

MEMO# 24884

January 18, 2011

European Commission Consultation on the Review of MiFID; Conference Call Scheduled for January 20

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TO: EQUITY MARKETS ADVISORY COMMITTEE No. 5-11
INTERNATIONAL COMMITTEE No. 2-11
INTERNATIONAL INVESTING SUBCOMMITTEE No. 2-11
SEC RULES COMMITTEE No. 6-11
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 2-11
ETF ADVISORY COMMITTEE No. 5-11
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 4-11 RE: EUROPEAN COMMISSION CONSULTATION ON THE REVIEW OF MIFID; CONFERENCE CALL SCHEDULED FOR JANUARY 20

The European Commission ("Commission") has issued a public consultation ("Consultation") on the review of the Markets in Financial Instruments Directive ("MiFID"). [\[1\]](#) The current review of MiFID, which came into effect in November 2007, is in response to the need for reforms to the regulatory framework for financial services within Europe to address developments in market structure since MiFID was enacted. The consultation is wide-ranging, covering all aspects of the equity, fixed-income and derivatives markets. Topics include transparency of the markets, "dark pools" and other electronic trading venues, high frequency trading, and transaction reporting. The most significant aspects of the Consultation for the fund industry are summarized below.

The Institute has scheduled a conference call for Thursday, January 20 at 1:30 p.m. Eastern time to discuss the Institute's comment letter on the Consultation. The call-in number for the call will be 866-541-3298 and the passcode for the call will be 6501781. If you plan to participate on the call, please contact Jennifer Odom by email at jodom@ici.org or by phone at 202-326-5833.

I. Developments in Market Structures and Practices

The Consultation discusses several significant developments in the structure of the European markets and the impact of these developments on trading.

A. “Organized Trading Facilities”

To address gaps in the current application of a number of MiFID provisions, the Consultation requests comment on broadening the scope of MiFID provisions to ensure the inclusion of all organized trading outside the current range of MiFID venues. Specifically, in addition to trading on regulated markets, multilateral trading facilities (“MTFs”) and systematic internalisers (“SIs”), the Commission would introduce the concept of an organized trading facility (“OTF”). The definition of an OTF would capture any facility or system operated by an investment firm or a market operator that on an organized basis brings together buying and selling interests or orders relating to financial instruments. [\[2\]](#) After reaching a specific asset threshold, an OTF would convert to a MTF. The Consultation lays out the general requirements that would be imposed on all OTFs.

B. Derivatives

The Consultation requests comment on a number of issues relating to the reform of the derivatives markets similar to what is being considered in the United States under the Dodd-Frank Act. This includes requiring all trading in derivatives which are eligible for clearing and sufficiently liquid to move either to: (1) regulated markets; (2) MTFs; or (3) a specific sub-regime of OTFs to be defined in MiFID.

C. Automated Trading and High Frequency Trading

The Consultation requests comment on several issues relating to “automated trading.” The Consultation provides several suggestions regarding the regulatory framework for automated trading. Specifically, the Consultation suggests that automated trading be defined broadly, as trading involving the use of computer algorithms to determine any or all aspects of the execution of the trade such as the timing, quantity and price. The Consultation notes that a specific type of automated or algorithmic trading is high frequency trading (“HFT”) and discusses several concerns that have been identified and associated with HFT. All persons involved in HFT over a specified minimum quantitative threshold would be considered as investment firms, subject to organizational requirements and full regulatory oversight. The Commission also envisions a series of new specific organizational requirements relating to, among other things, risk controls to mitigate potential trading system errors, sponsored access, co-location, stress testing and circuit breakers.

The Consultation also discusses minimum tick sizes and states that market operators would be required to ensure that orders would rest on an order book for a minimum period of time before being cancelled. Alternatively, market operators would be required to ensure that the ratio of orders to transactions executed by any given participant would not exceed a specified level. Finally, the Consultation states that market operators would be required to ensure that if a high frequency trader executes a significant number of trades in financial instruments on the market then it would continue providing liquidity in that financial instrument on an ongoing basis subject to similar conditions that apply to market makers.

[\[3\]](#)

II. Pre- and Post-Trade Transparency

The paper discusses the importance of pre- and post-trade transparency of market information to investors in general, and specifically the quality, reliability and timeliness of market information.

A. Pre-Trade Transparency

The Consultation notes that the growth of electronic trading has facilitated the increased use of “dark liquidity” and recognizes that certain market participants use dark liquidity to not disclose their own trading interest, thereby minimizing market impact costs. The Consultation states, however, that the increased use of dark pools raises regulatory concerns as they may ultimately affect the quality of the price discovery mechanism on the “lit” markets and the issue of dark liquidity therefore merits ongoing observation by regulators. The Consultation states that the reasons for allowing waivers under MiFID from pre-trade transparency under certain conditions still appear valid but that there is room for improvement as to the calibration, actual content and consistent application of the waivers.

B. Post-Trade Transparency

The Consultation notes that post-trade transparency is important for efficient price formation and for best execution to show which venues or firms are providing the best prices and to enable clients of firms to monitor whether they are receiving best execution. The Consultation states that market participants have expressed concerns related to the timing of publication of post-trade information. Specifically, publication of trade reports currently must generally take place in real time, and in any case within three minutes, but for large transactions delays between sixty minutes and up to four trading days are allowed. The Consultation suggests reducing the maximum permitted delays. For real time publication, the Commission recommends that post-trade information would be published as close to instantaneously as is technically possible, that the deadline for reporting in real time be reduced from three minutes to one minute, and that systems not be designed to publish details of a transaction in a “batch” but instead to publish the details as soon as they are entered into the system. For the current delayed publication deadlines for large transactions, the Commission recommends shortening the delays permitted so that almost all transactions are published no later than the end of the trading day. [\[4\]](#) In addition, the intra-day delay period would be shortened from three hours to two hours and the intra-day transaction size thresholds would be raised.

C. Equity-Like Instruments and Non-Equity Markets

The Consultation discusses pre- and post-trade transparency for “equity-like” instruments and non-equity markets. The Consultation notes that the pre- and post-trade transparency requirements currently only apply to shares admitted to trading on a regulated market and that a number of instruments that are similar to shares are outside the scope of MiFID transparency requirements. However, given the similarity of many instruments to equities, the Commission believes that MiFID could be amended to extend the transparency regime to certain equity-like financial instruments if admitted to trading on a regulated market including: (1) depositary receipts; (2) exchange-traded funds; and (3) certificates issued by companies. The Consultation states that the regulatory regime for these instruments would be based on the regime that applies to shares but with appropriate differentiation to take into account specific differences in the nature of the instruments. [\[5\]](#)

Regarding non-equity markets, the Consultation states that the principles of the existing MiFID transparency regime for shares could be adopted, but that the detailed requirements should be suitably tailored to the specifics of the different non-equity asset classes. The Commission therefore believes that MiFID could be amended to require pre- and post-trade transparency for all trades in specific non-equity products, whether executed on regulated markets, MTFs, OTFs or OTC. This requirement would apply to: (1) all bonds and structured products with a prospectus or which are admitted to trading either on a regulated market or MTF; and (2) all derivatives eligible for central clearing and reported to trade repositories

under the Commission's proposals to reform the derivatives markets.

III. Data Consolidation

The Consultation states that it is important that market data be brought together in a way that allows for comparison of prices across different venues. The Consultation recognizes that since the implementation of MiFID, the reporting and publication of trade data has not been adequate, primarily due to the quality and format of the information, the cost charged for the information, and the difficulty in consolidating the information. The Commission therefore provides recommendations in several different areas including: (1) improving the quality and consistency of raw trade data and ensuring it is provided in a consistent format to facilitate consolidation; (2) reducing the cost of post-trade data for investors; and (3) introducing a consolidated tape for the European markets.

A. European Consolidated Tape

The Consultation discusses the benefits of a European consolidated tape to provide comprehensive consolidation of post-trade data and offer market users a single point of access to post-trade information about trading of instruments across Europe. The Commission recommends that MiFID be amended to provide for the establishment of a mandatory consolidated tape and to set the conditions that such a tape should satisfy including, for example, requirements relating to the information that must be included in the consolidated tape; its format, accessibility, latency and cost; and the period for which data must be kept. The Consultation requests comment on three possible models for the consolidated tape: (1) a consolidated tape operated by a single, non-profit entity, established and appointed by a legal act; (2) a consolidated tape operated by a single commercial entity appointed following a public tender of bids submitted to the European Commission; or (3) prescribing in MiFID conditions that must be met for the provision of a consolidated tape and then allowing competing commercial entities to provide the consolidated tape if they meet those conditions.

IV. Transaction Reporting

The Consultation discusses several options for addressing concerns regarding the scope of the current MiFID reporting regime and the possible extension of transaction reporting to new financial instruments. The Consultation also discusses the current content of reporting and several issues relating to the channels through which the transactions are reported.

Specifically, the Commission recommends extending the scope of transaction reporting in MiFID to: (1) all transactions in financial instruments that are admitted to trading or traded on an MTF or OTF; (2) all financial instruments the value of which correlates with the value of a financial instrument traded on a regulated market, MTF or OTF; (3) depositary receipts that are related to a financial instrument that is admitted to trading or traded on a regulated market, an MTF or an OTF; and (4) commodity derivatives that are not admitted to trading or traded on a regulated market, an MTF or an OTF. The Consultation also suggests introducing a transaction reporting obligation on regulated markets, MTFs and any OTF that offers access to firms not authorized as investment firms or credit institutions.

The Commission also recommends that the transaction reporting obligations be modified to specify that, for transaction reporting purposes, a transaction refers to any agreement concluded with a counterparty to buy or sell one or more financial instruments; to introduce an obligation on firms that receive and transmit or otherwise handle orders but which are

not executing transactions to transmit the required details of such orders to the receiving investment firm; and to require transaction reports to include means of identifying the person who has made the investment decision, i.e., a client identifier and the trader who executes the transaction, i.e., a trader ID.

Finally, the Commission recommends that the transaction reporting obligations could be modified to amend MiFID to explicitly enable direct reporting by investment firms to a reporting mechanism at the EU level, i.e., a database permanently accessible to regulatory authorities and to amend MiFID to clarify that third parties reporting on behalf of investment firms should be approved by competent authorities as an “Approved Reporting Mechanism.”

V. Investor Protection and Provision of Investment Services

The Consultation discusses several issues relating to investor protection. Specifically, the Consultation states that several regulators and market participants have raised concerns regarding investor protection with regard to the content and the practical application of certain MiFID provisions, particularly advice regarding unsuitable products or the impact of complex products on investors who did not fully appreciate their risk. The Consultation therefore suggests that the revision of several MiFID provisions is necessary including modifications to ensure that the scope is sufficiently clear and that MiFID includes financial products, services, practices and entities which are currently not covered.

One of the issues that the Consultation discusses in the context of investor protection is the transparency of information regarding execution quality and best execution. The Consultation states that a well functioning pre- and post-trade transparency regime provides a critical part of the information needed to assess execution quality and to review firms’ execution arrangements but that other information also can be relevant. The Commission believes that requirements could be introduced for trading venues to produce data on execution quality for all financial instruments traded on different types of venues to improve compliance with best execution obligations.

The Commission also believes that the quality of information available on the execution policies adopted by firms and the possibility to verify firms’ compliance with best execution obligations can be improved to ensure that firms provide different categories of clients with meaningful, clearer and substantive information to enable them to effectively understand how their orders are executed. For example, firms using internal matching systems could clearly disclose and explain how best execution is achieved and a template for policies to facilitate disclosure to clients could be introduced.

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endnotes

[1] The Consultation can be found on the European Commission’s website at http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf. Comments on the Consultation are due on February 2, 2011.

[2] The Consultation states that examples of OTFs would include broker crossing systems and interdealer broker systems bringing together third-party interests and orders by way of voice and/or hybrid voice/electronic execution.

[3] The Consultation also discusses and requests comment on a series of questions regarding “systematic internalisers.”

[4] The Consultation states that only the very largest trades that occur late in the trading day would be able to be published on the next day but even then before the opening of the following trading day.

[5] The Consultation also requests comment whether there are any additional products, such as UCITS, which could be considered for further regulatory requirements.

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