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ESMA's Technical Advice to the Commission on MiFID II and MiFIR
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Outline of AMAFI's main concerns

On 19 December 2014, the European Securities and Markets Authority (ESMA) published its final report on Technical Advice to the Commission on MiFID II and MiFIR.

AMAFI[1] has begun to carry out a thorough analysis of ESMA's proposal and will publish its general and detailed comments at a later stage, when the analysis is completed.

Nevertheless, AMAFI has already identified some matters of great concern which are outlined below.

1. *The legitimacy of inducements to be paid to/by a third person: investment research*

ESMA's decision to consider that investment research is an inducement as defined in MiFID II is a cause for serious concern[2] for the following reasons.

- Investment research is not dealt with in any specific form in the current MIFID regulation (apart from its mention as an ancillary service). No mention exists, even in recitals, of issues justifying drawing up specific measures and this matter has never been discussed by the Council or the European Parliament when elaborating MiFID II and MIFIR provisions. Furthermore, as acknowledged by ESMA, new rules would only make sense if they were extended to collective investment schemes that fall under the UCITS directive and AIFMD. Given that, ESMA advises the Commission to consider the possibility of aligning the relevant provisions of these regulations. In addition, buy-side companies which carry out both portfolio management and funds activities will not be able to adopt different ways of managing the financing of research between both activities. Hence, the rules that could result from ESMA's advice, given in the sole context of MiFID II and MiFIR will actually be applied more broadly to investment schemes subject to UCITS and AIFMD.

  ESMA is therefore clearly pre-empting the European co-decision that should take place at level 1 on the regulatory framework applicable to collective investment.

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[1] **Association française des marchés financiers** (AMAFI) is the trade organisation working at national, European and international levels to represent financial market participants in France. It acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI has more than 120 members operating for their own account or for clients in different segments, particularly organised and over-the-counter markets for equities, fixed-income products and derivatives. Nearly one-third of its members are subsidiaries or branches of non-French institutions.

[2] AMAFI is not alone in voicing this concern, since as noted by ESMA in its final report, alarge majority of respondents to the Consultation Paper did not agree with ESMA's proposal to characterise investment research as an inducement, a view also shared by the "Securities and Market Stakeholder Group".

- ESMA's approach (applied to portfolio management and/or at collective investment schemes) would jeopardise the current business model of investment research. Our analysis is that it would inevitably lead to a deflation of research provision, given the extreme complexity of the proposed provisions which are concretely unworkable. For instance, the requirement to obtain the prior written consent of each client on a research budget and on any subsequent increase introduces significant operational challenges**. The fall of investment research production would be especially important in relation to the coverage of SMEs, as in this area** the demand for research comes mainly from small and medium-size asset management companies which would be unable to comply with these requirements.

- This is especially worrying since the capacity of issuers to raise money on the markets through equities and/or bonds is intimately linked to the existence of a diverse and high-quality research. This is particularly true for SMEs where the existence of investment research is crucial to attract investors, as these companies are generally not known well or not known at all by them. This is illustrated by the link existing between coverage of a company and its cost of capital. Recent academic studies[3] have indeed demonstrated that when coverage by analysts ceases, capital costs increase and investment and financing decrease.

- It is therefore inappropriate to change the business model of investment research in such a dramatic way without having analysed and assessed thoroughly all the consequences of the changes. It is all the more inappropriate that the end result will be detrimental to SMEs at a time when their participation in the European growth requires facilitating their access to market funding. **Such move would be in sharp contrast with the stated political will of fostering their development, as reflected in the Capital Market Union (CMU) initiative.**

2. *Algorithmic and high frequency trading: situation of market makers*

ESMA's Technical Advice in order to specify what should be considered algorithmic trading as opposed to high frequency trading tends to assimilate market making and high frequency trading. AMAFI considers that this should not be the case for the following reasons.

- It should be remembered that market makers are useful to the economy (as it has been confirmed recently by the ECB) and should not be affected by the regulatory treatment applied to HFT.

- Most high-frequency traders who are not market makers (such as proprietary boutiques operating as hedge funds) have **little to no regulatory obligations** and are subject to very light regulatory oversight. Furthermore, their activity on trading venues is not constrained by any liquidity commitment such as the obligation to provide continuous quotation on a pre-defined set of stocks or instruments.

- On the other hand, market makers are regulated entities, which have strict liquidity obligations towards the exchanges with which they have signed liquidity provision contracts. This interpretation is consistent with the definition of a market making strategy under Article 17(3) and 17(4) of the Directive. These articles provide that market makers have two defining and unequivocal characteristics: (i) they have **binding liquidity agreements** with one or several trading venues (ii) whereby they commit to **supply liquidity** to these venues under strict conditions (constant provision of two-way quotes of comparable sizes at competitive prices during a certain proportion of the venue's trading hours). These criteria are another difference between HFT and market makers: engaging into market making strategies has significant entry and running cost associated with it, as opposed to implementing pure high-frequency strategies.

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[3] See for instance: "The Real Effects of Financial Shocks: Evidence from Exogenous Changes in Analyst Coverage", Derrien F., Kecskés A. *Journal of Finance* 68, 4 (2013).

- We acknowledge that market makers have certain characteristics in common with HFTs**,** which is probably where the confusion comes from: they make use of high speed infrastructures and also place large volume of orders, parts of which are subsequently cancelled. But one has to bear in mind that **being a market maker requires execution speed and frequent quote adjustments**. This constraint applies to all stocks and derivatives markets (futures and options) on which market makers are active. The market makers who would not use such techniques would be outliers in the market as they would not be in a position to fulfil their role as liquidity providers in an effective and competitive manner. In particular, the market makers who would not be fast enough in adjusting their quotes would be arbitraged by faster HFTs having the capacity to spot instantaneously off-market quotes.

- Finally, we believe that the classification of market makers as HFT would **not bring any additional comfort to the regulators**: MiFID II and MiFIR already prescribe–very strong organisational and operational standards to market makers using algorithmic trading techniques.

- Thus, classifying these entities as HFT will not change anything to the way they will operate after the entry into force of MiFID II and MiFIR. It could even have **negative consequences on the public image of market makers** if their name was associated to the largely negative media coverage of high frequency trading. As a result, there is a high risk that some of them seriously reconsider their role as liquidity providers and cease performing it to avoid facing **sensitive political and reputational issues.**

3. *Product governance*

In detailing in its advice the provisions that should apply in relation to product governance, ESMA chooses to apply the same requirements to relationships with eligible counterparties, professional and retail clients irrespective of the type of financial instrument concerned and investment service provided. This is in contrast with the mandate provided in the level 1 text[4].

AMAFI considers that this approach is inappropriate for the following reasons:

- It results in onerous obligations, ill suited to the wholesale market where **relationships between regulated professionals are not akin to distribution relations** (examples of execution services on flow products, reverse enquiries from clients, secondary markets where there is no distribution but mere trading...). This is especially an issue because the **requirements go well beyond the mere approval process of the product and are workable only in certain situations**, such as the definition of a distribution strategy, the determination of a granular target market, the scenario analysis, the charging structure, the regular review of existing financial instruments, the information to distributor, the design to meet the needs of the target market, the compatibility of distribution compatible with target market or the compatibility with clients' needs.

- The concepts of manufacturing and distribution apply easily to a retail context for products such as funds or structured products; but they are not adapted to vanilla flow instruments such as bonds and equities for which there are no manufacturer as such.

- **Product governance requirements should apply to in-house products**, i.e. to financial instruments that are designed and/or issued by an investment firm on which the firm has some amount of control, not to shares or bonds issued by third parties.

[4] The delegated acts "*shall take into account:*
(a) the nature of the service(s) offered or provided to the client or potential client, taking into account the type, object, size and frequency of the transactions;
(b) the nature and range of products being offered or considered including different types of financial instruments;
(c) the retail or professional nature of the client or potential clients" (Directive 2014/65/UE, Art. 24.14)

4. *Information to clients on costs and charges*

In its advice on costs and charges, ESMA has considered the specific case of relationships with eligible counterparties and professional clients and has decided that all information requirements shall apply to those except if a limited application is agreed[5]. AMAFI considers this approach to be inappropriate for the following reasons.

- **An opt-in approach** (i.e. applicability of the requirements on demand) would be more adapted because professional clients and eligible counterparties, due to their knowledge and experience, should be sufficiently informed of the types of costs and fees applicable to their transactions. If not, they should anyhow be in a position to **ask for additional information**, which the investment firm cannot refuse to provide. Moreover, they can request to be treated as retail clients in general or for particular transactions if they consider it is better adapted to their situation.

- Relationships with eligible counterparties, and especially regulated financial institutions, are not always governed by a written agreement, such that an opt-out approach would create an **administrative burden of contracting with all eligible counterparties**, which is disproportionate compared to the value added of the measure.

- **The consideration of the costs related to the transaction or the service is a pre-requisite of any decision made by an eligible counterparty** to trade with an investment firm, whether it shows in the price/conditions proposed by the firm or commissions agreed ex-ante (example of the business carried out though request for quotes). **It seems therefore inadequate to set up administrative processes that will generally be of no interest to eligible counterparties.**

- As stated in recital (104) of MiFID II, "*it is appropriate to extend some information and reporting requirements to the relationship with eligible counterparties. In particular, the relevant requirements should relate to (...) reporting requirements concerning **more complex** financial instruments and transactions*". In this respect, considering that the requirements applicable to retail clients should apply to businesses with eligible counterparties as a general principle seems disproportionate. This will cause some feasibility issues with no clear benefit for eligible counterparties (annual post-sale information about all costs and charges, illustration showing the cumulative effect of costs on return,...).

- Relationships with eligible counterparties most often do not fit within a client/service provider relationship, so that there would be an obvious issue of determining **who should disclose to whom** (example of the provision of execution service to an eligible counterparty).

[5] With the exception of financial instruments embedding a derivative likely to be re-sold to retail investors and, as regards professional clients, of the provision of investment advice or portfolio management services