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Creating a European Market System under MiFID

Niamh Moloney, LSE

‘HKEx and the Market Structure Revolution’

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Context

- Presentation based on joint paper with Professor Guido Ferrarini, on *Equity Trading and the MiFID Review: Law, Market Change and Interest Groups in EU Financial Markets* (2012), which examines the political economy of MiFID I, how interest groups were impacted, and the likely impact of MiFID II

Context

- Market regulation as a ‘second wave’ of crisis-era reform
- Examples:
  - -Pittsburgh G20 2009: repatriating trading of standardized derivatives (also MiFID II); Seoul G20 2010: conclusions on market efficiency and integrity
  - -IOSCO initiatives: 2011 Principles on Dark Liquidity; 2011 Report on High Frequency Trading
  - -MiFID II in EU (Proposal, October 2011)
  - -UK FSA, Markets Regulatory Agenda (2010)
  - -SEC/FSA Roundtable on market issues in October 2011
- Reflects current direction of travel
  - -Wider range of actors and venues within regulatory perimeter
  - -Wider range of asset classes covered
  - -Efficiency of trading venues in allocating capital

Context

- **Drivers?**
  - -Suspicion of lightly-regulated sectors
    - -Washington Declaration 2008 (G20)
    - -IOSCO Objectives and Principles of Securities Regulation (2010): ongoing examination of regulatory perimeter
    - -'Less is more is no longer valid' (EU Commission, 2011)
  - -'Feedback loop': venue-related reform (G20 derivatives agenda) feeding back to wider cash equity market reform
  - -Overspill of systemic risk agenda:
    - -High frequency trading
  - -Suspicion of financial market intensity and innovation
    - -Financial Transaction Tax (EU Commission Proposal, 2011)

Context

- **Outcomes**?
  - -Venues/platforms as devices for addressing perceived gaps, achieving regulatory outcomes, and tighter regulation
  - -Reshaping venue regulation?
    - Longstanding debate, since arrival of Alternative Trading Systems, on nature of venue regulation, how diverse functionalities can be captured, which venues can act as proxies for regulators, how intense should regulation be
    - **MiFID I:** EU's liberal response to this; diversity of venue and competition supported
    - **MiFID II:** EU moving from liberal, cash equity model, to intensely-regulated, cross-asset model;
      - → Closing OTC space; moving trades to regulated venues; tightening regulation of in-scope venues; regulation calibrated to the asset class traded, not the venue

The EU and MiFID I

- Markets in Financial Instruments Directive I (MiFID), in force 2007: pillar of EU regulation
- Pre-crisis regulatory context: liberal and facilitative
- Sought to liberalize equity trading and drive competition between different execution venues and functionalities: ambitious, market-shaping measure
- How? Competitive approach based on:
  - -Competition between firms and exchanges/platforms, non-discrimination, and market transparency
  - -Abolition of the ‘concentration’ rule and liberalization of trading across different venue types
  - -Fragmentation, liquidity, and conflict of interest risk addressed through transparency and best execution rules
  - -Sought to provide a level playing field by using two core sets of functionalities: (1) multilateral venues and (2) OTC market
  - -Equity-market based

The EU and MiFID I

- Venue classification
- Not ‘blue sky’ thinking: reflects very difficult political negotiations and clashes between the exchange and OTC sector
- Broad distinction between (i) formal, multi-lateral, non-discretionary, and lit; and (ii) informal, bi-lateral, discretionary, and dark
- Between venue regulation (price-setting, systemic effects, neutral operator) and broker regulation (client-facing, fiduciary in nature)
    - -Subsequent difficulties with technological developments, driving automation in the brokerage sector (broker crossing systems)

The EU and MiFID I

- **Venues**
- (1) **Regulated Markets**

  -Multilateral non-discretionary trading venues which bring together multiple third party buying and selling interests in accordance with non-discretionary rules and which opt in to regulated market (RM) status

  -RM status linked to levels of issuer disclosure and exchange ‘bonding’ effects

  -RMs operated by RM market operator under RM license
- (2) **Multilateral Trading Facilities**

  -Same definition as to functionality, but does not opt-in to RM status

  -Often associated with ‘second tier’ markets but also trading platforms more generally

  -MTF operated by RM market operator or by investment firm

  -Where investment firm, MTF operated under the **investment firm license,** and investment firm subject to range of **firm operating and organizational rules**, with additional **venue-related** regulation and **exemptions from brokerage rules**

The EU and MiFID I

- **Rules for (1) and (2)**

  -Equivalent detailed pre- and post-trade transparency (waivers available to support RM/MTF dark pools for pre-trade transparency)

  -Broadly similar organizational and operating regime; market abuse monitoring rules; somewhat lighter for MTFs as organizational regime broadly based on investment firm model and subject to proportionate approach for firm regulation; RM regime specific to RMs

  -Generally principles-based, with significant discretion for venues (including on admission standards, although higher admission standards for RMs, linked to RM issuer disclosure regime)

The EU and MiFID I

- (3) **OTC**
  - -Default category: ad hoc, irregular, carried out with wholesale counterparties, large trades
  - -MiFID's investment firm regime applies (conduct; order handling etc)
  - -The RM/MTF post-trade transparency regime applies, but no pre-trade transparency
  - -Tolerance of OTC space
- (4) **Systematic Internalizer**
  - -A subset of OTC, reflects difficult political negotiations and tensions between the venue/OTC sector with respect to systematic internalization of trades for execution against proprietary order books, and the perceived disruption of a level playing-field between venues and firms
  - -Qualitative not quantitative: firms which 'on an organized, frequent and systematic basis' deal on own account by executing client orders outside an RM/MTF
  - -MiFID's investment firm regime applies
  - -High complex pre-trade transparency regime (essentially designed to catch retail orders)
  - -Post trade transparency as for RM/MTF and OTC

The EU and MiFID I

- **Data publication and dissemination**

  -Venues (including OTC) to make mandated data available, essentially on reasonable commercial terms, as close to real time as possible, and in an accessible manner

  -Specification of dissemination channels: facilities of an RM/MTF; third party facilities; proprietary arrangements (controversial)

  -Facilities must: ensure information is reliable, monitored continuously for errors and corrected; facilitate consolidation; and make information available to public on non-discriminatory commercial basis at a reasonable cost

  -Reliance on market mechanisms to consolidate dissemination channels

- **Best execution**

  -Applies to all investment firms

  -Process-based

  -Price-based retail benchmark

What Happened?

- Some five years experience, but intervention of financial crisis
- Data emerging, but often opaque and contradictory
- MiFID Review, commenced 2010/2011, formal legislative proposals October 2011
- What is the context?
  - -Experience with MiFID, particularly: (i) growth of dark equity trading and venue competition for dark trading (ii) fixed income/derivative segment experience over crisis
  - -Wider drivers of international regulatory crisis-era agenda (pulling in HFT)
  - -G20 derivatives trading agenda
- Key questions
  - -Classification issues (discretionary/non-discretionary; bi-lateral/multi-lateral; and implications)
  - -Balance of ‘dark’ and ‘lit’?
  - -Scaling back the OTC markets?
  - -Moving beyond equities - but liquidity risks?
  - -How much discretion to afford venues?

What Happened?

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- Difficult to disentangle MiFID effects from wider market developments
- But can be associated with major market restructuring and enhanced competition
- Some 231 trading venues in EU (132 MTFs; 92 RMs; and 12 SIs) (EU Commission, 2011)
  - -Equity trading on 45 RMs and 50 MTFs
- Significant increase in MTF market share:
  - -Approx. 25-30% of equity trading; largest three MTFs account for 23% of equity trading; 11% in 2008; 24 MTFs in 2009; Chi-X third largest venue for equity trading by market share; operated by RMs and investment firms (EU Commission, 2011)
- Increase in dark pools operated by MTFs/RMs under MiFID waivers, particularly MTF dark pools

What Happened?

- **Size of OTC sector?** 30-40%, but highly contested, given nature of 'executable liquidity'
- **Actors in the OTC space and level playing field**?
  - -Focus on broker crossing networks (but estimated at 1.5% of equity trading (ESMA, 2010) – although tripled between 2008 and Q1 2010)
    - -Technological innovation; functionally different broker models (conduct of business model and discretionary re access and trade execution) but venue-like systems; not subject to SI/MTF regime
  - -Small number of SIs (12, EU Commission 2011) (gaming effects related to the SI definition?)
  - -Scale and nature of OTC trades not within spirit of MiFID? (significant proportion of OTC trades small and would not generate market impact risk (Celent 2010))

What Happened?

- **Balance of dark and lit trading?**

  -RM/MTF equity trading represents (broadly) some 60-70% of equity trading and is 90% lit (eg, Gomber/Gsell, 2010)

  -Nature of dark trading? Dark RM/MTF 5.6%; crossing networks 1.2%; other OTC (37.8%) (FESE, 2009); Dark RM/MTF 7%; OTC 38%; total 45% dark (EU Commission, 2011)

  -Concerns re growth in dark trading and drivers (crisis and uncertainty; new technical solutions; reduction in trade size; RM/MTF waivers not effective?)

  -MiFID II process dominated by concerns re scale of dark equity trading and impact on price formation and level playing field

- **Transparency levels**?

  -Widespread concern re poor post-trade dissemination and consolidation, particularly in OTC channel

What Happened?

- **Liquidity levels**?
- **Trading costs**?
  - -Spreads on LSE's AIM reduced by 16% compared to pre MiFID (EU Commission, 2011)
  - -Decrease generally for intermediaries
  - -But Increase in best execution costs, particularly for retail investors
- Massive growth in **HFT**
  - -Estimated at 30-50% of equity trading
  - -Linked to increase in arbitrage opportunities, and increased pressure for dark trading as trades decrease

Does law matter?

- Hard to disentangle MiFID effects – but yes
- Unexpected effects?
  - -HFT and arbitrage
  - -Gaming effects: SI classification; MTF and ‘non-discretionary’; default OTC definition and small trades
  - -Inability of market to lead data consolidation efforts
  - -Drift to OTC dark trading given MiFID restrictions on RM/MTF ‘dark pool’ waivers
- Lessons?
  - -Law can be a difficult tool for achieving market shaping effects
  - -Law and obsolescence risks
  - -Risks of classification-driven systems
  - -Importance of empirical analysis
  - -Importance of operational mechanisms (data consolidation; best execution systems)
  - -Peculiarities of the EU: liberalization; competition between venues

Developing MiFID II

- **Dark equity trading**
  - -Level playing-field effects and industry concern
    - Platform/firm dynamic longstanding feature of EU regulation (early 1990s and London dealer platforms on LSE v continental exchanges)
  - -Currently high on regulatory agenda worldwide
    - FSA, 2010: importance of equity market trading structure; SEC; ASIC
    - Damage to price formation, competition?
  - -Tolerance for dark OTC markets?
    - Extent to which investor choice of different trading venues will be supported; market impact risks and HFT
  - -Legal/classification complexities

Developing MiFID II

- **Extending the equity transparency model to fixed income/derivatives**
  - -New issue for the EU
  - -Commission (2008) decided fixed income segment operating efficiently under self regulation by venues/traders
  - -Change of position driven by (i) wider lack of tolerance for unregulated sectors; (ii) concerns re liquidity over crisis; (iii) need to improve transparency and resiliency of non-equity markets
  - -Impact of G20 derivative trading repatriation on transparency rules
  - -Scale of withdrawal from market discipline
- **New trading rules**
  - -HFT
- **Political focus on the SME sector and facilitating access to equity finance through venue regulation**
  - -SME MTF segment (changing previously competitive, market-driven approach)
- **More ambitious approach to venue regulation**
  - -Facilitate a shift of trading to more regulated and transparent venues (European Parliament, 2010)

MiFID II: New Venue Classification

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- Major change to classification: a new trading venue: the Organized Trading Facility (additional to RM/MTF/SI/OTC)
- Why?
  - -Unclear
  - -BCS and dark equity trading; but also G20 agenda and venues for trading derivatives
  - -Catch BCS, swap execution facilities, inter-dealer broker platforms
  - -Closing the OTC space: Commission – all organized trading should be conducted on regulated venues; 'future proof' (?) MiFID; address arbitrage possibilities
  - -Allow different business models for venues, but subject all to same transparency and organizational rules

MiFID II: New Venue Classification

- **What is an OTF**?
  - -System or facility which is not an RM or MTF, operated by an investment firm or market operator, in which multiple third party buying and selling interests in financial instruments are able to interact in a way that results in a contract
  - -Would include broker crossing systems
- **Rules which follow?**
  - -Organizational requirements (MTF/investment firm rules)
  - -Trading process rules
  - -An OTF may not execute orders against the proprietary capital of the operating investment firm or market operator (ie: it cannot act as a Systematic Internalizer)
  - - RM/MTF transparency regime

MiFID II: New Venue Classification

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- **Key feature**
  - -Assumes RM/MTF/OTF operators all neutral
  - -RM/MTFs offer non-discretionary order execution and non-discretionary access
  - -But: OTF operator has a ‘degree of discretion’ over how transaction is executed; is subject to conduct of business rules and best execution re the transaction concluded in the OTF; and can control access to the system

MiFID II: New Venue Classification

- **Implications**
  - -Further close the gap between public and private markets in the EU
  - -Remove distinction between discretionary/bi-lateral and non-discretionary multi-lateral
    - -OTF can exercise discretion over execution of client order
  - -Greater potential for confusion, overlap, and arbitrage?
  - -Greater pressure being placed on the quality of market regulation, given the movement away from market discipline?
  - -More complex rules, more risk of error?

MiFID II: Extending the Transparency Regime

- **The context**

  -Transparency regime tightening, and opportunities for dark trading being limited

  -The transparency 'perimeter' will fall around RMs, MTFs, SIs, and OTFs

- **Equity markets**

  -Equity markets: tighter control on transparency waivers for RMs/MTFs; transparency requirements to apply to equity-like instruments

  -Emphasis on operational effectiveness

    Operational reforms to the pipe-line for post-trade transparency disclosures through a new **Approved Publication Arrangement** regime for OTC and efforts to support a consolidated tape

MiFID II: Extending the Transparency Regime

- **Extension to other asset classes**
  - -Bonds, structured finance products, derivatives
  - -Same regime, regardless of venue (only pre-trade for Systematic Internalizers)
  - -Calibrated according to the instrument
  - -Waivers for sets of products based on (i) the market model, the characteristics of trading activity in the product, and liquidity; (ii) size of order and method of trading
- **Closer regulation of data distribution**
  - -Distribution through authorized Approved Publication Arrangements for OTC; detailed rules for APAs (organizational; governance)
  - -New actor: Consolidated Tape Provider
  - -Pre and post trade data to be unbundled

MiFID II: Execution rules

- **Algorithmic trading and HFT**
  - -Attempts to define ‘algorithmic trading’ (where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission, with limited or no human intervention’)
  - -Investment firm rules governing algorithmic trading
    - -Risk controls (including trading thresholds and limits)
    - -Reporting on nature of trading strategies to supervisor
    - -Market making obligation to prevent rapid withdrawals of liquidity (obligation for algorithmic strategy to operate continuously during trading hours, and to post firm quotes at competitive process with ‘the result of providing liquidity on a regular and ongoing basis’
    - -Direct electronic access rules

MiFID II: Execution rules

- **Algorithmic trading and HFT**

  -Specific authorization for HFT firms where they are direct members of a trading venue

  -Venue (RM/MTF/OTF) rules

  -Systems resilience; circuit breakers; minimum tick sizes

  -Also detailed guidance from the EU's securities regulator (European Securities and Markets Authority)

MiFID II: Lessons?

- **Dark liquidity and the OTF**
  - More transparency, but..
  - Overkill?
  - Muddling the nature of a venue and a broker?
    - Conduct of business regulation of the OTF transaction
    - Difficulties in capturing the complexity of some OTF models
  - Liquidity risks and removal of firm capital from OTFs
    - Particular problems for dealer-driven markets (interest rate swaps, FSA (2012))
  - Overly complex regime?

MiFID II: Lessons?

- **Dark liquidity and the OTF**
  - -Information based strategy on nature of OTF trading more effective?
  - -Increase arbitrage risks? Incentives to drift to OTF from MTF model?
  - -Risks to intervening in relative size of formal/OTC venues?
  - -Current industry positions:
    - -Broadly:
    - -OTC/brokerage sector concerned re removal of firm capital
    - -Exchange/venue sector supportive of all organized trading on regulated RM/MTF venues, and concerned re ‘discretionary’ feature of OTFs

MiFID II: Current State of Play

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- European Parliament response to Commission Proposal, March 13 2012
  - **HFT**
    - Differentiation between algorithmic trading and HFT
    - Definition of HFT and HFT strategy (emphasis on % of turnover, orders subject to liquidity rebates, and proportion of positions unwound)
    - More specific rules (orders must be open for at least 500 milliseconds)
    - Market-making style obligation retained for HFT only
    - Prohibition on Direct Electronic Access through investment firms
  - **OTF Venue**
    - Seems to accept, but sceptical, given availability of other MiFID classifications, and subject to review clause

MiFID II: Overall Lessons?

- **Widening the regulatory perimeter?**

  -Liquidity risks

  -Pressure on regulatory effectiveness? Muddling the nature of a venue and a broker?

- **HFT?**

  -Severe definitional difficulties (HFT or algorithmic trading?)

  -Information overload/moral hazard risk for supervisors

  -Aligning HFT and market maker model not effective