms imposed by the trading venues would be a better way of meeting the Commission's goal, which is to ensure that high frequency traders remain committed to a market as much as possible. Besides, market abusive behaviour is already addressed in the proposed revisions of the Market Abuse Directive.

Proposal for trading venues to reinforce what is already in place

Towards the objective of ensuring integrity and their efficient functioning of their markets, FESE exchanges already have in place many of the provisions that are proposed in the Commission's MiFID proposal. In this regard we agree with the formal introduction of circuit breakers, the ability to halt trading or to block erroneous trades that are too wide off the given spread. However, we are not able to identify all erroneous trades ("fat finger syndrome") and reject them as currently described and proposed in MIFID. Similarly, we agree that all trading venues should have the ability to deal with peak orders and message flows and to have effective business continuity arrangements as this is essential to ensure the proper functioning of markets. Exchanges also welcome the proposal to have in place transparent, fair and non-discriminatory rules on co-location services and fee structures.

Regarding the proposal to limit the ratio of unexecuted orders to transactions, slow down order flow and to limit the minimum tick size, we do have certain suggestions. We believe that any calibration on the ratio of unexecuted orders to transactions and to slow down order flow should not be a one-size-fits-all approach and that this should be set by each individual market. This is due to the different functioning of each individual market and the need to take into account the specific client base that exists on them. Concerning tick sizes, we believe that the problem with tick sizes is not harmonisation of content (ie tick sizes) but implementation of agreed tick sizes. We would welcome any role that could be played by regulators to ensure that all markets are subject to a tick size regime agreed by the industry, as happened in 2009 and continues today.

FESE RECOMMENDATION:

- **Towards the goal of ensuring a robust and efficient market, we broadly support the provisions in Articles 17 and 21. Many of these are already in place today and we welcome their introduction across Europe.**
- **However, we do believe that certain aspects need to be properly calibrated and that a one-size-fits-all approach should be avoided. In particular, we believe that the Commission should review Article 17(3) on continuous quoting obligations and instead consider relying on the efficiency of the market-making mechanisms already in place on many trading venues.**
- **Finally, it would not be reasonable to expect that any system can identify all erroneous trades ("fat finger syndrome") and reject them, as currently described and proposed in MiFID. This requirement would have to be re-formulated in a way that focuses on having the right system but not necessarily an absolute outcome.**

10. New regime for SME MTFs: Not necessary to address the difficulties faced by SMEs, but acceptable if voluntary and flexible.

FESE has been very active on SMEs in the last year, working with both Commissioner Barnier and Commissioner Tajani. We welcome the joint action plan just published by the two Commissioners. Our members' long experience shows that there is a market failure in SMEs accessing capital markets and that the main obstacle is the lack of scale to attract institutional investors. In our experience, the current range of venues – RMs and MTFs – already fully satisfies the needs of SMEs as issuers and provides a well-regulated trading environment to investors. The real source of the problem with regard to market failure to attracting investors within the Single Market is not the reputability of the venue (RM or MTF) but the lack of scale of the SME listed on these venues, as well as a set of issues related to scale (eg the difficulty of getting research on small companies). These problems are not likely to be solved through the proposed 'quality label' of an MTF dedicated to junior markets.

FESE RECOMMENDATION:
Based on our members' vast experience with SMEs, the 'MTF quality label' is not needed and is not going to solve the real problems that SMEs do face in accessing capital markets. However, if it goes forward, we believe that its requirements should be carefully set with proper industry input and that it should remain voluntary for MTFs to attain this label or not.

11. 3rd Country Access: On what basis should we open our doors to the brokers, exchanges, CCPs, etc from outside the EU?

The current MiFID text was drafted without introducing a European approach to 3rd country service providers. As long as a supervisor did not give a 3rd country provider more preferential treatment than an EU entity, it was permitted to grant it access to the Single Market based on its evaluation of the 3rd country's regulatory framework and to set the conditions of access for such entities to its market. This resulted in inconsistent practices which may have harmed both the EU investors and disadvantaged EU entities who apply the EU rules. The Commission's proposal of finally unifying this regime is therefore most welcome and appropriate given the level of harmonisation of the EU Single Market at this stage.

We fully agree with the Commission that an EU regime for 3rd country providers should be firmly based on **equivalence** (similar outcome in all the main areas of market regulation) and **reciprocity** (openness to other countries being conditional upon them being open to EU entities).

However, the Commission's proposal will need to be amended to become a fully functional 3rd country regime that meets EU's needs today and in the foreseeable future. First, the proposal as currently stated will harmonise only <u>some</u> aspects of 3rd country access to the EU while leaving other, important areas unharmonised. While some services provided by 3rd country investment firms will fall under the new regime, it is not entirely clear whether other activities of investment firms (such as when they serve professional clients or when they operate trading venues) will be covered. We assume that the Commission intends these areas to be covered, and therefore suggest that this intention be made more explicit.

Moreover, in the selected areas that are being harmonised, the application/switching off of the EU rules that have been proposed may need to be re-considered because they may undermine investor protection and market monitoring. For example, it is not entirely clear whether investment firms servicing European eligible counterparties will have to do any public transparency or transaction reporting to the EU supervisors. We assume that the Commission's intention is to apply these measures, and therefore again suggest that this be made more explicit in the text. Otherwise we would have a loophole that would hamper fair asset price formation and market oversight by depriving the EU of key public and supervisory data on big volume business.

More importantly, none of the authorisation and regulation activities of market operators of trading venues will be covered. In all these cases, the new MiFID/MiFIR will miss a major opportunity by leaving it to Member States to determine access to the EU. Even if the timeframe for these areas may need to be different than the regime for other services, we believe that the new MiFID/MiFIR needs to set a framework for this work to be carried out in the future.

Finally, on certain issues – such as the assessment of equivalent reciprocal treatment - we believe MiFID II needs to give more guidance as to how the European Commission will achieve this at Level 2.

FESE RECOMMENDATION:

- **We support the Commission's proposal; in particular we agree that the principles of equivalence and reciprocity as the conditions of access should be retained.**

In addition, we believe that it needs to be improved as follows:

- **Make it explicit that the harmonised regime will extend the scope to cover all, and not only some, of the activities and services regulated by MiFID (ie to extend it to investment firms carrying our services to professional investors, investment firms carrying out the activity of operating a trading venue, and market operators operating trading venues);**
- **Make it explicit that the regime will apply the key EU rules to investment firms providing services to eligible counterparties, including public transparency and transaction reporting; and**
- **Provide political guidance not only for the regulatory/supervisory equivalence assessment, but also that of equivalent reciprocal recognition.**

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<u>Annex 1</u>: Are Broker Crossing Networks covered by MiFID today?

Due to relatively minor ambiguities in the wording and the fact that the main OTC definition is only in a recital, the line between platform and OTC in MiFID has been read very differently by market participants with different commercial interests. In the end, the line was not clear enough and has led to a lot of uncertainty and confusion in the market. In particular, many brokers have come to argue that they can set up trading platforms in the OTC space. This is the origin of the so-called "broker crossing networks" trading equities.

As a result, we have the following types of trading activities in the market today:

- MiFID-compliant trading platforms: RMs, MTFs and SIs
- Broker crossing networks not regulated as trading platforms, subjected only to OTC rules.

These platforms are claimed not to be either MTF or SI for a number of different reasons, all of which result from the imperfect definitions. A number of the most common reasons cited – and our views on why these are not valid reasons - are as follows:

- *'The platform is <u>both</u> multilateral and bilateral, because it is hybrid (ie mixing client orders with own trading book). Therefore it should be subject to <u>neither</u> MTF <u>nor</u> SI rules.'* This is not a legitimate reason to be in the OTC space, because if the business is hybrid, then the platforms should be split into an MTF and SI and each element should be regulated properly.
- *'The platform is multilateral but not subject to MTF rules because it is not following one of the MTF rules, ie the one requiring non-discretionary execution'*. The confusion comes from the fact that the non-discretionary execution requirement is included both in the rules for MTFs and in the MTF definition. It is easy to address by simply keeping the reference to the rule in the requirements to be followed by MTFs but deleting it from the definition of an MTF. Then the platform would be correctly captured as an MTF and then be subject to all the MTF rules, including predicable execution.
- *'The broker crossing network is bilateral but not really a platform, since we only execute occasional client trades'.* By definition, an established organised platform run on a broker's own account should be considered as systematic and regular, and therefore not qualify for the OTC definition. It should be an SI.
- *'The platform is there to meet the needs of the large buy side'.* A platform executing exclusively large orders should be either an MTF (if the operator is not taking on a risk) or an SI (if the broker is running his inventory). If the platform is an MTF, then the large order must be subject to all the MTF rules (in which case a large BCN trade will be allowed to be dark before the trade is executed if complying with the MiFID waivers, but it will be subject to other trading platform rules on access, execution and surveillance), as opposed to benefitting from all the OTC flexibilities. If it is an SI, then it will be exempted from the pre-trade transparency rules because of the size of the trade, but it will be subject to other SI rules. The only case in which a large order will not be either MTF or SI will be if the broker is taking on risk <u>and</u> not doing this on a regular basis. Moreover, evidence calls into question whether BCN trades are even really large. The Frankfurt University/Celent study has shown that only 13% of all OTC trades during 2007-2010 were indeed truly large in the sense of being allowed to be kept dark if the broker is not taking on risk, and only one half were large enough to be kept dark if the broker is taking on risk.
- *'The platform should be considered as OTC even if the final ('child') trade is small, because the original ('parent') order was large.* Again, this is a mis-reading of MiFID. The OTC definition in

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Recital 53 clearly states that bilateral ad hoc trades will not be subject to pre-trade transparency only if they are above a certain size. Moreover, the MTF definition makes it clear that all small multilateral trades should be subject to all MTF rules including pre-trade transparency.

Annex 2: Why do we need non-discretionary execution and non-discriminatory access in all multilateral trading? Why shouldn't these measures be optional?

(1) Why is non-discretionary execution so important?

'Non-discretionary execution' means that when orders are entered into a trading platform, the trade is executed based on pre-existing, predictable rules (hence, not allowing for any 'discretion' on the part of the platform operator). Why is there a need to regulate this? Could we not for example leave it to the trading members or their clients to monitor the way their orders are executed and, if they are not happy with the final execution, complain to the operator or even perhaps leave the venue for another?

In fact, we are aware that some BCN operators have claimed that 'discretion' is one of the defining characteristics of their businesses and that their clients actually prefer them to have discretion in the execution. We are also aware that these operators believe that they were allowed to have discretion in their trading platforms based on their reading of MiFID, and that any changes to MiFID should conserve this flexibility, which they consider to be a key characteristic of their business. We have also noted that some BCN operators have characterised any imposition of non-discretionary execution on their platforms as 'taking away choice from the investors', because, it is claimed, investors in a diverse marketplace may need both non-discretionary and discretionary execution.

We disagree with this view. First of all, we believe that any consistent reading of MiFID must conclude that multilateral trading platforms cannot be discretionary. Moreover, we firmly believe that any amendment to MiFID should re-affirm this principle and remove all possible ambiguities so that all platforms must have non-discretionary execution. The reason is that a predictable, fair, impersonal execution of orders is one of the basic protections all investors want to get from their trading platforms. Therefore it should not be a voluntary safeguard but remain a mandatory one for all platforms. The absence of non-discretionary execution in a platform is the equivalent of a weight scale not being correct in a store. While customers might have different expectations from different stores, the basic service they expect from any store is that their merchandise be weighed in a correct transparent and consistent manner that does not tilt the balance against them. Exactly in the same way, a platform operator who is not constrained by a predictable execution requirement may well be tempted to execute a trade more or less favourably in a given situation, especially if, for example, some of the investors involved in the trade bring bigger business to the platform than others. While the clients in whose favour the scale might be tilted will not complain, the absence of fairness in the execution will in the long run harm all investors. For these reasons, we believe that the MiFID Review should re-affirm the principle that all trading platforms fulfil this requirement, irrespective of the license that the operator chooses.

Whilst it is the Commission's intention that OTFs should operate in a multilateral and transparent manner (like RMs and MTFs), OTFs will be permitted to have **discretionary rules** (unlike RMs and MTFs, which must organise trading in an objective and non-discriminatory manner). This differential casts doubt on the **quality of the price formation process** within the proposed OTFs. If OTFs are to be multilateral venues, contributing to price formation, then it is not coherent for operators to have discretion over prices or order handling, since the prices displayed would not be subject to objective rules and could thus be arbitrary.

In the **<u>derivatives space</u>**, trading on RMs and MTFs is capable of facilitating a virtuous circle, in which trading in these venues produces reliable and robust pricing points which can be used for mark-to-market purposes in a CCP's risk management processes. In times of crisis, such venues also facilitate the unwinding by the CCP of positions held by a defaulting participant. Thus, trading on regulated markets and MTFs and clearing by CCPs ensure that the G20 clearing and trading mandates work <u>together</u> effectively to create a virtuous circle. **<u>Some of those benefits would be lost if an OTF with discretionary rules were fulfilling the G20 trading mandate and undermining the liquidity of regulated markets and MTFs and thereby also undermining their crucial central role in times of stress.</u>**

(2) Why is non-discriminatory access so important?

According to MiFID, RMs and MTFs have to provide non-discriminatory access to all market participants.[1] The reason is that when a multilateral liquidity pools is created – in the legal form of a RM or MTF - **fair and equal treatment of investors and the principle of efficiency** demand that **the largest number of buyers and sellers are brought together.** This is needed because in a multi-trading venue environment – where trading can be fragmented across various platforms – we need the liquidity to flow seamlessly from one venue to another, giving everyone the same chances to buy and sell at the best prices. If we allowed some liquidity pools to be open only to their own clients, we would have two-tiered or multi-tiered markets with pockets of investors cut off from each other. For example, a small or medium-sized broker in a specific jurisdiction might not have access to a significant trading platform in a large financial centre. While this may not, in the short run, be a problem for the trading members of the platform based in this large centre, investors and brokers based in the jurisdictions where small or medium-sized brokers do not access platforms in large financial centres would be cut off from this pool and would be disadvantaged. In the long run, the prices in the private club would also cease to reflect the real supply and demand, and even the privileged clients of that private club would begin to suffer.

Again, we are aware that there has been resistance to access for BCNs. We hear that this would force the BCN 'to open its doors to non-clients', and that this would supposedly violate one of the most basic capitalistic principles, i.e. that a bank should be able to decide with whom to do business. We assume that the Commission has accepted the same logic, because they have not proposed the same access rules on OTFs as for RMs and MTFs. Hence the Commission seems to accept the claim that even if a BCN is doing multilateral business, it should not be forced to apply the access rules for MTFs regarding access. Again, this is a very big misunderstanding that needs to be corrected by the MiFID Review. In our reading of MiFID, a platform is classified as doing multilateral trading, and from that point on, the only choice it has is as to whether it wants to be licensed as a RM or MTF, both of which are fully regulated to provide open access to the platform. A broker who finds the MTF rules for access too cumbersome would continue to have the freedom <u>not</u> to do multilateral trading and instead continue to do bilateral trading (in which case as a SI and will have some obligations about how to treat the clients but will have more flexibility than as an MTF). If, however, a broker is doing multilateral trading, they should not have the freedom to ignore the MiFID rules on fair access to multilateral trading platforms. This is necessary to ensure that the Single EU Market remains a seamless liquidity pool, open to all investors, large and small.