MIFIR

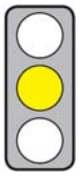
cep**Policy Brief** No. 2012-16 of 16 April 2012

Centrum für Europäische Politik

MAIN ISSUES

Objective of the Regulation: The Commission wishes to improve the transparency of financial market transactions, move derivatives trading to organised trading venues and strengthen supervision and competition.

Parties affected: Investment firms, credit institutions, central counterparties, supervisory authorities and trading venues.



Pros: (1) Enhanced trade transparency can increase pricing efficiency.

(2) Non-discriminatory access to trading venues and CCP strengthens competition.

Cons: (1) The conditions for governmental product intervention are defined too imprecisely.

(2) Restricting trade with certain qualified derivatives to trading venues curtails the freedom of market players and privileges trading venues for no obvious reason.

CONTENT

Title

Proposal COM(2011) 652 of 20 October 2011 for a **Regulation** of the European Parliament and of the Council **on markets in financial instruments and amending Regulation (EMIR)** on OTC derivatives, central counterparties and trade repositories.

Brief Summary

- **General and objectives**
  - Along with the Directive [COM(2011) 656, referred to as "Directive" below, see CEP Policy Brief] proposed by the Commission, the Regulation establishes the regulatory framework for the "provision of investment services" (Explanatory Memorandum, p. 2).
  - The existing MiFID Directive (Directive 2004/39/EC) is in parts replaced by the current Regulation and in parts recast by the Directive (Recital 7 and Article 98 of the Directive).
  - The objective of the Regulation is to improve the transparency of financial market transactions, to transfer the trading of derivatives to organised venues and to strengthen supervision and competition. (Explanatory Memorandum, p. 2, 4 and 14)
- **Terms**
  - Financial instruments: "Equity instruments" are shares, depositary receipts, certificates, exchange-traded funds and other similar financial instruments (Art. 3 (1)). "Non-equity instruments" are bonds, structured products, emission allowances and derivatives (Art. 7 (1)).
  - "Trading venues" are regulated markets (traditional exchanges), multilateral trading facilities (MTF) and organised trading facilities (OTF) (Art. 2 (1) No. 25; for more details see CEP Policy Brief of the Directive).
  - Counterparties: "Central counterparties (CCP)" are entities for the processing of transactions taking place between a buyer and seller (Art. 2 (1) of the EMIR Regulation, see CEP Policy Brief). "Financial counterparties" are financial service companies (e.g. banks investment funds). "Non-financial counterparties" are companies from other sectors. (Art. 2 (6) and (7) of the EMIR Regulation).
  - "Systematic internalisers" (SI) are investment firms which regularly and in an organised form conduct on their own account bilateral, over-the-counter trade (Art. 2 (1) No. 3). They belong to the financial counterparties.
- **Scope**
  - The Regulation regulates the activities of investment firms, credit institutions and trading venues (regulated markets, OTF and MTF) (Art. 1 (2)).
  - The Regulation also applies to CCP, financial and non-financial counterparties (Art. 1 (3) in conjunction with Art. 24-27, Art. 1 (4) in conjunction with Art. 28-30).
- **Trade-transparency**
  Pre-trade-transparency
  - The operators of trading venues must make public "on a continuous basis" and during normal trading hours the current bid and offer prices (i.e. the purchase and sale offers) and the depth of the trading interests at those prices (i.e. the market's ability to ensure large trade volumes at the market prices).

Author: Philipp Eckhardt | eckhardt@cep.eu
CEP | Kaiser-Joseph-Straße 266 | 79098 Freiburg | Germany | Telephone +49 (0)761 38693-105 | www.cep.eu

– To date, the pre-trade transparency obligation has applied only to shares; now it is to be extended to cover all above-mentioned financial instruments. The only precondition is that the financial instrument concerned is admitted to trading on a regulated market, is traded on an MTF or OTF or has a published prospectus (information on a financial instrument that must be published when the instrument is issued). (Art. 3 (1), Art. 2 (1))
– SI are also obliged to adhere to pre-trade-transparency and must publish their firm quotes for all financial instruments. In general, the same requirements apply as for trading venues; however, firm quotes for equity instruments only have to be published up to the average value of the orders ("standard market size"). (Art. 13 Abs. 1) The obligation to publish in case of equity instruments only applies when the market is liquid. If the market is illiquid, SI quotes need only to be published on the clients' request (Art. 13 Abs. 1, 2, 4). In the case of non-equity instruments, SI only need to publish quotes if they and their clients wish to do so (Art. 17 (1)).

Exemptions from pre-trade transparency

– Depending on the market model or the type and size of a transaction, national supervisory authorities may exempt the operator of a trading venue from its pre-trade transparency obligation, especially in the case of "orders that are large in scale compared with normal market size" for the share (Art. 4 (1), Art. 8 (1) and (2)). In the case of transactions with non-equity instruments, exemptions are also possible depending on the degree of liquidity (Art. 8 (1) and (2)). The requirements for an exemption (e.g. the type and size of bids and offers in respect of the financial instrument category, liquidity) are defined by the Commission in delegated legal acts. (Art. 4 (3) lit. b and c)
– Six months at the latest before granting an exemption, the national supervisory authority must inform the European Securities and Markets Authority (ESMA) and the remaining supervisory authorities. Should another authority be against approving an exemption, the ESMA may arbitrate between the parties in a legally binding manner. (Art. 4 (2), Art. 8 (3))

Post-trade transparency

– Operators of trading venues must publish the prices, volumes and time of all transactions on their trading venues "as close to realtime as is technically possible" (Art. 5 (1), Art. 9 (1)).
– The national supervisory authority may allow the operator of a trading venue to deferred publication, in particular where transactions are large in scale "compared with the normal market size" (Art 6 (1), Art. 10 (1)).
– SI and investment firms trading over the counter ad hoc and irregularly must publish the volume price and time of all transactions with financial instruments through an "approved publication arrangement (APA)" approved by national authorities (Art. 19 (1), Art. 20 (1), Art. 2 (1) No. 18, Art. 66 of the Directive). Transactions with derivatives must be entered on the transaction repositories.

Publication costs of trade transparency data

– The operators of trading venues may only demand money for access to trade data within the first 15 minutes. Afterwards, data must be provided cost-free. (Art. 11 (1))
– The Commission fixes the fees by means of delegated acts "on a reasonable commercial basis" (Art.12).

- **Trading of derivatives**
  – In future, ESMA will not only stipulate which derivatives are cleared in post-trade by central counterparties (CCP) ("qualified derivatives"; EMIR Regulation, COM(2010) 484; see CEP Policy Brief), but also which of these qualified derivatives are traded only on trading venues (Art. 26 (1) lit. a). The precondition of the trading venue obligation is that the derivative concerned is admitted to trading or traded on at least one trading venue and is sufficiently liquid (Art. 26 (2)). The latter criterion is decided by the European Securities and Market Authority (ESMA) in technical standards (Art. 26 (3)).
- **Reinforce supervision**

Obligation to report transactions to supervisory authority

– The operator of a trading venue must maintain records of certain data on transactions carried out through their systems for at least five years for the attention of national supervisors. The same obligation applies to investment firms with regard to their transactions. (Art. 22)
– Investment firms must "as quickly as possible" and "no later than the close of the following working day" report the transactions carried out on one of the trading venue. The reports must include amongst other things "the names and numbers of the instruments bought or sold", the transaction prices and the designation to identify the investment firm and their clients (Art. 23 (1) and (3)).

Powers to intervene in trading: product intervention powers of the supervisory authority

– The national supervisory authority may prohibit or restrict the "marketing, distribution and sale" of financial instruments or a certain "type of financial activity or practice" (Art. 32 (1)).
– If the national supervisory authority does not take appropriate action to avert threats, ESMA may adopt temporary prohibitions or restrictions. They expire after three months unless renewed. (Art. 31 (1) and 6, Art. 31 (2) lit. c)
– Prohibitions or restrictions must serve to protect investors or the functionality and integrity of financial markets. They are admissible only if the existing European legislation does not suffice. Interventions by the national supervisory authority may not discriminate against activities from other Member States. (Art. 32 (2), Art. 31 (2))

Powers to intervene in trading: Position management powers of ESMA

- ESMA may request from any person information on the "size and purpose" of a position entered into via a derivative and require any such person to take steps to reduce the size of the position or exposure (Art. 35 (1) lit. a and b). Moreover, it may limit the ability of a person to enter into commodity derivative contracts (Art. 35 (1) lit. c).
- The measures can be taken only if they "address a threat to the orderly functioning and integrity of financial markets" or the stability of the whole financial system of the EU, and if national authorities fail to take sufficient measures to address the threat (Art. 35 (2)).
- The MiFID Directive (see CEP Policy Brief) grants national authorities the power to request from individual persons that they limit the volume of derivative positions entered into (Art. 71 and 72 of the Directive).

▸ **More competition through access to trading venues and clearing counterparties (CCP)**

- Trading venues and CCP must allow each other the clearing of financial instruments "on a non-discriminatory and transparent basis". CCP must obtain access to the data of a trading venue; trading venues must clear through each CCP. (Art. 28 (1) and 2; Art. 29 (1))
- The Commission stipulates through a delegated act the conditions under which trading venues and CCP may deny access and under which access is "granted" (Art. 28 (6), Art. 29 (6)).
- The national authorities may deny an application for access if it "would threaten the smooth or orderly functioning of markets" (Art. 28 (4), Art. 29 (4)).

Changes to the Status quo

To date, the pre-trade and post-trade transparency obligation for operators of trading venues and SI have applied to shares only. Now an obligation to keep records of transactions is to be introduced and the requirements for reporting transactions to supervisory authorities are to be tightened. Certain standardised derivatives will have to be traded on organised trading venues in future. Supervisory authorities will become entitled to intervene in trading (product intervention, position management).

Statement on Subsidiarity by the Commission

Investment service providers and trading venue operators need EU-wide harmonised requirements. Otherwise there is the risk of efficiency losses and the "splitting of markets", distortion of competition and regulation arbitrage.

Policy Context

In June 2009, the EcoFin Council undertook to improve the supervision of less regulated markets, in particular of OTC trading. The G20 also agreed to improve the regulation of commodity markets in September 2009. The proposal complements the Regulation Proposal on OTC Derivatives [COM (2010) 484, see CEP Policy Brief].

Legislative Procedure

20 October 2012	Adoption by the Commission
9 July 2012	Committee Meeting in the Parliament
11 September 2012	1st Hearing in the European Parliament

Options for Influencing the Political Process

Leading Directorate General:	DG Internal Market
Committees of the European Parliament:	Economic and Monetary Affairs (leading), rapporteur: Markus Ferber (EPP Group, DE); Legal Affairs; Budget; Research & Development and Energy
Committees of the German Bundestag:	Finance (leading); Legal Affairs; Economics and Technology; Economic Cooperation and Development; Affairs of the EU
Decision mode in the Council:	Qualified majority (approval by a majority of Member States and at least 255 out of 345 votes; Germany: 29 votes)

Formalities

Legal competency:	Art. 114 (1) TFEU
Form of legislative competence:	Shared competency (Art. 4 (2) TFEU)
Legislative procedure:	Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

Trade transparency: **Expanding the pre-trade and post-trade transparency obligation to cover all financial instruments in general** promotes market integrity, since market manipulation and insider trading can be more easily identified by market participants. Moreover, **it enables** market players to better compare the

transaction platforms and makes **pricing more efficient** by facilitating the pricing process**.** Pre-trade transparency reduces the costs of seeking a qualified trade partner; post-trade transparency allows for an easier evaluation of whether a transaction has been carried out at the best price possible.

However, planned pre-trade and post-trade transparency can in individual cases also jeopardise market efficiency. For instance, the disclosure of quotes and depth of trading on, for example, illiquid bond markets can eliminate the incentive for certain market participants to invest in such markets and thus increase their illiquidity. Therefore, it is decisive which market models and business types are deemed sufficiently liquid by the national authorities and which are exempted from transparency obligations.

The fact that large transactions remain exempted from the pre-trade transparency obligation is correct, for a disclosure would make it more difficult for investors to close the project at adequate prices and increase transaction costs.

Transaction reports: **Both the recording and reporting obligation of transactions** to the supervisory authorities **promotes the stability and integrity of markets,** as authorities can better ensure the compliance with rules (for instance of the new market abuse rules; COM (2011) 654, see CEP Policy Brief). **Both strengthen the confidence** of market players **in the functioning of financial markets**. Reporting obligations and post-trade transparency should, however, not entail a double administrative burden.

Derivatives trading: In its Regulation proposal on OTC derivatives (KOM (2010) 484, see CEP Policy Brief), the Commission has already initiated important steps to reduce systemic risks. This includes the clearing obligation for standardised derivatives and the transparency of transactions (reporting obligations to the transaction repositories). **The rule** – which reaches even beyond this scope – **that certain qualified derivatives should be dealt only on trading venues** (regulated market, MTF and OTF) **is inappropriate**. **It restricts the freedom of trade players** when choosing the optimal trading venue and partners **and favours trading venues although they do not provide any added-value**. In particular, are there no advantages obvious for retail investors, as mainly professional investors deal with these derivatives. Moreover, these rules can restrict the competition between the different trading venues which until now the MiFID Directive has aimed to increase.

Powers to intervene in trade: **Product intervention powers** of authorities represent severe interventions in the market and **should** therefore **only be applied in strictly defined cases**. **Yet the Proposal is not in line with this assumption**. It grants authorities too much scope, which evokes uncertainty among market players and will distort prices. The fact that several authorities are granted product intervention powers bears the risk of politically motivated conflicts. EU-wide harmonised prohibitions or restrictions eliminate the risk of the transactions concerned leaking to other EU countries. Therefore, ESMA should be the central decision body.

Access to trading venues and CCP: Non-discriminatory **access to trading venues and CCP strengthens competition** in the clearing process of financial instruments **and thus contributes to reduced trading costs**. Due to the systemic relevance of CCP it is, however, vital that the requirements for CCP remain in effect, in order to control their default risks (e.g. of the collaterals which members of CCP must deposit).

Legal Assessment

Competency

The Regulation is based on Art. 114 TFEU (Internal Market) correctly as different national financial market rules could impede the internal market.

Subsidiarity

Unproblematic.

Proportionality

Depends on how the Commission shapes the legal act.

Compatibility with EU Law

The position management powers of ESMA are, measured against the Meroni case law of the ECJ (C-9/56), incompatible with EU law. The power to adopt discretionary decisions must not be delegated to institutions not explicitly mentioned in the treaties.

Compatibility with German law

The Regulation applies directly in each Member State (Art. 288 sub-para. 2 p. 2 TFEU), which means that national implementation acts are not necessary. In Germany, the Securities Trading Act and the Stock Exchange Law will have to be adjusted.

Conclusion

Reinforced trading transparency can contribute to increased price efficiency, as the pricing process is simplified. In individual cases, however, this can jeopardise market efficiency. Recording and reporting obligations promote the integration and stability of the markets. Limiting the trading of certain derivatives to trading venues restricts the freedom of market players and privileges trading venues for no obvious reason. The conditions for the product intervention powers of authorities are not clearly defined. Non-discriminatory access to trading venues and CCP strengthens competition.