MIFID REVISION
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AMAFI's follow-up to the meeting with Mr. Ferber

This note is aimed at presenting AMAFI's view on main issues which it deems are arising from the European Commission proposals of regulation and directive as well as Mr. Ferber draft reports. Proposals of amendments are being drafted in this respect and will be forwarded subsequently.

1. "Market" aspects

- **General : Market model and competition**

As a general observation, in a period when the financing of the economy and allocation of savings in Europe are facing crucial challenges, AMAFI regrets that no thorough reflection has been undertaken yet on the role and models Europe would like to have for its financial markets. These are fundamental issues that should be a pre-requisite to any reform of the core European legislation of financial markets.

One important aim of MiFID 1 was to strengthen competition in equity markets between regulated markets, multilateral trading facilities and OTC. This model has created some obvious benefits but also some strong drawbacks, mainly by fragmenting liquidity and decreasing market transparency. Today, these benefits and drawbacks should be discussed to ensure that the competition model is the most appropriate for answering the needs of the European economy. At least, the reality of competition between venues must be questioned with regard to the situation where only most liquid shares are subject to competition when all other shares are not.

Attached, is a memo issued by AMAFI on "Competition and market infrastructures – The competition model is ill-suited to current developments and lessons must be learned" (*AMAFI / 11-40*), which gives a view more in depth on that question.

- **Fees structure**

The increase of competition between regulated markets and the incumbent MTFs has had a strong impact on their fees structures. Trading venues' strategies being to attract volumes, they have adopted fees structures which benefit to the main liquidity providers with larger volumes in the most liquid stocks, where competition is the fiercest. For those providers, an obvious cut in their fees has been observed. At the same time, medium and small size members, which are mainly active on less liquid stocks, have not benefitted of the same kind of evolution. By comparison, fees attached to the trading of those stocks are much higher.

This situation has raised some concerns which should be thoroughly discussed. In the coming years, we know that medium and small issuers are going to increase their needs to access the market for raising funds to finance their growth. This ability is vital to ensure a healthy European economy. The actual fees structure of trading venues creates some imbalances which have to be questioned. For instance, is it appropriate to concentrate the orders flows on a few number of market members, being able to take full advantage of the fee structure of trading venues? Is the competition between trading venues not reducing the competition between market players? Is it also appropriate to create imbalances, detrimental to the ability of medium and small members to help medium and small issuers to access the market? But is it possible if those members have no more access to the order flows on big caps, which are the more profitable, and pay higher fees on medium and small caps?

This question is a very important one. It demands a political decision which is closely linked to the competition one and which could exceed the need for having a fees structure which is fair, transparent and non-discriminatory or Mr. Ferber's willingness to monitor HFT activities.

- **High Frequency Trading**

HFT raises specific questions which are distinct from algo trading in general. Therefore, AMAFI agrees on Mr. Ferber's proposal to treat HFT as such. All measures that are aimed at ensuring that such strategies do not lead to/ allow for market manipulation or abuse are welcome.

The issue of HFT is still discussed within AMAFI. It is centered on a core question: do the benefits of HFT (narrowing of spreads and, for some observers, provision of liquidity) offset their downsides (costs for all markets participants and regulators, difficulty to "read" orders books, decrease of the average order size, …)?

At least, AMAFI's members agree on the need for HFT to be monitored, via notably granting ESMA with the power to set and monitor tick sizes.

In addition, AMAFI would also suggest introducing in the Report an amendment requiring ESMA to make an assessment, and to report, on the actual HFT benefits on liquidity.

As explained hereinafter about Authorization / Access to market, AMAFI welcomes the European Commission's proposals which aim at requiring all entities involved in HFT to be regulated when they are members of an RM or MTF.

- **OTFs**

AMAFI has not identified benefits of creating a fourth category of venue in the equity area. Therefore we agree on Mr. Ferber's proposal to limit the OTF category to non equity segments.

- **Market transparency**

Preliminary observation: For pre- and post-trade transparency issues, AMAFI is conducting its analysis only in the area of equity markets.

Pre-trade transparency

AMAFI has always supported the need for markets to be as transparent as possible. Exemptions to pre-trade transparency must remain marginal and monitored. Whatever may be the final option as to markets' organization, waivers to pre-trade transparency must be limited and granted in a harmonized way, at ESMA's level, in order to avoid regulatory arbitrage.

Post-trade Transparency – Consolidated tape

AMAFI does not believe that "market forces" will succeed in providing a European tape within two years, since they have been unable to do so in the last four years.

AMAFI considers that the regulation should:

- Require ESMA to set up regulatory technical standards on data standards and reference data.
- Define the conditions for setting up a consolidated tape comprising all transactions carried out on equity markets.

- **Authorization / Access to the market**

AMAFI has always considered that all members of RMs or MTFs should be firms with a MIFID license to provide client order execution or to deal on own account. Indeed, since members of the markets are essential components of the markets' overall security and integrity, there is no reason why entities which do not have a MiFID license should be able to access them.

The European Commission seems to share this view if we consider article 2-1, d, ii of its proposition: "*This Directive shall not apply to (…) persons who do not provide any investment services or activities other than dealing on own account unless they (…) are a member of or a participant in a regulated market or MTF*". But we also need to consider articles 19-2 and 55-3 which allow RMs and MTFs to "*admit as members or participants investment firms, credit institutions authorised under Directive 2006/48/EC and other persons who* [meet specific criteria defined by article 55-3]". It seems that members or participants of RMs and MTFs could access such venues without being authorized to provide the investment service of execution of orders on behalf of clients, which needs to be agreed as an investment firm or a credit institution.

This inconsistency must be revised. Thus, it is necessary to reword article 55-3 as to specify: "*Regulated markets may only admit as members or participants investment firms or credit institutions authorised under Directive 2006/48/EC to provide client order execution or to deal on own account*".

- **Direct electronic access**

For the same reasons, AMAFI welcomes Mr. Ferber's amendment proposal which bans the practice of direct electronic access.

- **Transaction reporting**

AMAFI would go further in this area than what is proposed. In our view, the current transaction reporting mechanism is not efficient because it implies the development of reporting mechanisms in the 27 Member States, with inevitable national differences leading to inconsistencies and double reporting by financial institutions.

Since the effectiveness and accuracy of reporting is absolutely fundamental to fight market abuse, the revision of MiFID should be an opportunity to get things right in this area, i.e. the creation of a central reporting system with free access by competent authorities. At least, an independent costs/benefits analysis of a mechanism based on 27 systems (expanded further to deal with all instruments and markets) with interconnected links versus a central reporting system should be performed.

2. Third country regime

The question of how third country access EU markets should be treated as far more than a technical issue. It is an issue which calls for a political decision. What is at stake here is the need to ensure that the two following sets of measures currently under discussion and to be adopted by the European authorities will be consistent with one another: on the one hand, the measures included in CRD 4 and Solvency 2 which will result in increased use of financial markets to finance business needs and on the other hand, those (like the current MiFID review) which aim at increasing the regulatory framework for the provision of financial services. It would be inconsistent and particularly odd, at a time when the EU is raising the constraints applicable to market participants, not to ensure that such participants have the same rights to conduct business outside the EU as those afforded to non EU firms to conduct business within the EU.

Ultimately there is a risk that the European financial sector will be less competitive and, simultaneously, that Europe will become more dependent on market participants and markets outside the EU for financing its economy and investing its savings.

AMAFI firmly believes that reciprocity of rights – just like the equivalence of applicable rules – is the fundamental underlying principle on which the "third country regime" should be built. Europe cannot allow foreign investment firms to set up easily within the EU while no reciprocity exists for EU firms. This was the case, for instance, for several months when EU clearing houses wanted to operate in the US. The protection of EU interests requires that clear rules be established to ensure true reciprocal access to respectively the EU and non EU markets for non EU firms and EU firms which are subject to equivalent rules.

- **Reciprocity**

Mr. Ferber clarifies the scope of the decision which the Commission may adopt stating (1) whether the third country firm is subject in that third country to legal and supervisory arrangements which have "*equivalent effect*" to the MiFID/MiFIR and CAD Directives and (2) "*whether that third country provides for equivalent reciprocal recognition of the prudential framework".*

AMAFI welcomes the rewording. It would add that:

- The concept of reciprocity should not be restricted to "*the reciprocal recognition of the prudential framework only*".
- It should be stated clearly that the Commission's decision referred to in article 41, paragraph 3 should state whether "*that third country provides for equivalent reciprocal recognition of the right for EU firms/financial institutions to provide investment services in that third country*".
- The same framework and provisions should be ensured for infrastructures.

- **The scope of the obligation to set up a branch**

Mr. Ferber has clarified and slightly expanded the scope of the obligation to set up a branch in the EU in order to provide investment services: to retail clients and also now, to one category of professional clients – those treated as such on request.

AMAFI supports the clarification regarding the scope of the obligation to set up a branch.

3. Commodities

- **Position limits**

Position limits are a particularly important issue. AMAFI wholeheartedly endorses the intention to introduce a strict system to ensure that excessively large positions held by some categories of participants do not undermine commodities markets, which are absolutely vital for industrial, trade and agricultural firms seeking to hedge their activities. However, the problems experienced by the CFTC in recent months show that setting up this type of system faces a number of hurdles.

The mechanism proposed under the revised directive is based on a system of position limits set at trading venue level. This may seem attractive because of the system's ex ante aspect, i.e. market participants could be "blocked" before they can make a trade that would exceed their positions limits.

Be that as it may, this ex ante system overlooks the importance of trading speed from an operational perspective. Given the way that commodity derivatives trading is currently organised, the moment when a participant enters an order and the moment that order is taken into the venue's trading system are bound to occur virtually simultaneously. Therefore, to ensure that trading venues can immediately accept or refuse orders on the basis of the defined position limits, they need at the very least to adopt systems – which do not currently exist – for real-time monitoring of positions, not only each member's positions but also those of each client on whose behalf the member may be acting. It should be remembered that the majority of a trading venue's members do not trade for their own account but for clients who may belong to different categories and hence be subject to different position limits. Moreover, for various reasons, many participants work simultaneously with different members and it is therefore necessary to assess their overall position, not just the positions they take with each member. This adds another layer of complexity.

In any case, even if the necessary mechanisms could be developed quickly enough, a system of position limits will not be effective unless trading venues communicate with one another to ensure that, for similar contracts, a participant that has reached its limit on one position cannot continue to increase it on another venue. Since this could not be done without impairing trading speed, the initial impact of an interconnection between trading venues would be to divert large numbers of participants away from the venues involved, thereby detracting from their liquidity, and to steer them towards platforms outside Europe, which will not be subject to this type of requirement.

Given these drawbacks, and the fact that no trading venue currently manages a system of position limits, AMAFI argues that preference should be given to a system managed by clearing houses. This type of system – currently used by the CFTC in the United States and under development at several clearing houses in Europe – does not operate entirely on an ex ante basis, but it comes very close to doing so and is much easier to implement.

Clearing houses are able to monitor changes in positions as trading venues feed transactions into their systems, which occurs in quasi-real time. A clearing house cannot block an order that would take a trader's position beyond the limit, it does have powerful resources for dealing with such situations ex post, not just through initial and variation margin but also, where applicable, by liquidating a position or imposing a penalty.

Furthermore, the enhanced clearing requirement introduced by EMIR gives clearing houses (possibility collaborating with their peers, as some do already) an overall view of trading, including some over-the-counter trades, rather just a view of the business transacted on trading venues.

It must nevertheless be remembered that the overall efficiency of a position limit system hinges on being able to make a sufficiently granular classification of the types of needs that traders are addressing, rather than of the traders themselves. Since a trader may address different types of needs, it is important to be able to distinguish hedging transactions from other types of trade. Therefore, when planning a system of position limits, it is necessary to take account of how it can be applied to the various links in the chain between an end-user and the clearing house.

- **Exemptions:**

AMAFI believes that commodities markets regulation is crucial and that all actors having the same business should be treated in the same way. In this respect, the proposed mechanism is still too flexible. We think it would be more appropriate to have an EMIR-like approach with a threshold based on the volume of activity.

- **Definition of a spot market:**

AMAFI agrees on defining what a spot market is. It is particularly important for carbon market.